WRESTLING with Bankruptcy

The economics – and politics – of reform

By Joseph S. Pomykala

Only suckers pay their bills.

Ready for some big numbers? In 1998 – seven years into an economic boom – one out of every 68 households in the United States filed for bankruptcy. Bankruptcy filings each year are now more than double the number that occurred during the entire decade of the Great Depression.

Are Americans becoming more inept at financial management? Are they victims of the moral decay politicians and pundits preach about? It's possible. But the root cause is depressingly simple: Legal incentives make it much too attractive to shed personal debt through bankruptcy.

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First things first. Widespread debtor distress seems inconsistent with the longest boom and the lowest unemployment in a quarter century. But in part, the paradox of bankruptcy amid plenty can be explained by a fairly familiar cycle in consumer confidence.

During periods of economic growth, consumers use current economic conditions as a proxy for their future ability to repay. Prosperity and optimism lead consumers to take more risks and incur more debts. Those who guess wrong pay the price – insolvency.

But when a recession hits and consumers turn pessimistic, savings rates increase and they pay down debt. For example, during the great economic prosperity of the 1920's, people threw caution to the winds and bankruptcies more than tripled. During the Great Depression that followed, bankruptcy filings actually fell.

A similar cycle seems to be at work today – but one that has been supercharged by changes in the financial system, which have broadened and deepened access to credit.

Consumer debt has increased an average of 8 percent annually over the last 20 years, with the average family carrying $58,500 in liabilities at mid-decade. Most of the current debt is still in the form of residential mortgages. But unsecured credit has grown by an average of 14 percent annually since 1978, mainly through credit-card borrowing. Thus, about 43 percent of non-mortgage consumer debt is now in the form of revolving credit, compared to just 14 percent in 1978. What's more, the median balance carried by those who use credit cards to borrow grew by half from 1992 to 1995.

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The growth in credit-card lending was spurred by a 1978 Supreme Court ruling that allowed banks to lend across state lines, permitting them to place their offices in states without usury laws, and thereby evade usury laws in their customers' states. At higher interest rates, banks could profitably expand lending to high-risk groups. But there was a downside: Consumers could easily erase such unsecured debt through bankruptcy.

The democratization of consumer credit has a parallel in the changing environment for business credit. Financial innovations and expanded markets for high-yield corporate debt during the 1980's enabled firms to borrow and expand. Similarly, the greatly expanded availability of consumer debt during the last 20 years increased opportunities for consumers who could not borrow prior to the lifting of state interest rate ceilings.

Credit-card companies were left more exposed, since increased personal bankruptcy typically obliterates unsecured debts. But higher interest rates on credit-card debt – now averaging 16 percent – reflects this risk and compensates lenders for it. Consumers thus pay up front for their ability to discharge debt in bankruptcy. The downside, of course, is that they cannot legally waive this right in return for, say, lower interest rates.

Computerized credit scoring of applications for loans does allow lenders to discriminate between high- and low-risk borrowers. But there are practical limits to such differentiation, because of the prohibitive costs of fuller credit investigations relative to the small size of unsecured loans.

Consider a credit card company lending one million consumers $2,000 each. The company earns, say, $300 in interest per account and must write off 5 percent of the loans annually. It could substantially reduce the default rate by interviewing potential borrowers, calling their prior employers, rating job security and the like. But the costs of such screening would far exceed the benefits. So consumer lenders tend to pool unsecured debtors, charging everyone more or less the same rate. And that implies the better quality debtors subsidize the riskier borrowers.

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TOO MUCH DEBT? PROBABLY NOT.

Consumer debt, as we've noted, has increased sharply in recent decades. But the consumer debt-service burden – the portion of income the average household pays to service interest and principal payments – fell from 15.6 percent to 15.4 percent between 1989 and 1995. By the same token, the value of consumer assets, mainly primary residences and liquid financial assets, has grown at about the same rate as indebtedness. Thus, consumer leverage has remained constant and the ability to service debt has marginally improved.

In the same period, though, the personal bankruptcy rate increased by one-third. Debtor distress did not contribute to the rise, especially in these rosy economic times. Rather, the incentives to declare bankruptcy have increased: More debt means more can be shed through legal insolvency.

DECLINING MORAL SCRUPLES?

