

# **The Empirical Case for Needs-Based Bankruptcy**

*Testimony Given by:*

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UNITED STATES HOUSE OF REPRESENTATIVES

Committee on the Judiciary

Subcommittee on Commercial and Administrative Law

# The Empirical Case for Needs-Based Bankruptcy

## SUMMARY

Needs-based bankruptcy is a generic term which refers to proposals that would guide debtors into Chapter 13 repayment plans if they have a significant capacity to repay their debts. Current bankruptcy law allows debtors the freedom to choose the chapter under which they file for relief, but does not require the Bankruptcy Court to assess a Chapter 7 petitioner's ability to repay debt out of future income as a condition to awarding a discharge. The possibility exists that some, perhaps many, debtors in Chapter 7 could actually fund meaningful Chapter 13 repayment plans.

In October, 1997 the Credit Research Center published a report which provided a snapshot of the ability of 3,800 bankrupt debtors to repay their debts in 13 major U.S. cities. The report found that 25 percent of Chapter 7 filers could have repaid at least 30 percent of their non-housing debt over a 5-year repayment period. Five percent of Chapter 7 filers could have repaid **all** of their non-housing debts over five years.

The U.S. General Accounting Office evaluated the CRC methodology. It concluded that "overall, the Center report represents a useful first step in analyzing the ability of bankrupt debtors to pay their debts," but advised caution in the interpretation of the results based on five areas of concern, which involved sampling issues, methods of calculating repayable debt, and the reliability of assumptions underlying the calculations. CRC responded with subsequent analysis and commentary.

The Center continues to believe that the uniformity of repayment results across such a diverse group of cities strongly suggests a nationwide pattern. Even under the extreme assumption that all secured debt was reaffirmed and after accounting for payment of all non-dischargeable student loans, we found that one quarter of all Chapter 7 debtors could pay, on average, 24.6 percent of their unsecured debts over a 5-year payment period. Five percent of all Chapter 7 debtors could pay all of their unsecured balances.

These results have been corroborated by two separate studies conducted by Ernst and Young. The more powerful of the two found that 150,000 Chapter 7 filers during 1997 (about 15 percent of the U.S. total) had the capacity to repay over \$4 billion on their unsecured debts had they been required to enter a 5-year Chapter 13 repayment plan.

Empirical research has now established that large numbers of debtors are filing under Chapter 7 who could fund significant repayment plans. A needs-based approach that utilizes well-defined criteria to clearly signal how the court will treat a given debtor would promote consistent treatment, streamline administration and reduce costly litigation. It would preserve access to credit for financially vulnerable households but still encourage creditors to lend prudently. It would preserve bankruptcy relief for those debtors who truly can't pay, but also bolster consumer incentives to use credit responsibly by removing the temptation of the free ride for those who can pay but would choose not to.

## **I. Introduction**

Good morning Mr. Chairman, and members of the Committee. My name is Michael Staten and I am a Professor of Management and the Director of the Credit Research Center at the Georgetown University School of Business. As you may know, over its 24-year history (the first 23 years located at Purdue University) the Credit Research Center has generated over 100 research papers, most of which examine the impact of public policy toward consumer and mortgage credit markets.

In 1996 the Credit Research Center undertook a large study of nearly 4,000 consumers who filed for bankruptcy during 1996. The project was partially funded through a joint grant from Visa, U.S.A. and MasterCard International. I am pleased to join you today to discuss our analysis of the petitions filed, and what they reveal about the apparent repayment capacity of those debtors. I will also compare our results with two additional studies of bankrupt debtors that were conducted during the past year.

I am aware 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 which I believe was coined this past year to refer to proposals that would guide debtors into Chapter 13 repayment plans who have a significant capacity to repay their debts. These proposals are based on the premise that the current code affords some debtors more bankruptcy relief than they need, where "need" is measured in terms of the debtor's ability or inability to fund a repayment plan out of future income. Current bankruptcy law allows debtors the freedom to choose the chapter under which they file for relief. In particular, the law does not require the Bankruptcy Court to assess a Chapter 7 petitioner's ability to repay debt out of future income as a condition to awarding a discharge. Given that Chapter 7 petitions can be approved without such an assessment, it would not be surprising to find that some debtors do have capacity to repay, but opt for the "fresh start" discharge obtainable through Chapter 7.

The concept of reserving the Chapter 7 discharge only for those consumers who truly can't repay sounds fair and reasonable. However, opponents of the needs-based approach have argued that such an evaluation would be impractical due to high administrative costs. They also dispute the observation that there are significant numbers of consumers currently filing under Chapter 7 who could fund meaningful repayment plans. The latter issue is an empirical question which I shall address for you today.

