As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America[1]

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This $250,000 study may be the most extensive empirical study of consumer bankruptcy ever undertaken, taking some six years to conduct. The authors describe the law and the statistics in clear, nontechnical language, combining a thorough statistical description of the social and economic position of consumer bankrupts with human portraits of the debtors and creditors whose journey has ended in bankruptcy court. The book devotes several chapters to hidden sub-groups in bankruptcy. One focuses on women, analyzing the desperate financial circumstances of single women and the increasing pressure on one-income families. Another reveals that more than half of the bankrupts are homeowners and discusses the anomalies in the way they are treated by current law. Other chapters examine the surprising role of medical debts in financial collapse and give a new account of the financial pressures on small businesses. The book also provides a detailed analysis of the position of various types of creditors of bankrupt persons.

Among the findings of the study are:

- Typical bankruptcy debtors carry staggering debt loads averaging more than two year's income.
- Creditors extend an enormous amount of unsecured credit to obviously bad risks and the traditionally conservative lenders, like banks, make many of the riskiest loans.
- Bankrupt debtors are a social cross-section of America, owning homes and holding jobs like their middle-American counterparts.
- Some creditors are able to avoid most bankruptcy losses.
- Many people file bankruptcy after their income has gone up.
- Single women in bankruptcy are the poorest of the poor.
- The amount of property that state law permits debtors to keep after bankruptcy has little effect on most debtors' bankruptcy decisions.

[1]*Oxford University Press, 1989, ($29.95), 200 Madison Avenue, New York, 10016.*

The authors take serious issue with the Purdue Bankruptcy Study which attempted to show that a significant number of bankrupt individuals could have paid off all or a portion of their debts. Instead, they found that perhaps only 5% of all bankrupt debtors might be abusing the system or might have more complicated financial situations than their files reveal. Or, they might have been badly advised by lawyers eager to process cases in a high-volume practice, rather like physicians who administer unnecessary treatment. (p.329)

The authors state:

> We found virtually no debtors who seemed to take bankruptcy on a lark (or) to deal with relatively minor debts in relation to their incomes. Instead, the debtors ... were in so much financial trouble we had to wonder how they had stayed out of bankruptcy so long and what it must have been like in the months or years before filing as they dealt with debts that grew mountainous beside an unsteady income. The fact that the debtors in our sample did not choose bankruptcy earlier, given the disastrous state of their affairs, suggests to us that many of them tried longer than was reasonable to avoid discharging their debts. If the economic theorists are correct that moral conviction and stigma are the principal deterrents to bankruptcy, the data suggest that these deterrents work. One out of five bankrupt individuals reaffirm some of their debts, often for no discernible reason other than their sense of obligation. (pp.337-338)
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> Perhaps our most dramatic finding confirms the marginal economic position of American women, especially women heading their own households. The bankruptcy data sound a different caution: The middle class wife who doesn't work may be an endangered species. (pp.329-330)

Another high-risk group uncovered in the bankruptcy data is entrepreneurs. "Many thousands of Americans go into personal bankruptcy each year as the price of an entrepreneurial system that includes a high rate of failure for small business" (p.330). One discovery in these data is a group of formerly self-employed debtors... who have found a job by the time of filing, but their financial collapse derives from failure of a small business. The 10.4% of the debtors in the bankruptcy sample in business at the time of filing is nearly matched by the 9.6% who are formerly self-employed, combining to make one in five people in bankruptcy a failed entrepreneur. Entrepreneurs are nearly three times more likely to go into bankruptcy than their representation in the labor force. The self-employed and formerly self-employed make up about 20% of our sample, but they account for more than half of all its debts. These are officially listed in official bankruptcy statistics as non-business bankruptcies, and any analyses that depend on that classification are fatally flawed" (p.330).

> A few debtors used bankruptcy to deal with crushing medical debts, a few others seemed unable to resist the lure of their credit cards, and a very few waltzed through the bankruptcy courts more than once. But their numbers were small.... The reality is the far more ordinary story of middle-class people drowning in debt. (p.331)

Causes of Bankruptcy

The authors observe that the primary causes of the bankruptcies they studied were:

1. The general increase in consumer debt:

> The rise in bankruptcy has, in a general sense, been coincident with the rise in consumer debt. (Bankrupts) represent a cross section of typical Americans, except that they have debts far out of proportion to their incomes. (p.331)
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> The analysis of credit card debt, for example, reveals a substantial group (about 15% of the wage earners) who owe more than half a year's income in credit card debt alone. These cases break down into two parts: those who ran up huge debts compared to existing income, and those for whom income dropped or was interrupted, making their debt insupportable. (p.332)

2. Income volatility:

> Income volatility is an important factor in consumer bankruptcy. Nearly half our debtors suffered large income changes in the two years before bankruptcy. Debtors who save little and charge to the limits of prudence are making a wager with Providence, betting that they can never get sick or be fired, or that they can quickly find new jobs if they lose the ones they have. The twin evils of economic volatility and irresponsibility haunt increasing numbers of debtors and creditors. (p.333)

3. Attorney advertising:

> Lawyers advertising bankruptcy services in newspapers and on television may contribute to increasing filing rates....The barrage of information about the availability of bankruptcy surely caused some consumers to decide that bankruptcy, rather than some other response, was the best solution to their financial problems. (This) was the unanimous view of the judges and other bankruptcy experts we interviewed, and it fits the available data. (p. 336)

The authors of this study also conclude that contrary to general opinion, Chapter 13 is a very poor option for most consumers having debt problems, and that they would be better off most of the time filing for Chapter 7.

The authors stress the importance of prudence:

> The data show debtors, middle-class people like ourselves, increasingly at risk for a sudden economic collapse....In effect, we have a consumer credit system in which the risk of individual or even system collapse rises with every increase in debt, and the only check on its growth is the prudence of its borrowers and lenders. The data suggest that borrower and lender prudence may be too weak to match the increasing risks of consumer debt. (pp. 324-325)

Conclusions

The extensively documented and readable findings of this bankruptcy study have broad implications. The findings frequently differ from what many observers have believed to be true including what action may be in the best interest of those contemplating bankruptcy. This book is certainly very important reading for AFCPE members, other financial professionals, and for those in the lending and policy-making segments of our community.

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