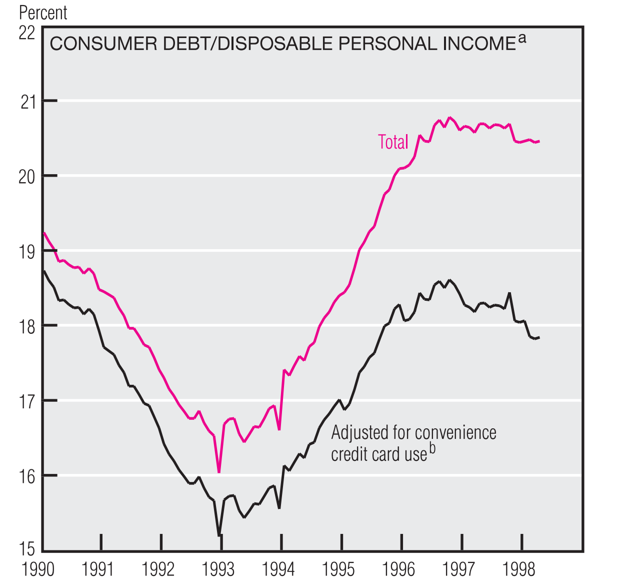
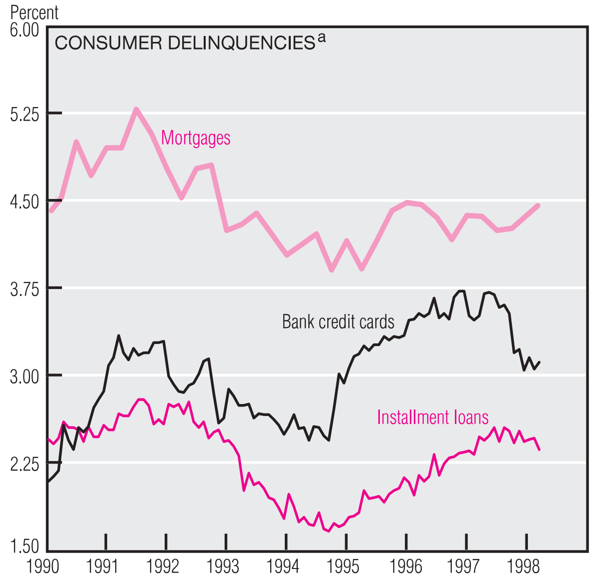
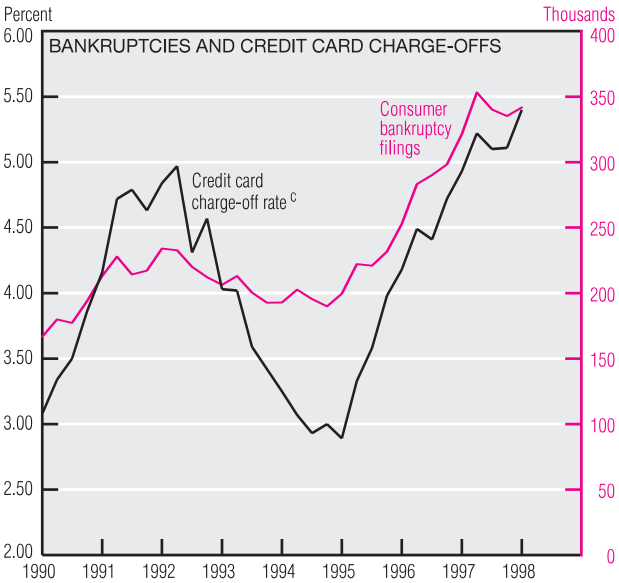
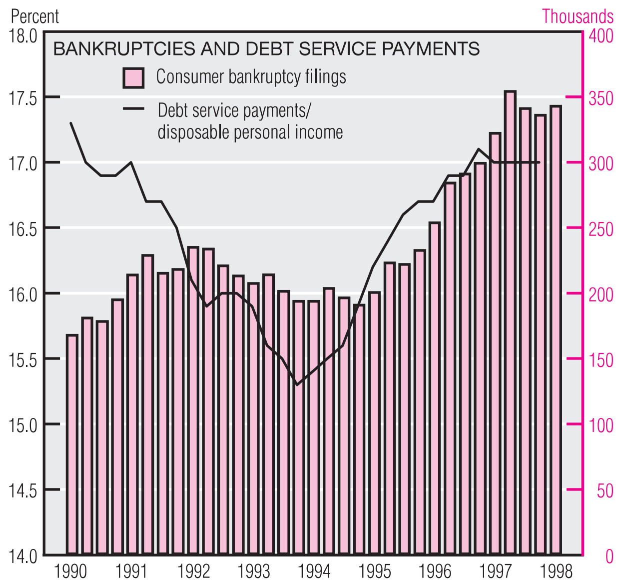
Consumer Debt and Bankruptcy