## II. Contemporary Evidence on Repayment Ability

### A. Credit Research Center, 1997 report

In October, 1997 the Credit Research Center at Georgetown University published the first in a series of reports on its ongoing study of Americans who file for personal bankruptcy (Barron and Staten, *Personal Bankruptcy: A Report on Petitioners' Ability-to-Pay*). The initial report provided a snapshot of filers' ability to repay their debts in 13 major U.S. cities. We found in all 13 cities that a sizeable percentage of Chapter 7 filers had enough income to repay at least some of their non-housing debts that would otherwise be discharged through bankruptcy.

#### Study parameters included:

- Approximately 3,800 usable bankruptcy petitions from a geographically diverse group of 13 major cities
- Selected cities represented about 18 percent of the nation's total filings in 1996
- All calculations were based on debtor statements filed with the bankruptcy court
- Calculations assume finance charges accrue on mortgage debt during the repayment period; no finance charge accrual on non-mortgage debt

#### Highlights of the results:

- 25 percent of Chapter 7 filers could have repaid at least 30 percent of their non-housing debt over a 5-year repayment period (see Figure 1).
- 5 percent of Chapter 7 filers could have repaid *all* of their non-housing debt.

### B. GAO Evaluation of CRC Report and Subsequent Analysis

At the request of Senators Grassley and Durbin, the U.S. General Accounting Office undertook an evaluation of our research methodology and formula for calculating the amount of petitioner income available to repay debts. In its evaluation (*Personal Bankruptcy: The Credit Research Center Report on Debtors' Ability to Repay*, GAO/GGD-98-47, February, 1998) the GAO concluded that "***overall, the Center report represents a useful first step in analyzing the ability of bankrupt debtors to pay their debts.***" However, the agency advised caution in the interpretation of the results based on five areas of concern.

A detailed discussion of our responses to the GAO's concerns is contained in the GAO report as Appendix 1. In several instances, we were able to supply additional evidence or analysis that was not available to the GAO from our original report. For the committee's benefit I have briefly summarized our response to each of the GAO's concerns below.

1. **GAO: *A scientific, random sampling technique was not used to select the courts so the conclusions cannot be projected to the entire nation.***

**CRC RESPONSE:** We did not draw a nationally representative probability sample. Instead, the study focused on samples of 300 bankruptcies filed in each of 13 major cities across 11 states. Selection of cities/courts was not random. Cities were picked to achieve variation in a number of factors believed to affect filing patterns (e.g., geographic location, unemployment rate, asset exemption rules in Chapter 7; see Table 1). This was the same approach used in the prominent and influential studies of bankruptcy petitions conducted over the past two decades, including Sullivan, Warren and Westbrook (*As We Forgive Our Debtors*, 1989) and the GAO's own study in 1983 (*Bankruptcy Reform Act of 1978 - A Before and After Look*, GAO/GGD-83-54, July, 1983).

Our sample revealed that a significant percentage of Chapter 7 filers had the capacity to repay some of what they owed in each of the 13 cities. ***We continue to believe that the uniformity of results across such a diverse group of cities strongly suggests a nationwide pattern.***

2. **GAO: *In determining how much income a debtor had available to repay creditors, the study did not subtract payments on debts that petitioners had agreed to reaffirm.***

**CRC RESPONSE:** In many bankruptcy cases, debtors agree to "reaffirm" a debt, i.e., repay a creditor on a set schedule outside the bankruptcy process, in exchange for keeping the asset on which the debt is owed (e.g., an automobile). The crux of the GAO's concern is how much *extra* could debtors pay toward their *unsecured* debts after accounting for such reaffirmations. We recalculated our payment percentages under two assumptions: 1) debtors reaffirmed none of their secured, non-housing debts and 2) debtors reaffirmed all of their secured, non-housing debts. Their actual experience falls somewhere in between.

***Even under the more extreme assumption that ALL secured debt was reaffirmed, we found that 31.6% of Chapter 7 debtors had enough income to repay, on average, 31.4% of their unsecured debt over five years (See Table 2 and Table 3).***

3. *GAO: The report did not clearly define the universe of debts for which it estimated debtors' ability to repay.*

**CRC RESPONSE:** In fact, our original report specifically defines this universe to include all debt not secured by real estate ("non-housing debt"), making no distinctions between secured vs. unsecured debts, or dischargeable vs. non-dischargeable debts. However, the GAO correctly pointed out that non-dischargeable debts impose a drain on the debtor's future income and should be incorporated into the calculations of a debtor's ability to repay **unsecured creditors**.

