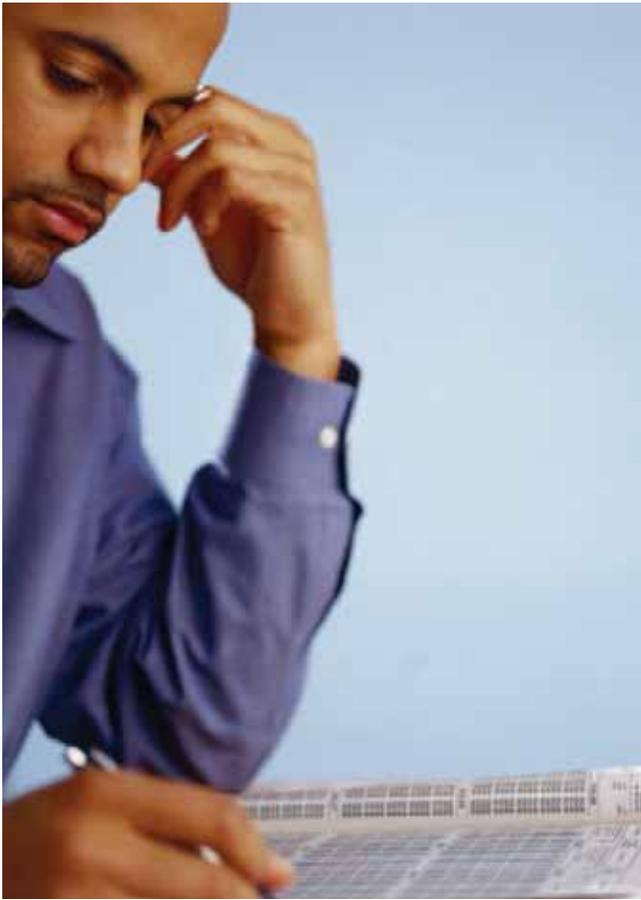


a look at household Bankruptcies



For most Americans, bankruptcy exists only in nightmares and the depression-era stories of our aging relatives. Our personal experience is limited to an unlucky stroll around the Parker Brothers' Monopoly® board, and we more often associate it with a struggling business than with our own family's finances. However, in 2003, a record 1.6 million U.S. households filed for bankruptcy to seek protection from their creditors and relief from their mounting debt. This figure has quadrupled in the last 20 years, and almost 9 percent of all households have now experienced a bankruptcy.¹ With financial insolvency becoming a reality for more Americans than ever before, it is worth taking a brief glimpse at the household bankruptcy decision. According to bankruptcy specialists and scholars, today's households are filing for the same reasons they were two decades ago. However, changes in the credit industry and the public mindset have potentially reduced the costs of bankruptcy—making it a more attractive option for families in financial crisis.

¹ As of the 1998 Federal Reserve Survey of Consumer Finance.



Bankruptcy: A Definition

Webster Merriam's English language dictionary equates bankruptcy with a state of financial ruin. However, the word traces its roots back to medieval Italy. An indebted Italian craftsman would find that his workbench, "banca," would be broken, "rotta," if he couldn't repay his debts. Fortunately for today's debtors, the modern concept is more forgiving:

One of the primary purposes of bankruptcy is to relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh.

U.S. Supreme Court, 1934.

As eloquently described by the chief justice, today's bankruptcy is a legal process intended for individuals and businesses who are unable to pay their creditors. Rather than fight an uphill battle to repay overwhelming debts, the U.S. bankruptcy system offers the unfortunate debtor a chance at a clean slate. The debtor has an

opportunity to settle his liabilities and end his cycle of debt.

When households file for bankruptcy, 70 percent of them file under Chapter 7 of the U.S. Bankruptcy Code. In these cases, the debtor liquidates all of his assets, using them to pay off his creditors. He is allowed exemptions for certain life necessities under state and federal law, but everything else is used to reconcile as much debt as possible.² Any unsecured debt, such as credit card and medical bills, that remains after the

liquidation is forgiven—free and clear—in a court-ordered discharge. The slate is not entirely clean, however. Secured debts, including home mortgages or car loans, as well as late child support payments and certain student loans, generally are not discharged. The debtor is required to repay these or risk foreclosure or other potential penalties.