a. Seasonally adjusted.

b. Adjusted consumer debt as a fraction of disposable personal income is calculated using an estimate of bank card debt actually accruing finance charges.

c. Net charge-off rate is the percentage of total credit card debt that banks remove from their balance sheets because of uncollectibility, less amounts recovered on credit cards previously charged off, annualized.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Administrative Office of the U.S. Courts; American Bankers Association, *Consumer Credit Delinquency Bulletin;* Federal Deposit Insurance Corporation, *Quarterly Banking Profile;* Mortgage Bankers Association of America, *National Delinquency Survey;* and Ram Research Group, *Bankcard Update/Bankcard Barometer.*

After rising at a breakneck pace early in the current economic expansion, total consumer debt burdens seem to have leveled off and even to have dropped over the last couple of years. Furthering this impression that household financial conditions are more stable than in the recent past, credit card delinquency rates have dropped sharply over the last 12 months, while delinquency rates on mortgages and other consumer installment loans have stayed relatively constant.

Despite these encouraging trends, record numbers of individuals have continued to file for bankruptcy, nearly 1.35 million of them last year alone (up 20% from 1996). Recently released figures show that consumer filings in the first three months of 1998 were up more than 6% from the same period last year. Following historical patterns, the percentage of credit card balances that lenders write off as uncollectible rose in lockstep with bankruptcy filings, to 5.4% of outstanding balances in the first quarter of this year.

Not surprisingly, the record rise in personal bankruptcy filings has fueled interest in reforming bankruptcy laws. Just last month, the U.S. House of Representatives passed the Bankruptcy Reform Act of 1998; the Senate is scheduled to debate its own reform bill later this summer.

During these debates, many analysts have cited record levels of consumer debt as the driving factor in the recent rise in bankruptcy filings. Research by Professor Michelle White at the University of Michigan, however, suggests that borrowers

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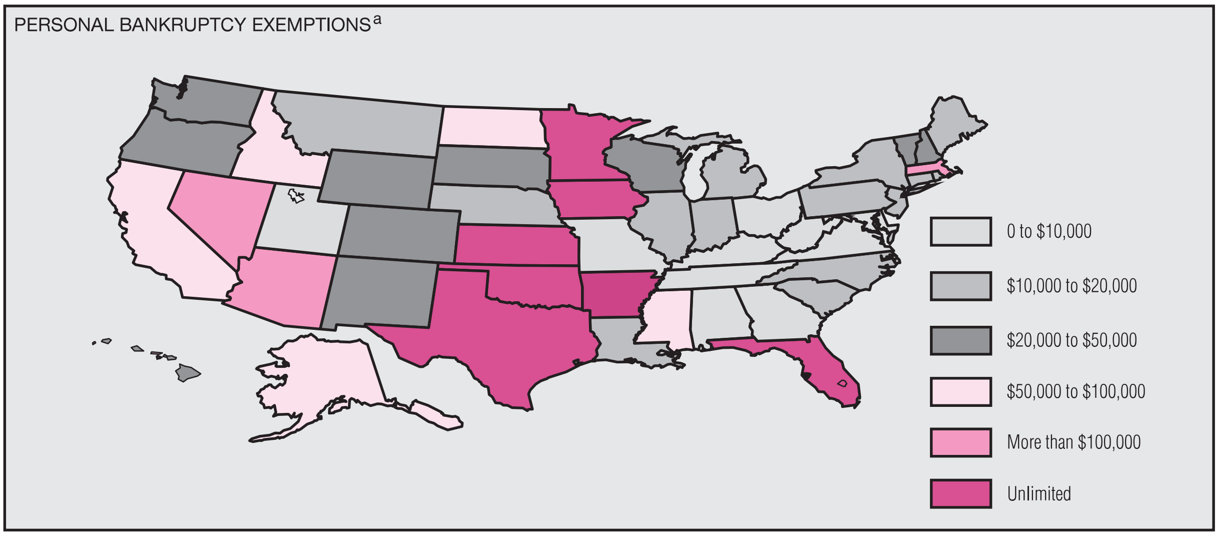
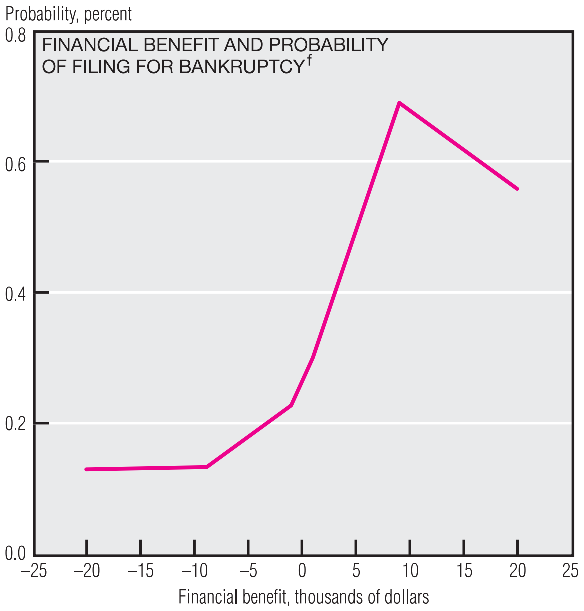
Consumer Debt and Bankruptcy (cont.)



