

# THE TRUTH ABOUT BANKRUPTCY

The several-years debate over reform of the bankruptcy system has been long on credit industry rhetoric and short on attention to the facts. The credit industry would have you believe that there is widespread, deliberate abuse of the system. There is not. Yet the Bankruptcy Conference report in the 107<sup>th</sup> Congress [HR 333] would have adversely affected honest and hard-working American families facing financial crises. The credit lobby is promoting passage of HR 333 in the 108<sup>th</sup> Congress—with the backing of influential Members of Congress.

## **1. Let's start at the beginning: Who asked for "reform" of consumer bankruptcy laws? Bankruptcy judges?**

No. The on-going battle over consumer bankruptcy "reform" legislation really began in 1995 when creditors urged President Clinton and Congress to establish the National Bankruptcy Review Commission (NBRC). The NBRC was charged by Congress to undertake a review of the bankruptcy laws. For well over a year, the NBRC conducted public meetings throughout the country, gathering testimony from witnesses that rarely included users of the system.

The credit industry was well-represented at those meetings. It pitched a highly restrictive "means test" for consumer bankruptcy--as it had without success to Congress for well over 50 years--as well as a host of other restrictions on consumers using the system.

The NBRC had nine members representing a variety of political perspectives, but none of these members primarily represented consumer interests. In 1997, the NBRC began to issue drafts of its report. It was apparent from these drafts that the NBRC did not believe that the credit industry had met the burden of proof in demanding a radical restructuring of Chapter 7 [the so-called "fresh start" form of bankruptcy] by forcing more people into Chapter 13 [which requires at least partial repayment of certain debts]. The industry sent a letter to Congress denouncing the direction the NBRC was taking and escalated its multi-million dollar public relations and lobbying campaign to discredit the NBRC. Turning to Congress for relief, the industry found sponsors for a bill to their liking [HR 2500], which was introduced in September 1997, about a month before the NBRC issued its final report.

## **2. Okay, so this is a credit industry effort, but can't a substantial number of people who file for bankruptcy actually repay their debts?**

No. In a study commissioned by the nonpartisan American Bankruptcy Institute, two researchers from Creighton Law School conducted a case-by-case analysis to determine whether debtors currently in Chapter 7 could plausibly repay some portion of their debts. They concluded that up to 3.6% of Chapter 7 debtors would be candidates for *any* repayment in Chapter 13--a finding that was subject to learning more about the debtors' expenses. [1]

Further, "studies" conducted by the credit industry ostensibly demonstrating that a substantial number of bankruptcy filers could afford to pay back many of their debts were criticized by both the Congressional Budget Office (CBO) and the U.S. General Accounting Office (GAO). There simply is no credible evidence that a significant number of debtors would be able to pay their bills if they were prevented from filing for Chapter 7. This is especially true since the nation's economy has weakened in the last two years and unemployment and under-employment has increased.

### **3. Who files for bankruptcy?**

Academic research demonstrates that individuals filing for bankruptcy on average earn under \$20,000 a year after taxes. This research shows that, as a group, the debtors who filed for bankruptcy in the 1990s were worse off than their counterparts who filed in the 1980s. Their incomes were lower and their debt loads are higher.

The top three reasons for filing bankruptcy are clear and have not changed: (1) layoff, furloughs, cutbacks or other job problems, (2) a medical crisis [this is the leading cause for those over 50]; and (3) divorce, particularly for women. These three problems alone jobs, medical, and family break ups account for more than 90 percent of all filings. [2]

It is true that consumer bankruptcy filings are at an all-time high. This reflects the prolonged economic downturn; business bankruptcies are also high. Equally important, as discussed below, consumer debt is at an all-time high. But even in tough times, most households pay their debts and do what they can to avoid bankruptcy—even though, from an economic standpoint, it would make better sense for many of these families to seek a fresh financial start. In fact, one academic study concluded that a much higher number of households would benefit financially from filing bankruptcy than actually file: about 15% compared to the about 1% that file on average. [3]

Attorneys who represent consumer debtors report that the stigma associated with bankruptcy remains very real. Clients are anxious to repay their debts and to keep their financial difficulties quiet. Most people find their attorney as the result of advertising because they are too embarrassed to ask family or friends for recommendations.