The remaining 30 percent of household debtors file under Chapter 13. These debtors set up court-monitored payment plans to pay back their creditors over time. Unlike Chapter 7 filers, these debtors do not liquidate their assets, but instead pay their creditors out of their paychecks for the next three to five years. At the end of the payment plan, any remaining unsecured debt is discharged. Under

² These necessities typically include an allowance of housing, clothing, furniture, and personal items, but vary in generosity from state to state. For example, New Hampshire allows a \$50,000 homestead exemption, while in Texas, the entire homestead is exempt, regardless of value.

both Chapters, once a debtor receives a discharge, he cannot receive another for six years. There is no additional safety net.

The Bankrupt Household: Who and Why?

Most individuals who file for bankruptcy are in the prime of their working years. They are between the ages of 25 and 55. One half are homeowners, and over a third are married. While less likely to be college graduates, more than 80 percent of filers have completed high school, and 52 percent have had some post secondary school education. By these metrics, the bankrupt population is not markedly different from the general population. However, the vast majority of bankrupt households are low income. A 2001 survey of bankruptcy filers found that nearly 85 percent of the filers had household income levels that were below the 40th percentile of all households. The median income of these households was only \$24,108—virtually half the U.S. median household income.

These characteristics are fairly consistent with those of the bankruptcy population 10 years ago, and it seems that the recent rise in the number of filings cannot be explained by a change in the composition of households that file for bankruptcy. Nor can it be explained by any major shift in the reasons why households file. The majority of debtors continue to cite the same three causes of their financial woes: job loss, medical problems, and divorce.

Among the three, the most pervasive reason for household bankruptcy is a sudden income disruption caused by lost employment, working hours, or overtime pay. Elizabeth Warren, a Harvard Law professor and bankruptcy specialist, surveyed bankrupt families with children and asked them what ultimately led to their bankruptcy. Seventy percent of respondents stated that they filed after losing a job,

receiving a pay cut, or experiencing some other job-related problem. Similarly, Boston Fed economist Joanna Stavins studied bankruptcy filers in the Federal Reserve Survey of Consumer Finance and found that unemployment was the strongest predictor that someone would default on a loan—the first step on the path to bankruptcy.

This academic research is corroborated by Ara Berberian's experience counseling clients at the Consumer Credit Counseling Service of Southern New England, an agency providing low cost financial counseling services. "Many people think that our clients are folks who have just overspent," he says. "They envision people who have bought themselves expensive clothes and a big screen TV and run up huge tabs on their credit cards, but it's not really like that. Some of the most common reasons why people end up in trouble are that they lose a job or overtime pay, or one spouse reduces their hours after the birth of a child."

Like job loss, life's other unexpected curve balls can lead to bankruptcy. A sudden family medical condition or death was the second leading cause of bankruptcy cited by the families in Warren's study. The third was divorce and family break-up. In concert with these statistics, Stavins also found that either having health insurance or being married reduced the probability of debt default.

These same major bumps in the road have been causing bankruptcies for decades. Perhaps, then, the rising number of filings reflects a recent rash of bad luck befalling American households. But data from the 1990s do not support any signs of such a hex, according to Todd Zywicki, a researcher at the George Mason University School of Law. Zywicki examined data on each of the top three culprits and found that none of them conclusively accounted for the growing number of household bankruptcy filings.