Financial Benefit from Bankruptcy

State	Total allowed exemptions[a]	Percent of households that would benefit[d]	Median net benefit of filing[c]
California	$76,600	16	$1,700
Florida[b]	Unlimited	14	$1,950
Illinois	$10,700	14	$1,500
Louisiana	$15,000	10	$1,720
Massachusetts	$101,675	18	$1,770
Michigan[c]	$12,850	14	$1,650
Mississippi	$85,000	30	$1,650
New Jersey[c]	$12,850	14	$1,650
New York	$14,900	16	$1,400
Ohio	$6,800	11	$1,585
Texas[b]	Unlimited	32	$1,680
U.S.	$12,850	17	$1,650



a. Total allowed state or federal exemptions, from White (1998).
b. State law permits residents to retain unlimited equity in a personal residence.
c. State law permits the more generous federal exemption.
d. Proportion of U.S. households for which the value of debt discharged would exceed the value of assets forfeited in bankruptcy.
e. Median net benefit of filing for bankruptcy among those for which this benefit is positive.
f. "Average" household's probability of filing for bankruptcy as the benefit from doing so varies.
SOURCES: Michelle J. White, "Why It Pays to File for Bankruptcy: A Critical Look at Incentives under U.S. Bankruptcy Laws and a Proposal for Change," *University of Chicago Law Review,* forthcoming, tables 1, 3, and 4; and Erik Hurst, Scott Fay, and Michelle J. White, "The Bankruptcy Decision: Does Stigma Matter?" University of Michigan, Department of Economics Working Paper 98–01 (1998), figure 5.

base the decision to file for bankruptcy on their overall financial benefit from doing so, not just their debt levels.

A borrower's financial benefit from filing is simply the value of any debt that would be discharged in bankruptcy minus any assets that would be forfeited. In bankruptcy, borrowers are allowed to retain some assets, even as their debts are erased. The permitted level of these personal exemptions varies from state to state, with some allowing an unlimited "homestead exemption" for a residence. As a result, an individual's total financial benefit from filing for bankruptcy varies not only with his level of debt, but also with the amount of personal exemptions his state allows.

Professor White calculates that, while these incentives vary substantially across states, roughly 17% of all U.S. households could benefit financially from filing for bankruptcy; within that group, the median reduction in debts compared to lost assets would be $1,650. Clearly, not every borrower with a financial incentive actually files for bankruptcy, but separate research has shown that borrowers who stand to gain a strong financial benefit are substantially more likely to do so. This suggests that to understand recent trends in filing levels, we must consider personal exemptions as well as consumer debt burdens.