APPENDIX G-2.b

Personal Bankruptcy: A Report on Petitioners' Ability-to-Repay (Prepared by Drs. John M. Barron, Krannert Graduate School of Management, Purdue University, and Michael Staten, Director, Credit Research Center, Georgetown University School of Business)

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I. Introduction, Background and Objectives

Consumers who petition for bankruptcy relief in the U.S. may choose the chapter under which they file. Close to 97 percent of the over one million personal bankruptcies in 1996 were filed under one of two chapters of the bankruptcy code, Chapter 7 (in which the proceeds from liquidation of non-exempt assets are used to repay creditors; remaining debts are discharged) or Chapter 13 (a court-approved reorganization plan in which debtors commit to full or partial repayment plans lasting 3-5 years). About 66 percent of all petitioners in the U.S. opt for Chapter 7, a proportion that has remained remarkably stable for the past 15 years, despite periodic changes in the federal statutes (most recently in 1994) to encourage Chapter 13 repayment plans.

A. The Role of Repayment Capacity in the U.S. Bankruptcy System

For at least 15 years, bankruptcy policymakers have debated the issue of whether debtors' capacity to repay out of future income should constrain the options available to them under the U.S. Bankruptcy Code. More precisely, the issue revolves around whether consumers should retain the freedom to choose the chapter under which they file, independent of their capacity to repay their debts. The law currently does not require the Bankruptcy Court to assess a Chapter 7 petitioner's ability to repay debt out of future income.

The code's indifference toward petitioner income dates back to the early part of this century when creditworthiness was determined largely by the value of assets a borrower could pledge as collateral. Mirroring the practices of creditors at the time, the bankruptcy code treated asset liquidation as the primary source of repayment capacity, an approach that is apparent in the language of Chapter 7. The debtor was allowed to keep certain exempt assets, but the price of the debtor's post-bankruptcy "fresh start" was the liquidation of remaining, non-exempt assets to repay creditors. Any remaining debts were discharged. Of course, the social stigma associated with public declaration of financial failure also served to deter consumers from taking inappropriate advantage of the option for a fresh start.

Over time, the criteria used to grant consumer credit have shifted dramatically toward an evaluation of capacity to repay out of future income. However, the code has not changed with the times, leaving consumers the choice of filing under either the asset liquidation chapter or the repayment chapter. Given the change in the basis for obtaining credit, it is not surprising that the vast majority of debtors who filed under Chapter 7 in 1996 had no (non-exempt) assets to liquidate. Nor would it be surprising, given that Chapter 7 eligibility is independent of income, to find that some debtors do have capacity to repay, but opt for the "fresh start" discharge obtainable through Chapter 7.

The perception that at least some Chapter 7 debtors could have funded meaningful Chapter 13 repayment plans has been fueled by the combination of rapid growth in total bankruptcies filed (28.6 percent increase from 1995 to 1996), strong economic and employment growth, and the failure of the 1994 amendments to produce a significant increase in the proportion of petitions filed under Chapter 13. Creditors, consumer advocacy groups and policymakers alike have been alarmed at the sharp increase in Chapter 7 filings under relatively favorable economic conditions. Consequently, various proposals have been drafted that would utilize an "ability-to-pay" test to calibrate bankruptcy relief (discharge of debt) according to debtor need.

Generally, these proposals to reorient the code toward "needs-based-bankruptcy" are based on the premise that the current code affords some debtors more bankruptcy relief than they need, where "need" is defined in terms of the debtor's ability or inability to fund a repayment plan out of income. Since 1984, Section 707(b) of the bankruptcy code (Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub.L. No. 98-353) has given judges the power to deny a Chapter 7 discharge if they suspect the debtor of "substantial abuse" of the statute. The code does not precisely define what constitutes substantial abuse, but some courts reportedly have interpreted it broadly to include personal bankruptcies in which the debtor has an obvious ability to repay a significant portion of debt. Nevertheless, such a review is anything but uniform and is certainly not specified by the bankruptcy statutes. Setting aside for the moment issues about the details and cost of implementing a comprehensive case review system, a fundamental question is whether it would effect substantial change in the proportions of people filing under each chapter, or the number of petitions filed.