It's difficult to measure changes in attitudes toward bankruptcy. But many would agree with Judge Edith Jones of the National Bankruptcy Review Commission, who notes that "at one time in our history, filing bankruptcy was regarded as shameful, and filers suffered social stigma and permanently ruined credit. The shame and stigma are no longer compelling.... Many debtors are well off and continue to be fully employed before and after filing bankruptcy.... Well publicized celebrity bankruptcies, plus "water cooler" gossip about increasing filings, have tended to reduce bankruptcy to an acceptable alternative for personal financial management."

Indeed, the discharge of unpaid debts has become more a tool of smart financial management and less a matter of embarrassment. Some mortgage brokers even recommend bankruptcy to loan applicants in order to remove high debt loads and qualify potential home buyers for new loans from lenders who are more concerned about debt load than past credit history.

A FINANCIAL WINDFALL? PASS THE WORD.

Economists do not wonder why the bankruptcy rate is so high, but why it's so low. Michelle White of the University of Michigan estimates that a whopping 15 percent of households in the United States could financially benefit from bankruptcy. Yet less than a tenth that many actually file.

Even more than 15 percent could benefit if consumers employed what economics call strategic behavior prior to bankruptcy. If debtors converted nonexempt assets to legally exempt property – using cash to contribute to IRAs or to pay off or reduce home mortgages – the percent that could benefit rises to 18 percent. And if debtors moved to states that allowed the highest property exemptions, the figure rises to 23 percent.

Presumably, one reason filings are not higher is the moral cost attached to bankruptcy. However, it's hard to believe that such scruples explain all of the hesitation to shed debt. A better explanation is linked to information – or, rather, a lack of it. Simply put, many debtors are unaware of the sweetheart deal awaiting them until they seek legal advice or talk to friends who have used bankruptcy to shed debt.

This is the information age and – no surprise – the information gap is narrowing. After the United States Supreme Court ruled in 1977 that state laws banning lawyers from advertising violated free speech rights, legal advertising grew rapidly. Spending by lawyers on television ads alone grew from $5 million in 1980 to $129 million in 1994. Bankruptcy filings began to accelerate about the same time, and according to a study by the Federal Deposit Insurance Corporation, the correlation was not coincidental. More people are finding out about the financial windfall available through bankruptcy and taking advantage of the opportunity.

HARD TIMES, AMERICAN-STYLE

Seventy percent of personal bankruptcy filings occur under Chapter 7 of the bankruptcy law, and are known as liquidations. Debtors retain all the property that Federal law or the laws of their states shield from creditors, while the rest of their assets are used to pay off their debts *pro rata.* Any debts not paid in full are then wiped off the books.

Future income cannot be garnished to pay past debts. An investment banker earning $1 million a year is as entitled to a full discharge as a welfare mother.

Exemptions to what creditors take can be generous. In some states, homestead exemptions are set by acreage, as opposed to value. Florida's 160-acre exemption allowed Paul Bilzerian, the well-known corporate raider, to retain a $6 million, 11-bedroom, 20-bath mansion near Tampa. And rules set for 19th century farmers still apply. In a Virginia case, a bankrupt was allowed to keep his "one horse" – an $800,000 thoroughbred purchased just prior to filing. Courts have also permitted debtors to keep mink coats, Rolex watches and expensive jewelry as clothing protected from creditors, and valuable antiques as exempt household furnishings.

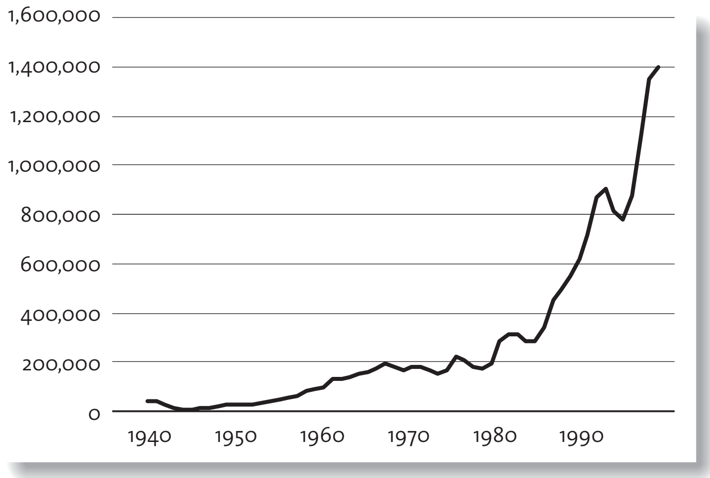
Unfortunately, the outrageous is not atypical. Chapter 7's title, "Liquidation," is plainly a misnomer, since, in 96 percent of cases, creditors receive nothing. Liquidation, in practice, is merely a few pages of paper filed with the court to remove unwanted debts.