**4. Opponents of HR 333 say that the credit industry – in particular the credit card lenders -- is responsible for most of its losses because of reckless extensions of high levels of credit. What is the relationship between bankruptcy and consumer debt?**

While about 90% of bankruptcy filings are ultimately triggered by one or more of the three factors listed above, debtors who file often have very high levels of consumer debt, particularly credit card debt.

Studies by the Congressional Budget Office, the Federal Deposit Insurance Corporation, and independent economists link the rise in consumer bankruptcies directly to the rise in consumer debt.[4] Deregulation of consumer credit interest rates has not produced a significant decrease in credit card interest rates. Instead, deregulation has prompted aggressive marketing and a loosening of underwriting standards that have contributed to a rise in consumer bankruptcies.

About sixty percent of cardholders carry credit card debt from month to month. The average credit card debt for households that carry a balance is more than \$10,000. Since 1997, credit card issuers have nearly doubled the amount of credit they offer to consumers, to more than \$3 trillion dollars--about \$30,000 per household. Revolving debt, which is almost entirely card debt, increased from \$554 billion to \$730 billion between 1997 and 2002. During the same period, credit card companies sharply increased the number of solicitations they mailed from three to five billion per year. [5]

Credit use overall has grown fastest in recent years among debtors with the lowest incomes. In the early and mid-1990s, Americans with incomes below the poverty level nearly doubled their credit card usage, and those in the \$10,000-25,000 income bracket came in a close second in the rise in credit card debt. By 2000, about one-third of lower income families spent more than 40% of their income on debt repayment, compared to 20% of moderate income households and 14% of middle income families. Riskier borrowers typically carry a higher debt burden, pay more interest, and suffer more defaults. With so many more at-risk families further in debt, it is hardly surprising that these families are vulnerable to the financial emergencies that lead to default and bankruptcy. [6]

**5. Why do lenders continue to extend credit to high-risk borrowers, knowing that they may never be able to repay it? Isn't this costing the industry a lot of money?**

No. The truth is that high-risk lending is high-profit lending. These profits have encouraged many institutions to substantially lower their consumer credit standards.

Credit card profits continue to be significantly higher than for other bank lending activities. Bankcard profits increased in 2001 to their second highest level in the last five years (3.24% of outstanding balances.) Growing profits were largely driven by the increasing “interest rate gap” between the benchmark rate set by the Federal Reserve, which has dropped significantly, and interest rates charged by card issuers to consumers. In 2001, the Federal Reserve cut interest rates by 4.75%, but major bankcard issuers cut their rates by only 1.35% on average. [7]

Credit card issuers earn about 75% of their revenues from the interest paid by borrowers who do not pay in full each month. Several companies have even attempted to institute charges or cancel credit cards for customers who pay in full each month, preferring customers with large credit balances who pay minimum monthly payments. [8]

Using a typical minimum monthly payment rate on a credit card with 18% APR, it would take 34 years to pay off a \$2,500 loan. Total payments would exceed three times the amount of the original principal. It would take a family with a balance of \$10,000—the national average—more than 57 years to pay off at a typical minimum rate, with total payments just under four times the amount of the original principal. Credit card statements, unlike those for mortgage and car loans, do not disclose the amortization rates or the total interest payout at the minimum payment rate. In fact, major credit card lenders successfully sued to block the state of California from requiring them to disclose this type of information to credit card consumers.

