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How Risky Are Young Borrowers?

By Peter Debbaut, Andra C. Ghent, Marianna Kudlyak, and Jessie Romero

Young borrowers are conventionally considered the most prone to making financial mistakes. This has spurred efforts to limit their access to credit, particularly via credit cards. Recent research suggests, however, that young borrowers are actually among the least likely to experience a serious credit card default. One reason why people obtain credit cards early in life may be to build a strong credit history.

Access to credit is an important way for individuals to smooth their consumption throughout their lives. This may be especially true for young people because they are more likely to be making large investments in their human capital and because they have not yet built up significant wealth. Credit cards may be a valuable source of credit and consumption smoothing to young people given their relatively limited exposure to other means of credit.

In 2009, Congress passed the Credit Card Accountability Responsibility and Disclosure Act (CARD Act), which regulates when lenders can change the interest rate on a card, the fees they can charge, and the language of credit card disclosure forms. In addition, Title 3 of the Act limits the marketing of credit cards to people under the age of 21 and makes it illegal to issue a credit card to anyone under 21 unless the individual has a cosigner or can demonstrate "an independent means of repaying any obligation arising from the proposed extension of credit." The impetus for this provision of the CARD Act was a concern that young people are more likely to accumulate excessive debt and to default on that debt, perhaps because they are not financially literate or because they are more prone to impulse purchases.[1]

Legislation designed to protect consumers from the consequences of financial decisions may be well-intentioned, but it presumes consumers are likely to make financial mistakes. From an economist's perspective, however, it's very difficult for an outside observer to determine whether a consumer has made a mistake. Choices depend on the preferences and constraints of the person making the decision, not on the beliefs of the observer. For a consumer who plans to sell a home in a few years, for example, an adjustable-rate mortgage that begins at a lower interest rate might be a better option than a fixed-rate mortgage. Likewise, obtaining a credit card might be a prudent choice for a young person who does not have access to other types of credit.

There is little empirical research on young people and credit card default. The CARD Act, however, offers researchers a quasi-natural experiment for examining the impact of credit card availability on young people. In a recent working paper, three of the authors of this brief (Debbaut, Ghent, and

Kudlyak) use the Act to study whether or not young people are worse credit risks than older borrowers.[2] The authors also examine the effects of early entry into the credit market on the likelihood of default. These effects are not straightforward.

On the one hand, a person who gets a credit card early in life has more time to accumulate debt and might therefore be more likely to be delinquent on that debt. On the other hand, someone who gets a credit card at a young age has more time to learn how to manage debt, perhaps lowering the risk of future delinquency or default.

The CARD Act and Credit Availability

The CARD Act was signed into law in May 2009, but credit card companies were not required to comply with all the provisions of the Act until February 2010. Borrowers and lenders thus were aware of pending changes for at least half a year before they went into effect. This knowledge could have influenced borrowers and lenders in several different ways. For example, consumers under age 21 might have obtained a credit card earlier than they otherwise would have, or they might have obtained an additional card. Credit card issuers might have tried to increase the supply of credit to young people in an effort to offset the effects of the Act. Conversely, issuers might have started changing their systems and procedures prior to February 2010 to make sure they would be ready to comply with the new law, thus reducing the supply of credit to young people.

Debbaut, Ghent, and Kudlyak compare the credit card status of individuals who were 18 or 19 years old in 2009, and thus would have been 19 or 20 years old when the law came into effect, with individuals who were 20 or 21 in 2009, and thus would have been 21 or 22 in 2010 and unaffected by Title 3. The authors find that anticipation of the CARD Act appears to have decreased, not increased, the availability of credit to young people. People who were 18 or 19 in 2009 were several percentage points less likely than those who were 20 or 21 to have a credit card, and if they did have a credit card, they were more likely to have a cosigner for that card.

Based on this evidence that the CARD Act affected credit availability before it was officially in place, the authors include 2009 in their analysis of the total effect of the Act. In this analysis, they compare credit available to young people via credit cards in 2008 to the credit available in 2010. They find that the Act did have a significant effect on credit card availability. People who were 20 years old in the fourth quarter of 2010 were 8 percentage points less likely to have a credit card than people who were 20 in the fourth quarter of 2008, and if they did have a card, they were 3 percentage points more likely to have a cosigned card.

Default and Age

Debbaut, Ghent, and Kudlyak look at the relationship between borrower age and credit card default. They find that in general, the risk of credit card default is highest for middle-aged borrowers and lower for young and elderly borrowers. Borrowers between the ages of 35 and 44 are 10 percentage points more likely to have a serious delinquency than a borrower between the ages of 18 and 20 and 13 percentage points more likely than borrowers over the age of 65. The reason might be that young borrowers have not yet had time to accumulate significant debt or that young borrowers have fewer spending commitments and can more easily curtail their consumption. But youth in and of itself is not necessarily a risk factor for serious delinquency.