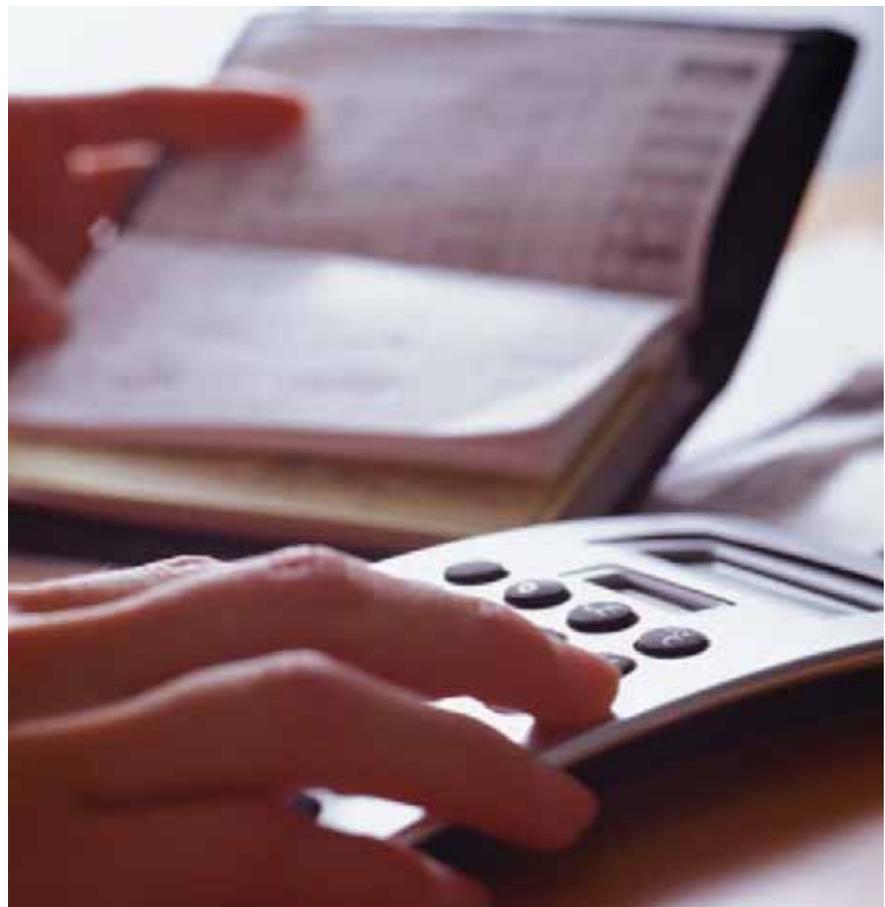
For example, the unemployment rate in the United States fell to record lows during the mid 1990s. Fewer families should have been hurt by job loss or affected by corporate downsizing during this period, not more. Similarly, Zywicki found that the divorce rate fell 25 percent between 1979 and 2002, suggesting that fewer households are experiencing this type of family break-up. While he did find that Americans' health care costs have risen, making an unanticipated trip to the emergency room all the more painful, the rise cannot sufficiently explain the increase in filings.

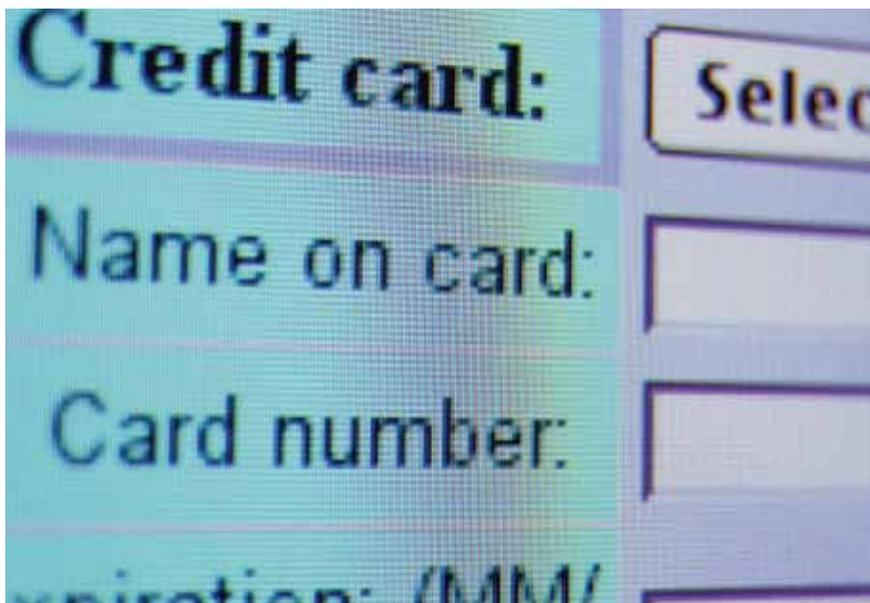
Becoming a More Attractive Option?

Americans are not experiencing a greater number of these triggering events, but more families do seem to be turning to the bankruptcy courts when calamity strikes. According to Warren, perhaps this should not be a

surprise. She estimates that 17 percent of all U.S. households would see a significant improvement in their current financial situation if they filed for bankruptcy. When families weigh the potential cost and benefits, the financial advantages of filing bankruptcy may be clear, and arguably the costs have decreased in recent years.