B. Research Objectives

In the summer of 1996 the Credit Research Center initiated a large, survey-based study of consumer insolvency choices. A key objective of the project was to assemble an extensive "bankruptcy" data base that could be used to address the following three main questions of interest:

1. ***What factors influence the choice of bankruptcy (either Chapter 7 or Chapter 13) as opposed to a non-bankruptcy alternative (such as repayment plans through credit counseling agencies) to solve serious financial problems*?**

   a) To what extent do an individual's financial circumstances, in terms of such factors as income, expenses, and types of debt, affect the bankruptcy choice?

   b) How does state-by-state variance in debt collection rules affect the likelihood of bankruptcy?

   c) How do prevailing federal bankruptcy statutes and the availability of private-sector repayment programs (e.g., non-profit credit counseling agencies) influence the bankruptcy decision?

2. ***For those consumers who choose to file for bankruptcy, what factors influence the choice of Chapter 7 versus Chapter 13?*** Among the issues to be considered in answering this question would be:

   a) Do individuals sort themselves according to their ability pay (i.e., those with incomes sufficient to fund significant repayment plans go to Chapter 13; those beyond such help go through Chapter 7)?

   b) What is the role of variations in state collection laws and bankruptcy asset exemption rules on the choice between Chapter 7 and Chapter 13?

3. ***For those consumers who do file, what is their apparent ability to repay debts?*** In particular, how big is the group of petitioners filing for Chapter 7 who appear to have the capacity to repay?

Answers to the above series of questions provide us with the necessary ground-work for understanding the effects of various proposals to change bankruptcy laws. By understanding behavior arising from current bankruptcy legislation, we should be better able to predict the changes in behavior that would accompany new legislation.

In assembling a bankruptcy data base, the project sought out several types of data. First, to gather information on the characteristics of consumers facing insolvency, we collected the petitions of consumers who filed for bankruptcy relief under Chapter 7, the petitions of consumers who filed for bankruptcy relief under Chapter 13, and records kept by consumer credit counseling agencies concerning consumers who agreed to debt repayment programs. Random samples of each of these three consumer groups who faced insolvency decisions were drawn specifically for this project between May and July of 1996.

A second key element of our bankruptcy data base is the Federal Reserve Board's 1995 Survey of Consumer Finances. This survey provides detailed financial characteristics of consumers, in terms of both income and debt profiles, for a random sample of all U.S. households. In predicting the bankruptcy choice, these data provide information on the "control group" of individuals who are not experiencing financial difficulties that would lead to either credit counseling or a filing for bankruptcy.

The final element of our bankruptcy data base is a mail survey of the bankruptcy petitioners in our sample to obtain more detailed information on the causes of bankruptcy beyond what can be obtained from data contained on the petition. Matching the responses to the individual filings provides a more detailed profile of those filing bankruptcy petitions.

The depth and breadth of this combined data base raises many more questions than we can answer in the context of a single report. Consequently, the following sections of this report utilize the bankruptcy petition portion of our data set to empirically address the third issue stated above by calculating the repayment capacity of bankrupt debtors. Subsequent reports will analyze the factors underlying the choice of bankruptcy vs. non-bankruptcy alternatives, as well as the choice within bankruptcy of filing under Chapter 7 vs. Chapter 13. Also ahead is analysis of the survey responses received from approximately 1,300 members of the sample, which include their views about the underlying causes and events leading to their financial problems, their awareness of non-bankruptcy alternatives, and their commitments to repay debt within bankruptcy.

II. Data Collection

The logistics of collecting and entering data from bankruptcy petitions is a substantial undertaking. The typical petition is 30 pages long and contains over 300 variables spread across a variety of schedules. Further, obtaining copies of the petitions requires negotiations with bankruptcy clerks and photocopying companies in each court district. On the positive side, the bankruptcy software now used by most bankruptcy attorneys provides clear, typed versions of the required schedules, greatly reducing the potential for errors deriving from illegible petitions. Below we provide details on sample design and data collection.