Alternatively, debtors can choose Chapter 13 of the bankruptcy law, which provides what is known as a wage-earner discharge. The debtor keeps all his assets, not just the exempt ones, and attempts to pay back some of his debts over three to five years with income left after provision for living expenses. But even here, many judges seem inclined to aid debtors and third parties at the expense of creditors. Approved expenses have included tithing to churches, gifts, vacations and private-school tuition for dependents when public school is available.

Discharges of debt under the bankruptcy law are generally limited to every sixth year. But once the forbidden fruit is bitten, many bankrupts come back for seconds. Approximately 8.6 percent of filers have declared bankruptcy once before; 2.5 percent have declared three or more times.

The ease of obtaining a discharge has plainly led to abuses. Just how common these abuses are is hard to say, but the anecdotal evidence makes for juicy reading. One physician took his family on a six-week, $60,000 European vacation charged to his American Express card, and upon return declared bankruptcy. An unemployed New York waiter amassed debts of $170,500 over six months for airline tickets, consumer electronics, perfume, cosmetics and gambling in Atlantic City. He obtained $50,000 in cash advances on his credit cards, claimed he lent funds to a friend who disappeared, and asked the court to absolve him of his debts.

CONSUMER BANKRUPTCY FILINGS IN THE U.S.
1940-1998



IT WASN'T ALWAYS THIS WAY

Roman law allowed debtors to post their bodies as loan collateral; upon default they were sold into slavery to satisfy creditor claims. In colonial America, the palms of those convicted of bankruptcy were branded with a "T" for thief. It was also common practice to nail a bankrupt's ear to the pillory in a public place for several hours before it was cut off. The "earmark" served to warn future creditors that the person was not a reputable person with whom to contract debts.

Early exemptions in the colonies were meager – mainly for clothing – and the discharge of indebtedness was forbidden until the early 18th century. It was a reward for honest debtors who showed up for court and revealed their property instead of fleeing. And it could only be granted if a four-fifths majority of creditors approved.

When the U.S. Constitution was framed, bankruptcy was a form of criminal fraud. Creditors were plaintiffs accusing defendant debtors of committing acts of bankruptcy – typically absconding with property. In England, bankruptcy was a capital felony and convicted debtors could be sent to the gallows. While the United States copied much English jurisprudence, the death penalty was replaced by a maximum 10 years' imprisonment when the first Federal statute on bankruptcy was enacted in 1800.

Bankruptcy law was at first aimed at recovering a bankrupt's assets and allowing creditors an equitable share of them. But the law slowly evolved into a system for debtor protection, a means of bestowing creditor-funded debtor relief during economic crises.

After the Panic of 1837 – then the deepest depression in America's history – debt relief became part of the Whig Party's presidential platform. The 1841 Bankruptcy Act widened eligibility to all debtors, where before only merchants and traders had been eligible. It also allowed debtors to voluntarily petition themselves into bankruptcy, instead of giving the option only to creditors. But the liberal new law quickly led to wide-scale abuse. Friends and family of debtors would claim fictitious debts, share in the distribution from the estate, and then vote for a discharge. The law was repealed after 13 months.

The 1867 Bankruptcy Act was designed to cope with bad debts arising from Civil War losses. Creditors' rights to vote over a bankrupt's discharge were cut back. States were allowed to set their own property exemptions, and those in the South legislated generous homestead exemptions in order to prevent Northern creditors from gaining title to Southern property. Amendments after the Panic of 1873 further weakened creditor voting rules. But, in an echo of 1842, the Federal law was repealed after a return to prosperity and rising popular distaste for abuses of debtors' rights.

Once again responding to general economic distress, Congress passed the Bankruptcy Act of 1898. The new law abandoned creditor voting in consumer bankruptcies. And this time around, the law survived a return to prosperity.

Welfare, food stamps, social security, disability, Medicaid – all are means tested. Bankruptcy ought to be means tested as well.