For starters, the expense of finding information about filing has noticeably declined. In 2004, people have greater access to information about bankruptcy than ever before. Advertisements for bankruptcy lawyers and services plaster phonebooks, pop-up ads, and billboards, while the Internet has put a plethora of information at our fingertips. Moreover, with the number of filers on the rise, a growing "word-of-mouth" network is informing the financial decisions of more and more families. Fully one-half of the filers surveyed by Warren first learned about bankruptcy through the first-hand experience of a friend or





family member. Given the increased awareness of bankruptcy, it is not surprising that the number of filings has risen.

The negative social image of bankruptcy has also lessened, reducing the public ramifications for many families. Economists David Gross and Nicholas Souleles recently found evidence that supports a decline in the social stigma associated with bankruptcy, in part explaining the rise in filings in the 1990s. The public softening toward bankrupts has been obvious to practitioners. Fleet Bank's head of consumer lending risk management, Steven Alexander, believes, "One of the major reasons for the rise in filings in recent years is that there is no longer as much stigma attached to it."

While these intangible costs are important, changes in the credit industry have reduced the monetary cost of filing for bankruptcy. Specifically, the 1980s and 1990s saw an escalating use of credit cards and the emergence of a sub-prime lending industry. Both events changed the bankruptcy cost equation for many families.

Changes in the Credit Industry

At the end of the bankruptcy process, a debtor's unsecured debt is forgiven, including credit card bills. As a result, the more unsecured debt you have, the more attractive bankruptcy becomes. In recent decades, Americans have taken on more credit card debt. According to Federal Reserve statistics, between 1985 and 2000, revolving debt rose from 20 to 40 percent of total non-real-estate consumer debt. Likewise, the percentage of households that carry at least one credit card jumped from 15 percent in 1970 to 76 percent by 2001. Credit cards have quickly become consumers' preferred form of currency, and the place where more households are choosing to carry debt. This shift toward credit cards has upped the amount of unsecured debt in the family portfolio, increasing the benefits of a bankruptcy discharge.

Accordingly, the credit card industry has been hit hard. In 2002, creditors lost \$18 billion in bankruptcy court. And while \$1.5 billion was recovered from filers in 2001, a mere \$350 million of this went to unsecured creditors. "By far, the biggest impact is on our credit card business," says Alexander. "Banks have raised their

projections for bankruptcies and charge-offs to try to cover these rising costs. However, a lot of smaller community banks' credit card programs are simply turning into retail outlets for larger credit card distributors who can better afford to take on the risk."

Despite this rising risk, the credit card industry has sustained its health, and today there are over 6,000 credit card issuers. Americans have greater access to credit than ever before, and stiff competition has made this type of credit blind to geographic and social factors. Today, you can get a credit card whether you live in Maine or Montana and regardless of your socio-economic status. However, given the copious supply, many Americans may be taking on more credit than they can handle. A study by economists Sandra Black and Donald Morgan showed that credit card holders have become a riskier bunch over time. In 1995, credit card holders were poorer, carried higher credit card balances, and maintained a higher debt to income ratio than they had in the late 1980s. The ready access of credit may be increasing some households' vulnerability to debt default and bankruptcy.

Emergence of Sub-Prime Lending

In addition to the credit card revolution, the sub-prime lending industry has also changed the bankruptcy equation for many households. Lenders in this business make loans at higher interest rates. As such, they provide a line of credit to individuals who may be ineligible for prime-rate loans, including former bankrupts. A red flag on an individual's credit report for 10 years, a bankruptcy has nearly always resulted in an automatic turn-down for loans. Today, however, many sub-prime lenders will extend loans to these debtors, and bankrupts can now find needed credit soon after they file.

This availability has reduced the cost of bankruptcy for many households. Being locked out of credit is a

formidable situation, and the thought of being barred from loans to purchase a house, buy a car, or pay for school proved a major deterrent for many households. Today, sub-prime loans are available to fill these credit needs—in some cases, within a year of filing. The financial implications of lost access to credit are no longer as pertinent as they once were. “People know that they can buy a home even if they choose to file,” says Berberian.