Industry consultants estimate that credit card companies could cut their bankruptcy losses by more than 50% if they instituted minimal credit screening. [9]

## **6.What is the difference between Chapters 7 and 13?**

Chapter 7 is used for those with substantial unsecured debt problems. Generally, a family that files for Chapter 7 bankruptcy is relieved of repaying its short-term, high-interest unsecured debt, principally credit card debt, along with some medical bills. After bankruptcy, however, the family must continue to make all payments on the family home, including interest, late charges and penalties, or they will lose their home. Any other debt secured by a home mortgage or home equity loan also must be repaid. These debtors must continue to make car payments, pay back taxes, and satisfy educational loans. Those who have outstanding child support or alimony obligations must also pay those in full. Chapter 7 is not total debt relief. Debtors often leave bankruptcy court with heavy financial obligations.

For those debtors who can afford to reorganize and pay some money to their creditors, Chapter 13 provides a well-defined and accessible method to adjust those debts. It is also the only way families in bankruptcy can cure defaults on home mortgages or pay defaulted car loans to avoid losing their homes and their cars. Debtors who file for Chapter 13 voluntarily agree to pay some portion of their debts over a three to five year period. Despite the good faith of those who choose this approach, the reality is that two out of every three debtors who file for Chapter 13 do not make it through the repayment plan. [10] Many face repeated unemployment and some encounter significant and unexpected expenses.

**7. Much has been made of the “means test” for Chapter 7 in HR 333. But I’ve been told by the credit industry that that HR 333 won’t hurt honest families of modest and low means.**

That’s simply not true. Virtually all of the dozens of consumer provisions in HR 333 apply to all debtors in bankruptcy, not just those above median income.

Here are just some of the provisions that would make it difficult for those of modest and low means to successfully file for Chapter 7:

Definition of Household Goods – This provision would allow finance companies who take security interests in families’ household goods (not purchased with the money loaned) to threaten to repossess household items that have little or no resale value, but high replacement value, in order to coerce debtors to enter into agreements to pay debts that would otherwise be eliminated.

Restricting the Automatic Stay of Evictions – The bill would virtually eliminate the stay of tenant evictions in current law that gives bankruptcy debtors, once they have eliminated most other debts, a chance to catch up on back rent.

Burdensome Paperwork Requirements – The bill would require all debtors to provide numerous additional documents, which will increase the cost of filing for every debtor. Some of these documents, such as tax returns and pay stubs, may be difficult for debtors to obtain if they must be obtained from a former employer or a hostile ex-spouse. In addition, the bill would allow creditors to continue to harass debtors if they do not receive “effective notice” at an address that debtors may not be able to obtain (or that may be time-consuming for their attorneys to obtain), even if they have actual notice of the bankruptcy.

Eliminating Protections for Mobile Home Residents – The bill would eliminate chapter 13 protections for mobile home residents, and would often

require them to pay far more than their mobile homes are worth to prevent loss of their homes.

Providing Multiple Opportunities for Creditors to Threaten Litigation – The bill creates numerous opportunities for creditors to bring or threaten to bring litigation against debtors, based on new provisions that allow creditors to seek dismissal of cases, repossession of property, or to prevent the discharge (liquidation) of debts. Families who cannot afford the \$1,000 or more it would take to defend against such actions will have no choice but to give in to creditor payment demands.

**8. As I understand it, HR 333 seeks to put more people into Chapter 13. What's wrong with that?**

Encouraging people who can afford to file Chapter 13 makes sense. Putting them into a program that is doomed to failure for most people--as HR 333 does-- is a recipe for disaster. HR 333 not only won't improve the dismal success rate in Chapter 13, it will INCREASE the number of people who fail. Before fundamentally altering Chapter 13, shouldn't we figure out why so many plans fail today and design a better approach?

The trustees who currently administer Chapter 13 plans have said that HR 333 contains many fundamental flaws that will increase the number of plan failures. HR 333 requires a five-year payback period from all debtors over state median income, squeezing more payments from the debtor and increasing the chance of failure by greatly lengthening the time the family will be vulnerable to income interruptions or emergency expenses. Moreover, these families' payments to creditors would be determined by the arbitrary means test using Internal Revenue Service expense standards, which may bear no relation to their true expenses.

