Personal Bankruptcy Reform of 2005: Means-Testing or Mean-Spirited?

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BAPCPA and means-test

Under old law...
- All filers eligible for Chapter 7
  - Liquidation of **nonexempt** assets
  - But remaining unsecured debt **discharged**

Under new law...
- Filers with income > state median may be forced into Chapter 13
  - Keep all assets
  - But must repay most of debt over next five years
Rapid increase in bankruptcy filings

Annual Consumer Bankruptcy Filings
Per 1,000 households

Source: Administrative Office of the U.S. Courts; American Bankruptcy Institute
Is average Joe worse off?

- Decrease in insurance against bad luck

“America is...likely to turn into a debt-peonage society”

Paul Krugman, NYT, March 8, 2005
BAPCPA has upside

- Increased creditor protection lowers creditors’ costs
- With sufficient competition, savings get passed on to borrowers
  - Over $30 billion written off every year
- Curb strategic filings by irresponsible borrowers
Evidence on strategic filing

- Reduced stigma
- Forum shopping: consumers move to high exemption states before filing
- Financial incentives are main driver in decision to file
Rush to file

Bankruptcy filings per week

Week of Year

2001-2004

2005
Higher rush in higher exemption states

Percent Change in Chapter 7 Filings
2005q4 over 2005q3
Strategic filings restrict access to credit and increase costs

- More likely to be turned down for credit in high exemption states
- Higher APRs in high exemption states
- Countries with more creditor protection have greater private debt/GDP ratios
- BAPCPA reduces strategic filings → lower costs of credit
Credit card competition is crucial

- Without it, lower creditor costs are not passed on to consumers
- Doubts…
  - Credit card interest rates sticky
  - High profits
  - Complex pricing may confuse consumers about true cost
  - Creditors gain with BAPCPA passage
Costs of credit have not fallen yet...

### Graph

**Spreads and Charge-offs**

**Credit Card Asset-Backed Securities**

- **Percent of Portfolio Par**
  - May-04
  - Aug-04
  - Nov-04
  - Feb-05
  - May-05
  - Aug-05
  - Nov-05
  - Feb-06
  - May-06
  - Aug-06
  - Nov-06

**BAPCPA ‘05**

- The graph shows the percent of portfolio par for spreads and charge-offs on credit card asset-backed securities from May 2004 to November 2006.
- There is a significant drop in the percent of portfolio par after November 2005, possibly due to the implementation of the BAPCPA ‘05.
...but they may: spreads rise and fall with charge-offs
Potential downsides from BAPCPA

BAPCPA

- reduces insurance
  - Half of filers cite medical causes
- reduces entrepreneurship
- reduces labor supply?