Table 2 reflects the recalculation of payment potential to incorporate **reaffirmation of all secured debt** and **repayment of all student loans**. Payments for unsecured priority debts (e.g., back taxes and child support) were already incorporated into the repayment calculations. Consequently, we believe Table 2 accounts for all debts which the GAO argued were repayable inside of bankruptcy ahead of unsecured creditors.

*We consider the remaining dollars that could be repaid to unsecured creditors to be substantial.* Even assuming full reaffirmation of all secured debts and repayment of all student loans, about 25 percent of all Chapter 7 debtors could repay something toward their unsecured creditors. On average, this group could pay 24.6 percent of their unsecured balances over a 5-year repayment period, but keep in mind that five percent of all Chapter 7 debtors could pay **all** of their unsecured balances.

4. *GAO: The report combined the results for all 13 cities sampled, with little discussion of the differences between individual cities.*

**CRC RESPONSE:** At least a quarter of the Chapter 7 petitioners *in every city* had the ability to repay at least some of their unsecured debt, even if we assume they reaffirm **all** of their secured debts (See Table 4).

5. *GAO: The report's findings are based on information provided by debtors, including estimates about their income and expenses in the future, which may not be accurate.*

**CRC RESPONSE:** This is true, but there is little practical alternative. Because there is no formal audit process conducted by the courts, there is no way to know whether the information reported by a debtor on the petition is accurate. The GAO conceded this point. Consequently, **any** empirical analysis of how much bankruptcy relief a debtor truly needs becomes problematic. Like all social scientists we necessarily made some assumptions (clearly stated in the report) upon which subsequent calculations were based. One assumption was to

accept without adjustment the debtor's own sworn statement to the court regarding monthly living expenses. *What the GAO seems to be recommending is for the bankruptcy court (or anyone else using the petition data) to compare the expense schedules with benchmarks of actual household expenses derived independently, such as those compiled by the U.S. Bureau of Labor Statistics. We would agree with that approach.*

As for future income, nobody (including the debtor) can know with certainty what will happen to the debtor's income over the 5 years subsequent to filing a petition. Certainly, a practical repayment plan ought to incorporate an income cushion to buffer the plan against unexpected expenses. Repayment plans should also contain re-write contingencies to adjust for potential income interruptions. In pointing out the need for both contingencies when implementing a repayment plan the GAO belabors the obvious. Nevertheless, until such time as the debtor's income does change from the level stated on the petition, our calculations reflect the best estimate available to the court of each debtor's ongoing payment capacity.

### C. Ernst and Young/Visa Petition Analyses

In its final commentary, the GAO stated that "We continue to believe that the concerns we found strongly suggest that additional research and clarification are needed to determine the accuracy of the Center report's conclusions . . ." (p. 19). In recent weeks two additional studies of petitioner capacity to repay have been released. Both were commissioned by Visa, U.S.A and both were conducted by the accounting firm of Ernst and Young. **In each case the results strongly corroborate our findings.**

The first study (February, 1998) focused on a sample of 5,722 Chapter 7 bankruptcy petitions filed in four bankruptcy courts (Boston, Chicago, Los Angeles, and Nashville), primarily during 1992 and 1993. The Ernst and Young research team replicated the calculations we used in the CRC study and found that repayment ability was somewhat higher in their own sample. For example, where we had found that 25 percent of Chapter 7 debtors could repay 30 percent or more of their non-housing debts over a 5-year period, Ernst and Young found that the top 25 percent could pay, on average, 45 percent of their non-housing debts over a 5-year period (See Figure 2)

The second study (March, 1998) was specifically designed to satisfy the GAO's statistical criteria for a nationally representative sample. Ernst and Young obtained a national sample of over 2,100 bankruptcy petitions filed throughout 1997 in 90 bankruptcy districts. Because that report was released just in the past few days, we have not yet had an opportunity (or the data) to conduct detailed comparisons with our own work.

However, because both Ernst and Young studies conducted a simulation of the impact of the "Bankruptcy Reform Act of 1998" (H.R. 3150), the results offer a basis for comparison if we conduct the same simulation with our own data. Table 6 displays results that are strikingly similar

across the three data bases. Using the criteria for needs-based bankruptcy as set forth in H.R. 3150, between 12 and 15 percent of Chapter 7 debtors *in each of the three samples* would be impacted by the needs-based provision of H.R. 3150 (See Figure 3). Of course, only the most recent Ernst and Young results was designed to make statistically valid national projections of the proportion of Chapter 7 debtors with repayment capacity. However, the similarity across the three data bases in outcomes triggered by the specific set of "needs-based" criteria set forth in H.R. 3150 suggests that many of the *hypothetical* sources of sample bias in the CRC data (i.e., city location, time of the year, day of the month) about which the GAO speculated in fact did not distort our calculations of repayment capacity.