In addition, under HR 333, many creditors who are treated as unsecured under current law would become secured, and others would be deemed secured for larger obligations. That is: secured and unsecured creditors would be entitled to greater repayment of their debt. That means the size of the repayment plan would be bigger even though the debtor's income on average would not grow.

Moreover, because HR 333 would prevent a debtor who cannot pass the means test from being eligible for a Chapter 7 case, if the Chapter 13 plan fails, the debtor is removed from protection of the courts, subject to loss of his/her home, car, household goods and likely to be continually harassed by creditors.

**9. So you're saying that HR 333 would accomplish exactly the opposite of what its supporters claim. The credit industry says it wants debtors to**

**repay more of their debts in Chapter 13, but the bill would make that outcome less likely. How did that happen?**

Early on, some secured creditors realized that there was an opportunity to gain ground on the current system, which already provides secured creditors a preferred position. Led by the auto lenders, they obtained special interest provisions that, as described above, create a lot more secured debt for the debtor.

This creditor feeding frenzy was detailed in an editorial in a leading bankruptcy journal, which asked: "Why Does Congress want to Kill Chapter 13?" and which noted that "bankruptcy reform has been hijacked by car lenders". [11] Bankruptcy judges, trustees and scholars have been outspoken about the destructive nature of the type of changes to Chapter 13 proposed in HR 333.

In fact, some opponents of HR 333 believe the real agenda of much of the credit industry is to keep debtors out of both Chapter 7 and Chapter 13, eliminating the protection of the courts.

**10. The bill's proponents say it will help women and children who are dependent on child support. Is that true?**

No, for three major reasons. First, supporters of the bill claim that it "puts child support first" because women owed child support will be first in line among unsecured creditors if there are assets to distribute in a Chapter 7 case. However, even today, with no means test limiting access to Chapter 7, over 96% of Chapter 7 debtors have no assets to distribute, according to the Department of Justice. The bill will let women and children wait at the head of the line in Chapter 7 – to receive nothing.

Second, after bankruptcy, women trying to collect support will face increased competition from credit card companies and other creditors. Under current law, child and spousal support are among the few debts that survive bankruptcy. Under H.R. 333, more debts -- especially high-interest credit card debt -- will continue after bankruptcy, putting women and children owed support in competition with the sophisticated collection departments of commercial creditors for the debtor's limited income. Being "first priority" during the bankruptcy process is legally irrelevant the minute the bankruptcy proceedings end.

Third, as described above, changes in Chapter 13 will mean that many creditors will be entitled to larger payments from the debtor's limited income – so payments of past-due child support will have to be stretched out over a longer time period. [12]

**11. Does the bill fix the homestead laws that allow wealthy debtors to keep their multimillion dollar mansions in certain states like Florida and Texas, even if they pay creditors nothing?**

No. Today, state law determines what property shall remain exempt from creditors in a bankruptcy. Homestead exemptions are highly variable. Six states (Arkansas, Florida, Iowa, Kansas, South Dakota, Texas) and the District of Columbia now have literally unlimited exemptions, while twenty-two states have exemptions of \$15,000 or less.

The central purpose of creating a uniform federal cap on the "homestead exemption," which was adopted by an overwhelming vote in the Senate, was to fix this fundamental injustice. Residents of one state should not be allowed to protect an asset worth millions, while residents of other states cannot even protect the least expensive home. Allowing this inequity is of even greater concern when it is part of a bill that creates so many harsh new barriers to bankruptcy for moderate-income Americans.

The "compromise" proposal in HR 333 would cap the equity of a home that can be shielded from creditors *only* for persons liable for a very limited number of frauds and felonies. Even then, the cap would be \$125,000 per person [\$250,000 per couple].