A. Sample Design

The sample design called for randomly drawing approximately 300 personal bankruptcy petitions filed in the U.S. Bankruptcy Courts located in each of 13 cities: Atlanta, Chicago, Dallas, Hartford, Houston, Indianapolis, Kansas City, Los Angeles, Memphis, Phoenix, Pittsburgh, San Diego and Tampa. Table 1 provides an overview of 1996 bankruptcy filing activity (7s and 13s only) for these courts, as well as the change between 1995 and 1996. The locations of the courts were selected to obtain variance in regional economic conditions, state-specific asset exemption levels (for Chapter 7), the proportion of bankruptcies filed under Chapter 7 vs. Chapter 13, and recent growth rates in the number of personal bankruptcies. The volume of Chapter 7 and 13 petitions filed in these 13 bankruptcy courts comprised 19.3% of total U.S. filings in 1996.

Table 1
1996 Petition Volume in Sample Courts

Court	Total Number of 7s and 13s	Percent Chapter 7s	Percent change from 1995 to 1996
Atlanta	19,839	34.4	10
Chicago	33,683	75.5	27
Dallas	8,680	43.7	22
Hartford	4,304	89.2	-12
Houston	10,833	51.7	19
Indianapolis	12,226	84.0	25
Kansas City	8,935	84.6	26
Los Angeles	39,639	77.6	28
Memphis	16,738	20.2	28
Phoenix	12,803	70.8	22
Pittsburgh	6,189	87.0	32
San Diego	17,404	73.3	27
Tampa	16,284	79.6	22
U.S. Total	1,078,080	68.5	27

B. Selection and Weighting of Sampled Cases

The sample was drawn from petitions filed primarily from May through July, 1996. Courts in two cities provided petitions for April as well. We contracted directly with the courts or affiliated document service companies to obtain copies of relevant schedules for each petition selected for the sample. Several courts were able to provide petition copies free of charge. To economize on document retrieval costs, we modified our standard sampling request to accommodate the period during which such copies were still available.

For eight courts, the sampling was conducted by taking approximately 150 sequential filings (according to case number, assigned chronologically) beginning the first week of May and to repeat the process for cases filed during the first week of June.[1] This method of sampling obtained all Chapter 7 and 13 petitions filed during the span of days necessary to obtain the 150 petitions. The length of the sampling period (in days) varied across courts according to petition volume. In three other cities, the same sequential sampling was restricted to the single month of June (Pittsburgh, Indianapolis, and Memphis). For Memphis, the sample size was increased to 500 to insure sufficient representation of Chapter 7 petitions given the low percentage of Chapter 7 filings for that city (see Table 1). In the two remaining courts, Atlanta and Tampa, the sampling framework deviated from that just described because free copies were available. In Atlanta, the cases were pulled randomly from petitions filed during April - June. In Tampa, the court sampled sequentially from cases filed only during July.

For the entire sample, 6.1% of the Chapter 7 filings and 10.7% of the Chapter 13 filings we sampled were unusable due to missing key schedules or data. In many of these cases, only the cover sheet was available. Such petitions have been dropped from the analysis reported below.[2] The resulting data set contains 3,798 usable observations, of which 2,441 were Chapter 7 petitions and 1,357 were Chapter 13 petitions. Our sample breakdown of 64% Chapter 7's is similar to the overall rate of 66% Chapter 7 filings for these 13 courts during 1996. Table 2 summarizes the total number of usable petitions collected from each court.