## Conclusions

At the outset of my statement I noted that opponents to needs-based reform doubt that there are more than a trivial number of debtors in Chapter 7 who could fund meaningful repayment plans. I believe that empirical research has established that debtors with the means to repay are filing for Chapter 7 in sufficient numbers to be worrisome. Each of three distinct and independent data bases found that many debtors who filed under Chapter 7 had income to repay a significant portion of their debts over a 5-year period. *The nationally representative Ernst and Young sample indicates that 150,000 Chapter 7 filers during 1997 had the capacity to pay over \$4 billion on their unsecured debts had they been required to enter a 5-year Chapter 13 repayment plan.* Of course, these costs are ultimately passed along to the vast majority of consumers who handle credit responsibly.

Whether referred to as "needs-based-bankruptcy" or by some other label, the concept of limiting the Chapter 7 discharge to those who truly need it is an idea whose time has clearly arrived. By offering the lure of a Chapter 7 discharge without a demonstration of need, the present bankruptcy system does little to encourage the responsible use of credit.

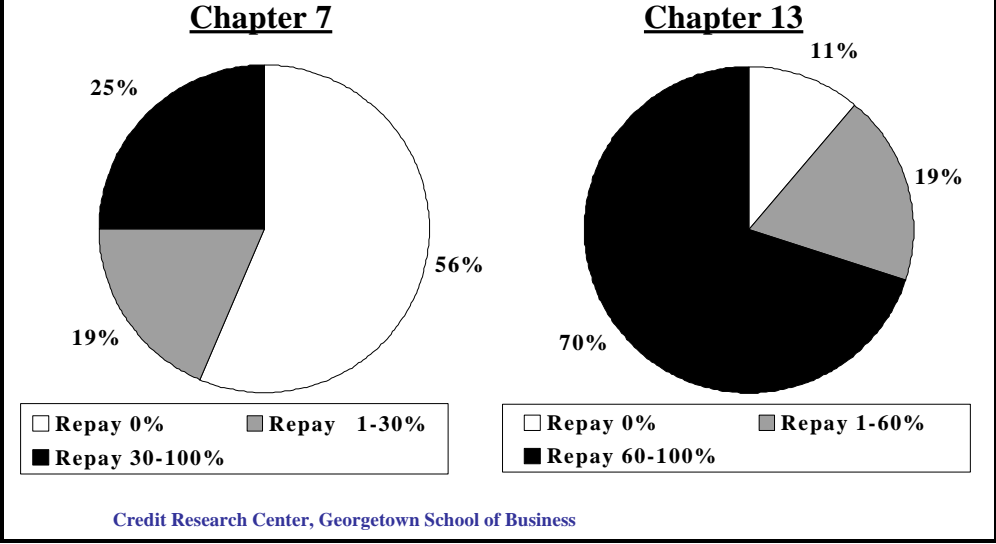
We are all worried about the dramatic and continued rise in the number of bankruptcy filings. Bankruptcy is a complex phenomenon with many causes, only a few of which can be addressed through the bankruptcy statutes themselves. Incorporating a needs-based eligibility requirement into the existing bankruptcy 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.

A needs-based approach that utilizes well-defined criteria to clearly signal how the court will treat a given debtor has much to commend it. Well-defined eligibility standards streamline the administration, promote consistent treatment, and reduce costly litigation. 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. It preserves bankruptcy relief for those debtors who truly can't pay. And, it 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.

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

**Figure 1**  
**Proportion of Debtors, By Percent of Repayable**  
**Non-housing Debt**  
**(5-year Repayment Plan)**



**Table 1**  
**Factors Underlying the Selection**  
**of Sample Cities**

<i>City/Court</i>	<i>% Chapter 7</i>	<i>% Change from Previous Year</i>	<i>Homestead Exemption</i>	<i>Unemployment Rate</i>
Los Angeles	82.2	15.7	\$75,000	8.4
San Diego	74.1	23.1	\$75,000	5.5
Phoenix	77.9	21.8	\$100,000	4.1
Houston	48.9	25.9	Unlimited \$	6.1
Dallas	50.2	19.5	Unlimited \$	4.6
Kansas City	84.2	24.5	\$8,000	4.4
Chicago	76.7	22.3	\$7,500	5.3
Indianapolis	81.6	16.8	\$15,000	3.3
Memphis	21.2	20.7	\$7,500	5.1
Atlanta	33.7	14.8	\$10,000	4.1
Tampa	82.0	21.9	Unlimited \$	4.1
Pittsburgh	86.7	31.9	No exemption	4.9
Hartford	87.2	19.4	\$75,000	6.3

