Conversations with bankers in the Fourth District suggest that careful examination of the causes of their consumer loan losses has not yet been undertaken. Few have compiled figures on loan losses due to bankruptcy or identified the characteristics of their bankrupt clients. Bankers agree, however, that the new code has increased consumer loan losses and that lending practices would be changed as a result.

Of the intended changes, many banks plan to extend less credit—by requiring larger down payments, making fewer loans, eliminating student loans, using stricter loan requirements (especially for persons with previous bankruptcies), and indirect lending. Others indicated that they would increase loan interest rates where possible, institute late payment fees on credit cards, and make variable rate loans.

Conclusion

Whether or not the new code is responsible for the increased number of bankruptcies, creditors are preparing to alter their consumer lending practices. If the code is totally or even partly responsible, it should be amended. If the new code is only partly or not responsible, bankruptcy experience can be an indication of a misallocation of resources—an over-supply of loans to the consumer sector that only tightened credit policies can remedy.

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Address correction requested

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Lender Reaction to Recent Consumer Bankruptcy Experience

When the new code went into effect, creditors were unable to assess its impact. The code is very complex, and its intention appeared to treat creditors and debtors more equitably. Since implementation of the code, creditors have become virtually unanimous in their beliefs that the new code favors debtors over creditors to a greater extent than the previous law. Although it is clear that the ability to negate certain nonpurchase money security interests favors debtors over creditors, the net effect of the other provisions is not clear. Some, including Ohio, have overridden the federal exemption levels with their own lower exemption levels. In other states, the differences between state and federal exemption levels most likely favor some creditors more than others, depending on which set of exemptions a debtor chooses. The new restrictions on actions that creditors can take against debtors unquestionably favor debtors over creditors, but their relative influence on creditors is again unclear.6 Some creditors are no longer able to take certain actions, but other creditors are better able to protect their interests. The new offset provisions, for example, favor creditors that are not also depository institutions.

Furthermore, all creditors may be better off if the new code eventually succeeds in promoting repayment rather than liquidation. It is too soon for anyone to have made a careful study of the impact of the new code on consumer bankruptcies. However, such studies will be required both for policymakers to correct deficiencies in the new code and for creditors to adjust consumer lending policies. If the new code has artificially encouraged bankruptcy filings, reform of the code will be required and creditors probably need not modify their lending practices. If the root of the problem goes deeper, other steps will be necessary. For example, many people argue that the amount of consumer credit has been too abundant in recent years, allowing consumers to overextend themselves too easily. When an economic slowdown occurs, consumers are severely constrained by highly leveraged balance sheets. In this case, creditors must tighten loan requirements for all consumers or at least for those consumers whose financial positions fluctuate with business cycles. Data on individual consumer debtors, as well as aggregate statistics on all consumers, need to be assembled and studied to recommend the appropriate creditor and/or policy responses.


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changing attitudes toward bankruptcy, ad-
vertising by lawyers, the economic slow-
down during the second quarter of 1980, and the deterioration of consumer balance
sheets; the new bankruptcy code may also be partly responsible for the increased
number of bankruptcies. This Economic
Commentary examines the major changes
of the new bankruptcy code and the poten-
tial reaction of consumer lenders.

Major Provisions of the New Bankruptcy Code

Consumer debtors continue to have two
voluntary bankruptcy options under the
new bankruptcy code—liquidation under Chap-
er 7 and rehabilitation under Chapter 13.3
Any consumer debtor can voluntarily file
for a liquidation or straight bankruptcy if he
has not filed for such a bankruptcy in the
previous six years, although he may file
within six years of a previous Chapter 13
bankruptcy. Under liquidation, debtors re-
linquish all nonexempt assets to creditors in
return for a discharge from all allowable
debts. Similarly for a straight bankruptcy,
a debtor must have a regular income, un-
secured debt totaling less than $100,000, and
debt secured totaling less than $350,000.
Unlike liquidation, Chapter 13 individuals
do not surrender nonexempt assets to
creditors for distribution. Instead, debts are
paid over time out of future income; when
payments are completed, a debtor is dis-
charged from all debts covered under the
plan. The basic criterion of a Chapter 13
bankruptcy is that all creditors must be at
least as well off as they would have been
had a debtor filed a Chapter 7 bankruptcy.
A major provision broadened under the
new code is the automatic stay; this provi-
sion significantly circumscribes creditor
action against debtors once a bankruptcy
petition is filed. The automatic stay under
the former law did not prevent certain
creditors from taking certain actions that
affect them an unfair advantage over other
creditors in the dissolution of a debtor’s
estate. The automatic stay under the new
code promotes equitable treatment of all
creditors by preventing their beginning or
continuing (without court approval) any
act of lien enforcement, repossession of a
debtor’s property, confiscation of a debtor’s
demand, savings, or time deposits (called
setoff), acceleration of debt repayments,
reaffirmation, or other alteration of a loan
agreement. In addition, the new stay applies
to all property of a debtor, regardless of
who possesses it or who holds the record title.
When the bankruptcy courts have a backlog
of cases, as they do now, the automatic stay
permits a debtor to retain possession of the
collateral at least until the bankruptcy
plan is settled.