One issue of concern with regard to the sampling design is apparent in comparing Table 1 to Table 2. Table 1 reveals that some sampled courts have substantially higher case volume than others. Yet the figures for usable cases in Table 2 reflect a sample design that called for drawing approximately equal numbers of cases from each court. Consequently, cases from some courts, for instance the Los Angeles court, are under-represented and cases from other courts, for instance the Pittsburgh court, are over-represented in the sample of petitions. Thus simple mean values based on sample observations would not be representative of the typical petition filed in these 13 courts. To correct for this, the sample observations were weighted. As a result, the means, medians, and means by decile reported below reflect unbiased estimates of the population means, with the population defined as either Chapter 7 and Chapter 13 petitions filed in the 13 bankruptcy courts during the sampling period.

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[1] On an ironic note, the June sample for Hartford was not completed as the copying company we were working with filed for bankruptcy.

[2] For those cases not missing cover page summary statistics, we tested to see if such unusable cases were different from the cases retained for analysis with respect to either the amounts of assets and liabilities. There were no statistically significant differences.

Table 2
Sample Size by Court
Number of Petitions

Court	Chapter 7	Chapter 13	Full Sample
Atlanta	169	128	297
Chicago	207	71	278
Dallas	77	188	265
Hartford	212	12	224
Houston	98	139	237
Indianapolis	262	50	312
Kansas City	260	46	306
Los Angeles	219	43	262
Memphis	92	368	460
Phoenix	241	79	320
Pittsburgh	144	128	272
San Diego	199	74	273
Tampa	261	31	292
Total	2,441	1,357	3,798

A second issue of concern with respect to the sampling design is the restriction on the sample to petitions filed during the May through July period. As such, an analysis of bankruptcy petitions regarding the ability to repay debt may incorporate a "seasonal" effect if petitions filed during this period differ in a systematic way from petitions filed at other times of the year. To check if this was the case, we sampled over 300 additional cases filed sequentially in Indianapolis during the period November 25, 1996 to December 4, 1996 and an additional 300 petitions filed sequentially in Indianapolis during the period February 28, 1997 to March 3, 1997. A comparison of the Chapter 7 and Chapter 13 petitions filed in these months to the original sample of Indianapolis Chapter 7 and 13 petitions filed in May and June of 1996 indicates no significant differences in total debt, net income, or net expenses. We did, however, find that Chapter 7 petitions filed during the November/December period were slightly more likely to have positive available income. Thus, a concern that seasonal differences in petitions could lead to an overstatement of the ability to repay debt across all petitions filed during 1996 is unwarranted.

C. Data entry

A bankruptcy petition contains the debtor's sworn statement listing monthly income, living expenses (including mortgage or rental payments), assets and itemized debts. These data are contained on 10 different schedules or forms following a summary page. Data from each petition was entered into a spreadsheet file set up with pages to correspond to the summary sheet and each of the 10 schedules/forms. Following the initial data entry for each city, one-third of the petitions were randomly selected for re-entry of data. This allowed us to detect systematic problems resulting from misinterpretation of either the data or coding instructions. In addition, computer programs were written to detect outlier values and inconsistencies in responses. These petitions were inspected and the previously coded data were either verified or corrected. Finally, for all petitions, we double-entered the data contained in Schedule I (debtor income) and Schedule J (debtor living expenses). Any clear error or misclassification of an item was corrected (Example: including monthly payroll deductions for savings as a monthly living expense).

III. Methodology for Evaluating Ability to Pay

Debtors have two fundamental sources of funds for repayment of personal debt. Repayment can occur over time out of after-tax income, or payment can be funded through liquidation of debtor assets. The following sections measure repayment capacity using modified versions of both approaches.

A. Key Assumptions Underlying Repayment Capacity

Generally speaking, a debtor's capacity to repay out of future income depends upon three key components: monthly net income (after taxes), monthly living expenses, and the size of a monthly payment necessary to amortize total debt over a specified repayment period. We calculated the percent repayable by taking net income, subtracting living expenses and dividing the resulting value by the monthly debt payment. Several simplifying assumptions were made in performing this calculation for each petition.