Young borrowers are, however, slightly more likely to experience minor delinquencies, perhaps because they have less financial experience than older borrowers.[3] As they get more practice using credit cards, they likely will discover ways to avoid minor delinquencies, such as automating payments or consolidating cards. Financial experience, however, does not seem to reduce serious delinquency, since the likelihood of serious delinquency is highest for middle-aged borrowers.

Who Gets Credit Cards Early?

Young people might not be at greater risk of serious default while they are young, but does early entry into the credit card market make them more prone

to financial problems later in life? Analyzing whether or not young borrowers are bad borrowers is complicated by the fact that people who choose to get credit cards early might be better or worse credit risks than average debtors because of factors that are not necessarily related to age.

Because the CARD Act had a material effect on young people's usage of credit cards, it is possible to use the Act to identify differences between people who choose to get a credit card before they turn 21 and people who choose to wait.

Debbaut, Ghent, and Kudlyak compare 22-year-olds in the fourth quarter of 2009 to 22-year-olds in the fourth quarter of 2012. In both groups, the individuals waited until age 21 to get their first credit card. Those in the former group waited until 21 to get a credit card by choice because they would have been unaffected by the CARD Act. But it is reasonable to assume that at least some of the people in the latter group, who were 21 in 2012, did not get a credit card until age 21 because they were prohibited from doing so by the CARD Act. Comparing the delinquency rates of these two groups can shed light on how people who self-select into early credit card usage (or who would self-select if they were able to) differ from those who wait.

The authors find that people who likely would have gotten a credit card prior to age 21 were less likely to experience a serious credit card delinquency than those who chose to wait until age 21. These results suggest that individuals who self-select into early credit card usage might be better credit risks than those who choose to wait.

Early Entry, Mortgages, and Defaults

Another reason to limit young people's credit card usage is to protect them from potentially damaging their credit and harming their ability to get credit in the future, for example to buy a home or to take out a small business loan. Debbaut, Ghent, and Kudlyak explore whether or not there is a link between early access to credit cards and the likelihood of having a mortgage at age 22 or 23. Young people who wish to own a home are especially likely to need a mortgage since they have not had a long time to accumulate wealth.

The authors find that people who enter the credit card market early are more likely to have a mortgage at age 22 or 23 than people who do not get credit cards early. This suggests that any potential damage to an individual's credit history might be outweighed by having a longer credit history.

Another interpretation of this finding is that people who want to get a mortgage early in life intentionally enter the credit card market early in order to build a credit history. To examine this possibility, the authors again use the CARD Act to compare individuals who chose to delay getting a credit card to those who were forced to delay getting a card. They find that the former are less likely to have a mortgage early in life than the latter, which suggests that one motivation for obtaining a credit card before age 21 is to build a credit history in order to purchase a home early in life.

The final question the authors explore is whether early entry into the credit card market has an effect on credit card default later in life. They find that earlier entrants are actually less likely to have a serious delinquency or default later in life, which casts doubt on the idea that getting a credit card when young results in more financial problems in the future.

Conclusion

The CARD Act offers researchers a way to study the effects of credit card availability on a variety of outcomes for young people. Contrary to the conventional wisdom, Debbaut, Ghent, and Kudlyak find that young borrowers are not necessarily bad borrowers. In fact, they are less likely to experience a serious delinquency than middle-aged credit card users. The authors also find that people who choose to get credit cards early in life are less likely to have a serious delinquency or default than those who wait to get credit cards. One reason, among many, why young people might want to begin using credit cards is to establish a credit history in order to purchase a home early in life. These results suggest that early

entry into the credit card market is not necessarily risky or short-sighted behavior and that a prescriptive approach to financial behavior might be inefficient because it limits consumer choice. ■

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Endnotes

[1] For example, see Walbaum, Michelle, "College Students Need to Handle Debt, Credit Cards Wisely," *USA Today*, August 14, 2009.

[2] Debbaut, Peter, Andra C. Ghent, and Marianna Kudlyak, "Are Young Borrowers Bad Borrowers? Evidence from the Credit CARD Act of 2009," Federal Reserve Bank of Richmond Working Paper No. 13-09R, Revised November 2013.

[3] A serious delinquency is defined as being more than 90 days past due, having a credit card account in collections, having a chargeoff, or declaring bankruptcy. A minor delinquency is defined as being 60 days or 30 days past due.

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