The new stay unquestionably alters the
court's role. As a result, certain limita-
tions are placed on the continuance of the
case. For secured lenders, the new code in-
cludes new provisions that would decrease
the value of their interest. More-

3. Consumer debtors also may be involuntarily
placed in straight bankruptcies if a bankruptcy
petition is filed by at least three creditors or by
at least one creditor if there are fewer than twelve,
and if the total value of the creditors’ claims
sum to at least $5,000. The filing of involuntary
bankruptcy is made easier under the new code.

the court modifies a secured loan contract; a secured
lender is to be “reimbursed” for his lost
value by receiving: a) periodic payments from
a debtor in cash, b) additional or
replacement liens on other property, or
c) other non-cash consideration. The reimbursement,
of course, is limited to the extent of the
decrease in the value of his interest. More-
over, any creditor may request the court
to void for fraud the stay if he feels that it
will be improperly enforced. If a creditor
believes that the collateral value is too low,
he must prove this to the court. Otherwise,
a creditor must prove that the stay is necessary.
The new code also restricts certain actions
taken by creditors before the bankruptcy
petition is filed. Setoffs are one example. When
a creditor takes a setoff within 90 days of filing, a debtor
may recover a creditor’s improvement of position between
the 90th day prior to filing of the bankruptcy
petition and the date of the setoff. For
example, suppose that a debtor owes $1,000
to a bank 90 days prior to filing and that
there is $100 in the debtor’s bank account at
that time. On the day before filing, $1,000 is
still owed, but there is $900 in the debtor’s
bank account. If the bank takes the setoff
when there is $100 in the account, the setoff
is invalid. If the bank takes the setoff when
there is $900 in the account, however, the bank
improves its position by $800 and the debtor
can try to recover the $800.

The new code also places tighter reins on
preferences. A preference is any transfer of
any property interest (including cash or se-
curity interest, for example) to a creditor
or for his benefit; the transfer must be made
within 90 days before the date of bankruptcy
while the debtor was insolvent, and it must
enable a creditor to receive more than he
would have received in the bankruptcy pro-
ceeding without the transfer. In the past, a creditor
could threaten wage garnishment or
repossession to force a debtor, before he
filed for bankruptcy, to pay some amount of
money, thereby favoring one creditor over
others. Considering the exclusions to the
preference provision in the new code, a
debtor can in effect recover payments made
to creditors within 90 days prior to bank-
rupency. Therefore, creditors can no longer
be paid in excess of the fair market value
made. However, to the extent that the credi-
tor is over-secured, payments received within
90 days will not be considered a preference.

Actions that unsecured creditors can
take continue to be severely restricted under
the new code; unsecured claims continue to
be subordinated to secured claims. The
automatic stay generally stops interest on
all unsecured debt, but if a debtor is
insolvent, interest is paid at the legal rate.
In a Chapter 7 bankruptcy, co-debtors can be
pursued without court permission; but
in a Chapter 13 bankruptcy, co-debtors
usually can be pursued only if the plan
does not propose full repayment of un-
secured debt. In addition, unsecured cred-
itors have no say in the confirmation of a
Chapter 13 bankruptcy.

The other major changes of the new
code relate mainly to the valuation of a
debtor's estate and hence the "fresh start"
available to a debtor. These include the
valuation of secured claims, exemption
levels, reaffirmations, and discharges. If the amount of a secured
debt in some property is greater than the
collateral value of that property, a creditor
has a secured claim only for the collateral
value and an unsecured claim for the excess.
That is, the present value of the secured
claim is only the collateral value. If the
collateral value is greater than the amount
of secured debt, then a creditor will be
allowed interest on the claim at the con-
tract rate plus any agreed upon fees.

A new set of federal exemption levels
has been introduced in the new code.
The former law permitted only state exemption
levels, which had not been revised to reflect
the recent inflation experience in the United
States. The new code allows debtors to
choose either federal or state exemption
levels, unless state law permits only state
exemption levels. Using federal exemption
levels, a consumer debtor can exempt
amounts from the value of his estate $7,000
in any property (of which $7,500 may be
a homestead or burial plot), $1,200 equity in
one motor vehicle, $500 equity in jewelry,
$4,000 equity in cashier surrender value of
life insurance policies, an unlimited amount
of equity in professionally prescribed
health aids, and miscellaneous public bene-
fits and injury awards. As long as property
is held primarily for immediate family or
household use of a debtor or his dependents,
a debtor also may exempt up to $200 to $300
in equity for any number of items in the fol-
lowing categories: household furnishings
and goods, wearing apparel, appliances,
boats, animals, crops, and musical instru-
ments.

Finally, a debtor may exempt an
amount of $750 to $250 in personal
professional books, or tools of his trade or
that of his dependents. If a husband and
wife file a joint-bankruptcy petition, two
sets of exemptions may be taken.4 Judicial
liens and nonpurchase money security
interests in household goods, books, or tools
does not tape or trade in professionally pre-
scribed health aids may be avoided in order
to enforce these exemptions.5

A related provision concerns redemption.
A debtor may redeem tangible personal
property from a lien securing a dischargeable
consumer debt if such property is declared
exempt or has been properly abandoned,
by paying the lienholder the lesser of the
collateral value or the amount of the debt.
Although the automatic stay restricts
actions that creditors can take to obtain
reaffirmations from debtors, debtors may
voluntarily reaffirm debts, the reaffirmation
must be made before the debt is discharged
and may be rescinded by a debtor within
30 days after court approval.