The Great Depression led to another ratcheting up of debtors' rights. Congress introduced payment plans for wage earners lasting three to five years, during which secured creditors – like mortgage-holders – could not enforce liens. Business reorganization became an alternative to liquidation. And municipalities were added to the list of entities that could discharge unpaid debts.

The law was changed again in 1978. The amount of personal property retained by debtors increased, and eligibility for Chapter 13 wage-earner repayment plans widened to allow debtors with significant equity in their residences to file for bankruptcy without losing their houses. This came on top of the Supreme Court rulings that effectively eliminated state usury caps and allowed lawyers to advertise. Consumers could easily borrow more and lawyers could more easily proselytize for bankruptcy, spreading the word of how they could painlessly rid clients of unwanted debts.

SOMETHING MUST BE DONE

Congress established a bipartisan National Bankruptcy Review Commission in 1994 to redraft the nation's bankruptcy laws again. But it imposed no particular mandate, and Commission appointees quickly split between pro-debtor and pro-creditor factions.

The Commission submitted its final recommendations in 1997. But the proposed amendments did not attempt to curb the skyrocketing bankruptcy rate. Indeed, some provisions actually increased debtors' benefits, and the proposal proved dead on arrival on Capitol Hill. Those seeking serious reform quickly drafted alternative legislation aimed at curbing growing abuses. Their proposed changes – still pending – soon become known as means testing.

Under existing law, debtors filing under Chapter 7 liquidation can often keep virtually all their property under generous personal property exemptions, and even repeat the process every six years. No test exists to see if bankrupts could otherwise repay debts from future income.

But under proposed means testing

reforms, debtors would be ineligible for Chapter 7 relief if they were likely to have an easy time paying back a portion of their debts later on. Those debtors could still file Chapter 13 plans, using disposable income to pay back debts over three to five years.

This hardly amounts to a return to Dickensian remedies. The means test would not apply to debtors with incomes less than the median American income – about $51,000 for a family of four. Those above the median would only be eligible for a quick discharge under Chapter 7 if they could demonstrate that they could not repay at least 25 percent of their unsecured debts from discretionary income over a five-year period.

However, some 80 percent of all filers would flunk the median income test, and only half of the other 20 percent would have sufficient income to pay back the minimum fraction of debts under a Chapter 13 plan. Thus, a creditor-funded study by Ernst & Young estimated that the bill's means testing provisions would reach just 10 percent of Chapter 7 filers and result in just $4 billion more recovered by creditors annually.

Judge Edith Jones defended the means-testing approach at Congressional hearings. Welfare, food stamps, disability and Medicaid are all means tested, she noted. "Bankruptcy is part of the social safety net. It ought to be means tested as well."

Needless to say, though, this view was not unanimous. Opponents of the changes include attorney groups who are getting rich off the bankruptcy boom (lawyers now earn more than twice as much from the Chapter 7 bankruptcy system as unsecured creditors manage to recover from bankrupts).

On the other side is the credit card industry. Over the last decade, uncollected debts as a percentage of all credit-card loans has doubled. In a study funded by Visa, the credit card consortium, Wharton Econometric Forecasting Associates estimated the financial costs of bankruptcy in 1997 at $44 billion – mostly discharged unsecured debt. If these costs were borne entirely by consumers, they would amount to $400 per household, or four percentage points more in interest on unsecured loans.

Since a minority of debtors who would be affected by means testing, the reform seems unlikely to reverse the trend in bankruptcy filings. But, then again, it might. The administration of the means test – estimating income, expenditures and creditor recovery under hypothetical Chapter 13 plans – would significantly add to the administrative and legal costs of bankruptcy. Thus the up-front costs of declaring bankruptcy could easily double, presumably deterring some debtors from taking this road to the Promised Land.

AND THE BEAT GOES ON

The battle over bankruptcy reform is plagued by misunderstanding. Bankruptcy is not a form of creditor-funded relief for debtors. Since the market for consumer loans is competitive, lenders ultimately pass on costs to borrowers, leaving all debtors to pay in the form of higher interest rates and more stringent loan qualifications. Thus, means testing would actually help most borrowers – especially low-income borrowers – who would more easily qualify for loans and pay lower interest rates.

Whatever the rhetoric, the politics will play out as a contest between lawyers and the credit card industry. Imposing means testing is not likely to significantly stem the growing tide of filings. But some day, some way, Americans are going to have to face the reality that the inability to enforce contracts between creditors and debtors creates real costs that someone must pay.