A diverse group of professors who teach bankruptcy and commercial law, wrote to urge change to this HR 333 provision. They said: "The compromise proposal does not cure the homestead problem. Although the homestead compromise was reached in good faith and with good intentions, its modest improvements are overwhelmed by the negative consequences it will have... On balance, the compromise compounds the unfairness of the homestead exemption. Instead of offering a hard, uniform cap that brings the state exemptions into closer alignment, the proposal makes it more difficult for people to use any homestead exemptions. " [13]

**12. It's my understanding that HR 333 requires debtors to undergo credit counseling before they file for bankruptcy. What's wrong with that?**

There is nothing wrong with encouraging people to seek credit counseling. Given the serious consequences associated with bankruptcy, most people consider it a last resort to be tried when all else has failed. Indeed, debtors usually seek out credit counseling and/or attempt to make special arrangements with their creditors to repay their debts before ultimately filing for bankruptcy.

However, there is reason to be concerned about the specific credit counseling provisions in HR 333, which deny access to the bankruptcy system in virtually all

cases until a debtor has sought the assistance of a credit counseling program. Although the legislation seeks to ensure some measure of creditability with respect to the credit counseling organizations by requiring that they be approved by the local trustee or bankruptcy court, the conference report does not authorize funds to investigate these agencies, their fees, practices or success rates. This will make it much harder to prevent shady operators from getting placed on the approved list maintained by the courts and trustees and to ensure ongoing compliance by these counseling organizations with the requirements of the law.

Newspapers and television news shows have been filled of late with stories about credit counseling scam artists, and “non-profit” counseling organizations that charge high fees and pay their officers “for profit” salaries. A number of states have enacted or are considering tougher oversight of credit counseling agencies. Most experts in the field acknowledge that it is getting much harder for consumers to find high-quality assistance that offers a range of counseling options, as opposed to a “one size fits all” consolidation plan that only helps some consumers get their finances under control.

As with Chapter 13 plans, credit counseling consolidation plans, in which the debtor pays the agency and the agency pays most creditors, have a high failure rate. Debtors who fail to complete a consolidation plan have a good chance of ending up in bankruptcy. In addition, the cost of credit counseling has risen significantly in recent years. Although the conference report attempts to ensure that counseling fees are reasonable, the credit counseling requirement will place debtors with extremely limited funds in the position of having to use money that would otherwise go to debt repayment.

Additionally, some debtors will only learn about the credit counseling requirement upon seeing a bankruptcy attorney. This is often too late in the process for credit counseling to make a difference. As mentioned above, many debtors delay filing for bankruptcy well beyond when it would make economic sense. It will only be upon making the difficult decision to seek bankruptcy that these people would be told that, first, they must receive credit counseling. At this point, credit counseling is unlikely to help the debtors in the most financial trouble, and the delay in filing for bankruptcy may actually harm them. H.R. 333 does not give bankruptcy judges enough discretion to ensure that debtors facing an emergency, such as the imminent shut off of electricity, will be able to file for bankruptcy immediately.

**13. Finally: The consumer credit industry claims that bankruptcies are costing each American family \$400 per year. Is that true?**

Absolutely not. This claim has obvious rhetorical appeal, but no basis in fact.

A lengthy article in the *American Banker* reveals the unsubstantiated origin of the number. It is not the bankruptcy system that causes creditors' losses. [14] Indeed, the credit industries' own studies concede that a majority of consumers in financial trouble will not be able to pay their debts, whether or not they file for bankruptcy. On the other hand, some borrowers who file for Chapter 7 relief pay some of their debts in spite of the fact that they can legally wipe them away. The industry wants you to believe that it is the bankruptcy system that causes them to have to write off some loans, not their own bad business decisions.