Assumptions:

1. **Debtor statements regarding levels of total income and living expenses were accepted at face value.** The only adjustment made was to reduce the amount of income available for debt service by an amount equal to estimated federal tax liability on non-wage income. This adjustment was made on approximately 20% of cases which had taxable non-wage income. This assumption necessarily means that any life-style changes made to either boost income (e.g., second job) or reduce expenses were already reflected in the debtor's statements of monthly income and expenses. Whether or not these statements accurately reflect reality is a topic of much debate. Nevertheless, they do result from sworn statements to the court and so provide a means for calculating repayment ability which accommodates a given debtor's special circumstances.

   We are well aware that Chapter 7 petitioners have an incentive in some jurisdictions to overstate expenses or understate income. Although bankruptcy law does not require the court to evaluate a debtor's ability to pay as a condition of a Chapter 7 discharge, it does grant the Court the authority to dismiss (reject) a Chapter 7 petition for "substantial abuse." In those courts that have interpreted "substantial abuse" to include bankruptcies in which the debtor has an obvious ability to repay a significant portion of debt, a debtor filing under Chapter 7 has an incentive to understate his/her capacity to service debt. To our knowledge, there is no systematic auditing of petitioner’s income and expense statements undertaken by the courts, and certainly none required by current law. Consequently, to the extent some debtors have tailored their statement of financial affairs, the following calculations will likely ***understate*** the actual percent of debt repayable, as measured at the time the petition is filed.

2. **Each debtor's monthly payment for housing (listed on the petition as a mortgage or rent payment) was treated as an ongoing monthly living expense.** For debtors with a mortgage on a primary residence, this assumption effectively put the mortgage-lender first in line for repayment. Consequently, to compare repayment percentages

across the sample of both homeowners and renters, the calculations have been constructed to yield the percentage of ***non-housing debt*** that could be repaid over a specified repayment period.

This assumption also leads to a ***conservative*** estimate of the potential to repay non-housing debt because it preserves a level of housing expenditure, relative to income, which may have been partly responsible for the debtor's financial problems. However, with this assumption we sidestep difficult questions regarding what to use as the cost of replacement housing if the debtor were to move to a less expensive residence.

3. **The debtor's income and expenses stated on the petition are assumed to continue, uninterrupted and unchanged, for the duration of the payment period.** Of course, over a multi-year repayment period debtor income may rise or fall. Not surprisingly given their petition for bankruptcy, most consumers in our sample of bankrupts experienced income declines during the 12 months prior to filing (68% of Chapter 7 debtors, 50% of Chapter 13 debtors). Whether income is more likely to rise than fall going forward is open to speculation. The same can be said for expenses relative to income. However, it is important to emphasize that our calculations are based on the same information (with inherent uncertainties) that the court would face in judging a debtor's financial ability to maintain a repayment plan.

4. **The debtor does not voluntarily forfeit assets to retire a portion of total debt.** Of course, in reality such forfeiture (voluntary repossession) does occur, an additional reason that the repayment statistics represent a lower-bound estimate of repayment potential.

5. **Debtors have no assets in excess of state-level exemptions to liquidate in Chapter 7.** This assumption is made to develop a repayment statistic that is purely income-based and is comparable across Chapter 7 (which does require asset liquidation in a small percentage of cases) and Chapter 13 petitions (which does not require liquidation of non-exempt assets).

B. Calculation of the Proportion of Non-Housing Debt Repayable

Repayment calculations are based on a 5-year repayment period. The proportion of non-housing debt repayable over 5 years was calculated as the ratio of annual income net of taxes and living expenses to the annual non-housing debt payment necessary to amortize total non-housing debt over 5 years. The resulting ratio yields the percentage of non-housing debt repayable for each petition. The formula, variable definitions and more detailed explanation follow.

$$\begin{array}{c}\text{Percent of Non-housing and} \\ \text{Non-priority Debt Repayable}\end{array} = \frac{\text{Annual Available Income}}{\text{Annual Non-housing, Non-priority Debt Payment}}$$

with the variables defined as follows:

Annual Net Income: Each petition reports monthly gross wage and overtime income of debtor and spouse, as well as payroll deductions. Take-home wage incomes for debtor and spouse derive directly from the petition by taking gross wage income minus payroll taxes and social security, insurance, union dues, and other deductions (as listed on the petition). The sum of net wage incomes for debtor and spouse = total household take-home monthly wage income. Multiplying this total by 12 provides a measure of annual take-home wage income.