High Costs Remain

While the various costs of bankruptcy have declined, households that file still face significant challenges in their financial future. Importantly, credit will still be harder to come by and more expensive. Many banks and credit card companies continue to automatically turn down applications when a bankruptcy appears on a credit report, and it may be several years before the bankrupt household can access the prime lending market again. “Sub-prime lenders will lend to former bankrupts after 1 to 3 years. However, most banks won’t for the first 5 to 6 years,” says Alexander. “At that point, they will consider it only if the individual has established good credit since the filing.”

The sub-prime loans that are available carry higher interest rates by definition and will cost more over the life of the loan. Likewise, credit card offers made to this population often contain high rates and fees. The higher priced credit can confound the budgeting efforts of a family that has already cut its financial safety net.

Some amount of bankruptcy’s social stigma also remains, affecting families in a number of ways. Potential employers will learn of a bankruptcy in their review of an individual’s credit record and perhaps raise some embarrassing questions. Similarly, landlords who run credit checks on prospective tenants will see the bankruptcy and may be less willing to rent their properties to former bankrupts, closing

the door on housing opportunities. Bankruptcies are also a matter of public record. Debtors may find that their names are published in the newspaper, and most debtors’ identities will turn up in any Internet search of filers. The stigma of bankruptcy may be weakening, but many negative perceptions remain.

For this reason, “the vast majority of our clients view bankruptcy as their very, very absolute, last resort,” says Berberian. “Probably nine times out of 10 when we tell them bankruptcy is an option, they tell us, ‘It’s not an option for me.’”

A Role for Financial Education

Given the remaining burdens of bankruptcy, solutions are needed to stem the rising tide of households that are finding themselves in financial trouble. Both research and experience have shown that the best way to reduce the occurrence of debt default is to teach individuals the basics of

debt and asset management. Financial education may be an effective way to curb the escalating number of household bankruptcy filings.

There is backing for this approach. “I’m a big supporter of using financial education to prevent bankruptcies,” says Fleet Bank’s Steven Alexander. “Most customers who build up debts want to work it out with us. They want to pay back the loan. But sometimes, they just don’t know where to start. The industry definitely sees an important role for financial education.”

Financial training is especially needed for the growing number of households that have already experienced bankruptcy. According to Alexander’s banker’s rule of thumb: “Those who have had one bankruptcy are more likely to have another.” The empirical data support this claim. Joanna Stavins found that former bankrupts had higher debt to income ratios and higher unpaid credit card balances and were more likely to



default on future payments than other households in her study. To aid these chronic filers, some federal legislators have proposed requiring financial education classes as part of the bankruptcy process.

Currently, credit-counseling agencies provide one of the major sources of financial education for potential bankrupts and struggling households. Each year, two million people turn to these agencies for help.

Financial education is the best way to reduce the occurrence of debt default.

The agencies aim to give these families a better understanding of their financial situations and the tools that they will need to start improving their financial pictures. The Consumer Credit Counseling Services of Southern New England goes through an extensive income and expenditure analysis with every client. “We ask them about everything: How much are you spending on stamps, hair cuts, socks, veterinary bills for that free cat you picked up at the shelter?” says Berberian. “In the end, most people say, ‘Wow! I really didn’t realize I was spending that much.’”

The Credit Research Center at Georgetown University showed that credit counseling is helping many American households to climb out of debt. Individuals who sought the advice of a credit counselor, and did not sign up for a debt management plan, significantly improved their credit profiles over a three-year period. These individuals decreased their debt, reduced their number of delinquent payments, and improved their credit scores.

Ideally, however, financial basics should be learned before any loan is

ever obtained, and long before bankruptcy is looming on the horizon. First-time homebuyer courses are one model of pre-emptive financial education. These classes help families to learn the responsibilities of homeownership and to gauge an appropriately sized mortgage. Controlling for other factors, Abdighani Hiram and Peter Zorn showed that graduates of pre-purchase homeownership counseling were less likely to become delinquent on their mortgages. Steven Alexander hopes, “This type of training could be created around all types of lending and equip borrowers with the skills they need to manage any loan.”

Many national and local programs have begun providing pre-emptive financial education, and many are targeting the next generation of borrowers—school-age children. Financial education alone will not halt the rising bankruptcy rate, and it certainly can not stop the unpredictable from occurring. Job loss, health problems, and family break-ups will continue to affect America’s families and threaten their financial stability. Financial education can, however, help each household to prepare for the challenges that lie ahead.

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