Equally important, there is no evidence that lenders would reduce rates on unsecured consumer lending if they could avoid these bankruptcy losses. In recent years, credit card profits have been largely driven by the increasing "interest rate gap" between the benchmark rate set by the Federal Reserve, which has dropped significantly, and interest rates charged by card issuers to consumers, which have dropped by far less. Given this, how likely is it that additional savings realized by lenders will be passed on to consumers?

The simple truth is that bankruptcy laws do not result in an increase in the cost of credit for bill-paying consumers. Credit card companies have never shown that interest rates have risen or fallen due to increases or decreases in bankruptcy filing rates or changes in bankruptcy laws. In fact, it can be argued that the high interest rates and the various and substantial penalties paid by marginal borrowers on their outstanding balance each month subsidize the cost of credit for all borrowers who pay their credit card balance in full each month.

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## NOTES

[1] Marianne Culhane and Michaela White, Taking the New Consumer Bankruptcy Model for a Test Drive: Means-Testing Real Chapter 7 Debtors, *American Bankruptcy Institute Law Review* 1 (Spring 1999).

[2] Elizabeth Warren, *Financial Collapse and Class Status: Who Goes Bankruptcy?*, 41 *Osgoode Hall Law Review* (forthcoming 2003.)

[3] Michelle White, Why Don't More Households File for Bankruptcy, Working Paper 98-03, Department of Economics, University of Michigan, March 25, 1998

[4] David Moss & Gibbs Johnson, The Rise of Consumer Bankruptcy: Evolution, Revolution or Both 73 *Am. Bankr. L.J.* 311 (Spring 1999); Diane Ellis, The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-offs, and the Personal Bankruptcy Rate, *Bank Trends* 98-05 (Division of Insurance, FDIC February 1998); Lawrence Ausubel, Credit Card Defaults, Credit Card Profits, and Bankruptcy, 71 *Am. Bankr. L.J.* 249 (1997); Statement of Kim Kowalewski, Chief, Financial and General Macroeconomic Analysis Unit, Congressional Budget Office, before the Subcommittee on Administrative oversight and the Courts, Committee on the Judiciary, United States Senate, p. 4 (April 1997); Jagdeep S. Bhandari & Lawrence Weiss, The Increasing Bankruptcy Filing Rate: A Historical Analysis, National Conference of Bankruptcy Judges (Winter 1993).

[5] See Facts About Consumer Debt and Bankruptcy, Consumer Federation of America, January 2003 and sources cited therein

[6] Id

[7] Federal Reserve Board, "The Profitability of Credit Card Operations of Depository Institutions," June 2002

[8] David S. Evans & Richard L. Schmalensee, The Economics of the Payment Card Industry Fig. 3 (1993). Beneficial National Bank of Delaware canceled the Mastercards for 12,000 customers who pay their bills in full; they are expected to cancel another 30,000 customers soon. Other lenders, such as NationsBank and GE Rewards MasterCard have imposed fees or canceled cards for customers who pay their bills in full. Bruce Mohl, The careful debtor loses credit at BJ's, The Boston Globe A1, col.1 (Sept. 25, 1997).

[9] Fair, Isaac & Co. released a new bankruptcy predictor that it says can eliminate 54% of bankruptcy losses by screening potential non-payers from the bottom 10% of credit card holders. Fair, Isaac & Co. @ [www.fairisaac.com](http://www.fairisaac.com); Credit Cards: Fight for Bankruptcy Law Reform Masks Truth, 162 Am. Banker 30 (September 8, 1997).

[10] Elizabeth Warren, Consumer Bankruptcy: Issues Summary, Harvard Law School, January 7, 2003

[11] Why Does Congress want to Kill Chapter 13?, Norton Bankruptcy Law Advisor, June 1999

[12] See Bankruptcy Bill Will Harm Economically Vulnerable Women and Their Families, National Women's Law Center, August 2002

[13] Letter from Law Professors to Senator Leahy and Representative Sensenbrenner

[14] Top Creditor Lobbyist Tassey Goes For Broke, The American Banker, May 17, 2001