Some debtors listed other income on their petitions. Other income included income from business (net of listed business expenses), property and interest income, alimony/child support, social security/disability payments, and pension income. To convert other income to an after-tax basis, the Federal tax liability on the taxable categories of other income was estimated. This adjustment utilized total household gross income, adjusted for exemptions and deductions (based on petition data), and applied the 1996 Federal tax tables to estimate the federal tax liability on other income. Consequently, total available annual income has been converted to an after-tax basis. Note that a petitioner can include as living expenses (on Schedule J) an estimate of taxes to be paid other than taxes on wage income. To the extent these listed tax payments incorporate Federal income taxes due on other income, we have overestimated total tax payments, and thus have underestimated net income, as well as the percent of debt that is repayable.

Annual Living Expenses: All expenses listed on the petition, including housing expenses (mortgage or rent payments) were summed to yield total monthly living expenses, with two exceptions. A few debtors listed included savings deposits through payroll deduction as a monthly living expense. These amounts were removed from total living expenses in calculating repayment capacity. More frequently, debtors listed monthly installment payments on a wide variety of non-housing debts as part of their living expenses. Presumably many of these payments covered reaffirmed debts, reflecting the debtor's

	plan to continue the payments after bankruptcy. However, there was not a one-for-one match between intended reaffirmations and an installment payment on the expense schedule. Since this income is obviously available for debt repayment, and because such debts are included in total non-housing debt, we subtracted these payments from living expenses for purposes of standardizing the calculation of the percentage of repayable non-housing debt. This adjusted measure of monthly expenses is annualized by multiplying by 12.
Annual Available Income:	Annual Net Income - Annual Living Expenses - Annual Priority Debt Payment. This term refers to the amount of after-tax income, net of all living expenses, and payments toward unsecured priority debt, which would be available for debt service. Values less than zero were set equal to zero. Values of available income were capped at an amount equal to the annual non-housing debt payment for those petitioners with incomes sufficient to repay 100% of their non-housing debt or more.
Non-housing debt:	Total debt equals the sum of secured debt (from petition Schedule D), priority debt (Schedule E), and unsecured debt (Schedule F). Housing debt was identified and flagged during the process of coding the petition. Subtracting housing debt from total debt yields non-housing debt.
Annual non-housing, non-priority debt payment:	Total non-housing debt minus total unsecured priority debt amortized over 5 years by dividing by 5. Note that the petition does not contain complete or reliable information about the remaining term on installment loans or the minimum payment on revolving balances. For this reason, this amortization calculation treats outstanding, non-housing debt as though it were reorganized into a 5-year repayment plan beginning on the day the bankruptcy was filed.

Several additional points should be noted regarding the repayment calculations.

Finance Charges: Because ongoing accrual of finance charges on first-mortgage debt are reflected in the monthly mortgage payments listed on the petition, they are incorporated directly into the repayment calculations (as a housing expense). However, the bankruptcy petition provides no information about contract interest rates on non-housing debt. Consequently, the repayment calculations do not attempt to impute ongoing finance charges to non-housing debt. Therefore, the calculations distribute total non-housing debt evenly across the 5-year repayment period as if the rate of finance charge were zero.

Although this may seem a radical assumption, for a sizable portion of unsecured debt in bankruptcy the issue of finance charge accrual is irrelevant. To the extent that unsecured creditors (particularly card issuers) have already charged-off debt in bankruptcy, finance charges no longer accrue. The component of non-housing debt on which finance charges are most likely to accrue (thereby lengthening the amortization period) would be debt secured by assets which the debtor wishes to retain (reaffirm). Chapter 7 debtors in our sample listed only about 18 percent of their non-housing, non-priority debt as secured (from Table 8). For this group, only 52.6 percent filed an intent to reaffirm, and the intended reaffirmations represented 45.7 percent of the secured, non-housing balances outstanding. Consequently, the assumption regarding zero finance charges on non-housing debt is likely to understate actual finance charges on 8-10 percent of the non-housing debt outstanding.