Source: US Administrative Office of the Courts; National Bankruptcy Review Commission (memo by Elizabeth Warren and Melissa Jacoby, April 11, 1997); Bureau of Labor Statistics

**Table 2**  
**Potential Repayment of Unsecured Debt,  
 by Chapter 7 Debtors Across 13 Cities**  
**(5 year repayment period)**

	<u>Assumptions</u>		
	No secured debt is reaffirmed	All secured debt is reaffirmed, but <u>not</u> student loans	All secured debt <u>and</u> student loans are reaffirmed
% of filers who could repay some unsecured debt	39.7%	31.6%	24.9%
% of unsecured debt repayable among this group	36.9%	31.4%	24.6%

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**Table 3**  
**Dollars Repayable Toward Unsecured Debt**  
**(5 years, all secured debt reaffirmed)**

% of Chapter 7 Debtors	Minimum \$ Repayable toward Unsecured Debt
5	\$20,100
10	13,140
15	8,449
20	5,284
25	2,590

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**Table 4**  
**Range of Repayment Potential**  
**Across 13 Cities**

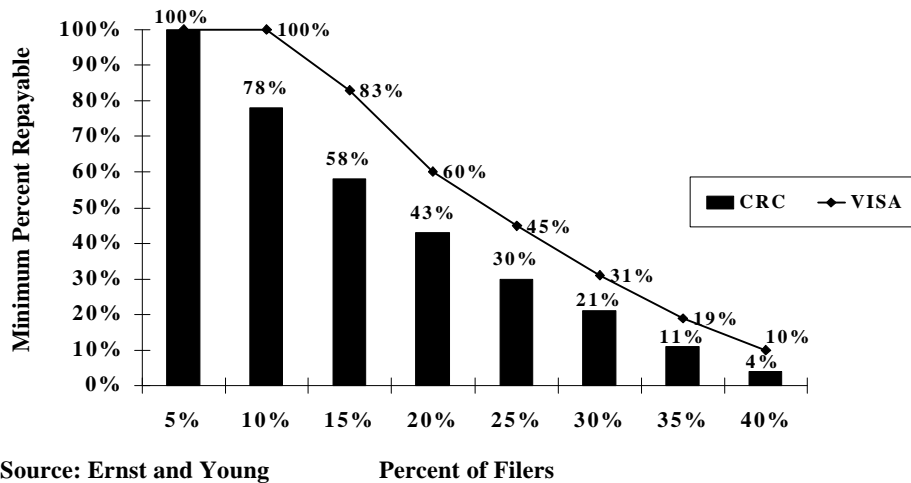
(secured debt reaffirmed, 5 year repayment period)

	<u>Overall (weighted)</u>	<u>Lowest City</u>	<u>Median City</u>	<u>Highest City</u>
% of filers who could repay some unsecured debt	31.6%	24.1 San Diego	34.6 Kansas City	49.4 Dallas
% of unsecured debt repayable	31.4%	19.2 Kansas City	31.8 Pittsburgh	47.3 Hartford

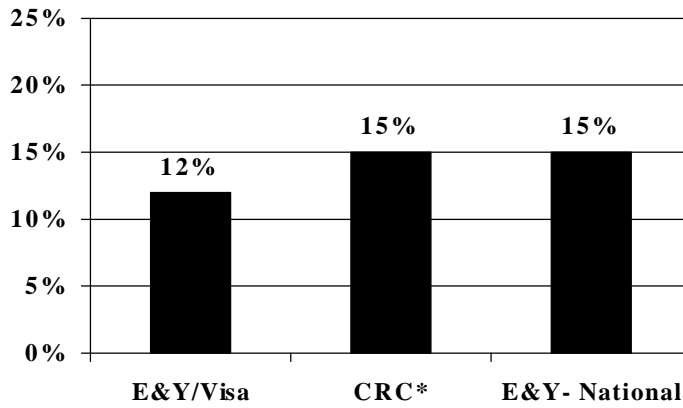
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**Figure 2**  
**CRC vs. Ernst & Young/Visa Results**  
**for 5-year Repayment**

(Non-housing, Non-Priority Debt Repayable by Chapter 7 Filers)



**Figure 3**  
**Three Perceptions of the Impact of HR3150**  
**Percentage of Chap. 7 Filers Moved to Chap. 13**



**\*Utilizes debtor's own statement of expenses (Schedule J)**

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