The Empirical Case for Needs-Based Bankruptcy

Oral Statement Given by:

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Good morning Mr. Chairman, and members of the Committee. My name is Michael Staten. I am a Professor of Management and the Director of the Credit Research Center at the Georgetown University School of Business.

I know that at least 3 bills have been introduced to this Congress that would amend the federal bankruptcy statutes. My testimony today is especially relevant to the concept of "needs-based" bankruptcy imbedded in those bills. Needs-based bankruptcy is a generic term that refers to proposals that would guide debtors into Chapter 13 repayment plans when they have income sufficient to repay a substantial portion of their debts. These proposals are based on the premise that the current code affords some debtors more bankruptcy relief than they truly need.

The concept of reserving the Chapter 7 discharge only for those consumers who truly can't repay sounds fair and reasonable. Bankruptcy, after all, is social insurance in its purest form. When the bankruptcy court awards a Chapter 7 discharge, the losses associated with one debtor's financial catatastrophe are spread across millions of other borrowers as creditors adjust their prices or product availability.

If bankruptcy were a free-market insurance program we wouldn't be debating the merits of a needs-based approach - it would already exist. Like the consumer whose house has suffered storm damage, debtors would be required to show they had suffered a loss, and the court would measure the extent of the damage prior to awarding relief. No free-market insurance program would pay out a claim without assessing the size of the loss. Yet, that is exactly how our current bankruptcy code operates when it permits debtors to file for a Chapter 7 discharge without requiring the court to evaluate the debtor's capacity to repay those debts.

Two years ago the Credit Research Center began a study of nearly 4,000 consumers who filed for bankruptcy during 1996 in 13 major U.S. cities. The project was partially funded through a joint grant from Visa, U.S.A. and MasterCard International. One of the project's objectives was to determine how well the current bankruptcy law calibrates bankruptcy relief to debtor need. That is, we attempted to measure petitioner repayment capacity using the same materials available to the court when the debtor requests the Chapter 7 discharge.

We issued our first report last October. We found that 25 percent of Chapter 7 petitioners told the court they had income net of living expenses at the time they filed that was sufficient to repay at least 30 percent of their non-housing debt over a 5-year repayment period. Five percent of Chapter 7 filers could pay all of their non-housing debts over 5 years.

Following the publication of our report in October the GAO evaluated our methods and procedures. You will hear more about their findings later in the panel. We believe that our analysis was stengthened as we responded to the GAO's questions and concerns. As you will see in my written statement, we resolved a number of issues by refining our calculations. In particular, we recalculated our repayment estimates to simulate full reaffirmation of secured debts and full repayment of student loans. The resulting numbers, displayed in Table 2 of my statement, indicate that 25 percent of Chapter 7 debtors would still have net income sufficient to pay, on average, 24% of their unsecured debts over a 5-year period. Of course, 5% could pay all of their unsecured debt.

In the past two months, two additional studies of petitioner capacity to repay have been released. Both were conducted by the accounting firm of Ernst and Young. Again, you will hear more detail about those studies later in the panel. However, **in each case the results strongly corroborate our findings.** The second study in particular was specifically designed to satisfy the GAO's statistical criteria for a nationally representative sample.

I now believe that the body of empirical research supported by these three distinct data bases has established **that debtors with the means to repay are filing for Chapter 7 in sufficient numbers to be worrisome.** Of course, while creditors may initially bear the cost of debts that could have been repaid, we know from long experience with competitive markets that these costs are ultimately passed along to all consumers in the form of higher prices or reduced availability of credit products.

I reject the argument by some opponents of HR 3150 that its needs-based criteria would place an excessive administrative burden on the courts. It seems to me that a viable needs-based approach would utilize well-defined criteria to clearly signal how the court will treat a given debtor. Well-defined eligibility standards streamline the administration, promote consistent treatment, and reduce costly

litigation. Our estimates of the impact of HR 3150, corroborated by the both Ernst and Young studies, is that 12 - 15 % of current Chapter 7 debtors would be directed into Chapter 13 repayment plans. Presumably, only a fraction of these would generate appeals for exceptions due to special circumstances. Consequently, the straightforward, up-front screening criteria imbedded in H.R. 3150 would allow the court to focus its attention on the subset of the 12-15% of cases which warrant closer scrutiny.

Some critics have argued that bankruptcy reform should penalize creditors for making bad lending decisions. I would simply point out that the needs-based proposal will not rescue creditors from bad lending decisions, because it preserves bankruptcy relief for those debtors who truly can't pay. A needs-based system would preserve the industry's incentive to make credit available, but also to lend prudently by differentiating between consumers who can pay and those who can't.

Perhaps most importantly, a needs-based approach bolsters consumer incentives to use credit cautiously by removing the temptation of a free ride for those who can pay but would choose not to. In contrast, by offering the lure of a Chapter 7 discharge without a demonstration of need, the current bankruptcy system does little to encourage the responsible use of credit.

Bankruptcy is a complex phenomenon with many causes, only a few of which can be addressed through the bankruptcy statutes themselves. Incorporating a needs-based eligibility requirement into the existing bankruptcy system will probably not reduce the annual number of filings to the levels we experienced a decade ago. However, if Congress desires to curb the growth in bankruptcies, at the same time preserving access to credit for those financially vulnerable households who need it most, I believe that incorporating a needs-based approach is the single most effective step that can be taken toward that goal.

Thank you for the opportunity to appear before the committee today. I will be happy to answer any questions.