Unsecured Priority Debt: Approximately 20 percent of Chapter 7 debtors (38.3 percent of Chapter 13 debtors) in the sample listed one or more types of unsecured priority debt. The most common types of priority debt include back taxes and past-due child support. The mean percent of total debt represented by priority debt was 2.5 percent for Chapter 7 debtors and 5.1 percent for Chapter 13 debtors. In calculating debtor capacity to repay non-housing debt, the outstanding balance for priority debt was amortized over 5 years and subtracted from monthly available income (for those with positive available income). In effect, the calculations dispose of priority debt first. All reported repayment percentages in the following sections refer to capacity to pay non-housing, non-priority debt **after** allocating income to repay priority debt.

It is important to note that, with the exception of unsecured priority debt, the calculations of repayment out of future income treat all non-housing debts equally across the repayment period to gain an overall sense of how much debt is repayable. That is, debtor available income is allocated to debt repayment in proportion to the size of the debt relative to the total.

C. Calculation of the Proportion of Non-Housing Debt Repayable with Liquidation of Collateral Assets

In addition to repaying creditors out of future income, all debtors have the option of voluntarily forfeiting the assets that were acquired through borrowed purchase money and which served as collateral backing those loans. The repayment percentages calculated using the method described in the previous section will necessarily rise if we also assume liquidation of collateral assets: total outstanding non-housing debt is lower at the outset of the repayment period (through retirement of some secured debt), thereby allowing more of the debtor income to be applied to payment of remaining debt.

We calculated this broader measure of repayment capacity using much the same methodology as described above. However, for those petitions which listed secured non-housing debt, we treated the debtor's statement of the market value of the collateral as a payment toward the outstanding balance on the corresponding loan. The sum of 1) the dollar value of liquidated collateral plus 2) the stream of payments from available income (over the specific repayment period) was then divided by total non-housing, non-priority debt to calculate the repayment percentage.

IV. Results

Table 3 displays selected characteristics of debtors in the sample. About 45 percent of the petitioners were married. Half of Chapter 7 debtors had no children or dependents other than a spouse (44 percent for Chapter 13 debtors). Only 39 percent of Chapter 7 debtors owned real property (primary residence or other real estate), compared to 62 percent of Chapter 13 debtors. Just over 3 percent of Chapter 7 debtors had been in bankruptcy prior to filing in 1996; over 25 percent of Chapter 13 debtors had been in bankruptcy court before. The large majority of debtors in both chapters (88 percent of Chapter 7s, 93 percent of Chapter 13s) hired an attorney to assist them with the bankruptcy petition.

Table 3
Characteristics of Petitioners/Petitions

	Chapter 7	Chapter 13
Percent filing joint petition	33.5%	28.7%
Percent of petitions listing a lawyer	88.0%	92.6%
Total fee to be paid to lawyer for those with lawyer (means)	$702	$1,139
Amount of fee paid prior to filing for those with lawyer (means)	$468	$230
Percent of debtors with prior bankruptcy (last 6 years)	3.4%	25.6%
Percent who own a home/real property	38.7%	61.8%
Percent married	44.4%	46.8%
Percent of currently married who filed joint petition	72.1%	59.7%
Percent of currently not married who filed joint petition	2.8%	1.7%
Average number of dependents (excluding spouse)	0.98	1.17
Percent with no dependents	50.2%	43.6%
Percent with 2 or more dependents	30.5%	37.1%
Percent with losses from fire, theft, gambling (prior year)	5.0%	3.3%
Percent who have had wages garnished	6.0%	5.4%
Percent who were involved in a lawsuit	25.0%	20.0%
Percent who have experienced repossession/foreclosure	11.8%	9.6%
Average job tenure (in years) for those debtors reporting tenure	5.26	5.14

A. Overview of Income, Expenses and Total Debt

Over 75 percent of both groups of debtors had wage income at the time of filing (Table 4). However, the majority of Chapter 7 debtors (68 percent) had experienced reductions in income during the previous 12 months. About 50 percent of Chapter 13 debtors saw their income fall during the prior year. At the time of filing, Chapter 13 debtors had substantially higher annual household incomes, on average, than Chapter 7 debtors: $26,334 vs. $19,620, after-taxes. In contrast, mean annual living expenses for the two groups were remarkably similar: $21,336 for Chapter 13s compared to $21,150 for Chapter 7s (Table 5).

Table 4
Debtor Annual Income
(Mean Responses)

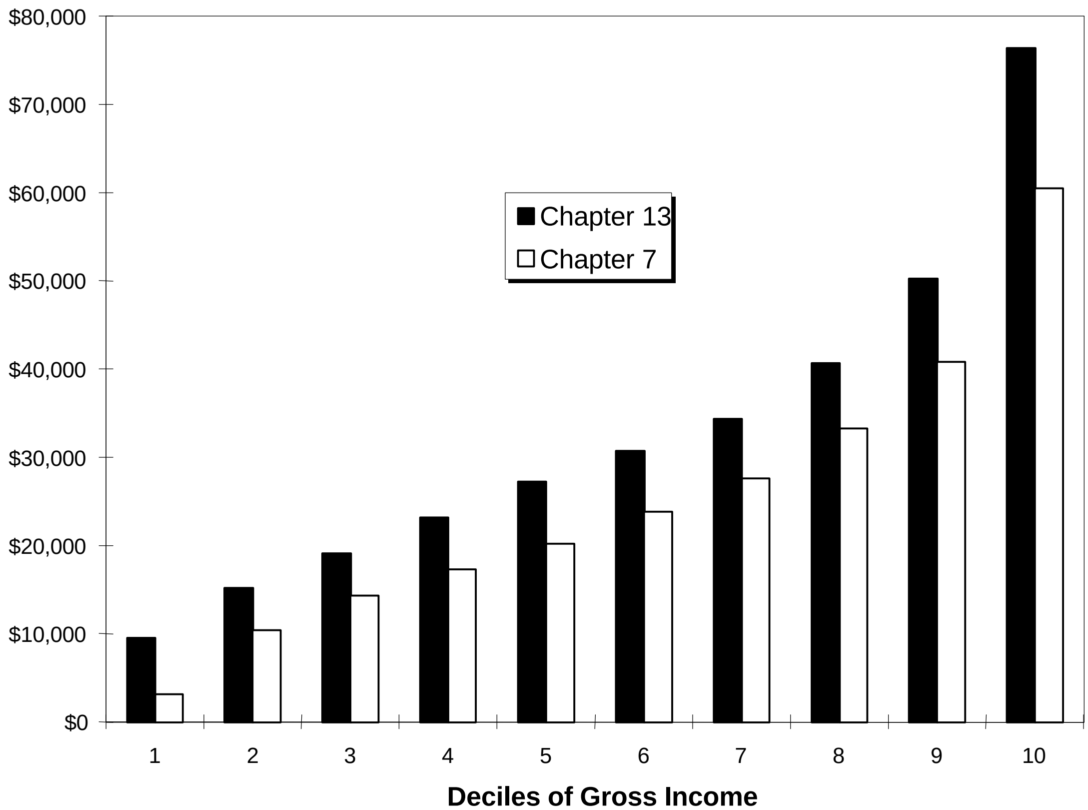
	Chapter 7		Chapter 13	
	Debtor	**Spouse**	**Debtor**	**Spouse**
Current annual gross wages	$17,744	$3,667	$21,380	$4,833
Percent with positive wages	76.7%	20.1%	84.7%	25.3%
Estimated annual overtime	$179	$25	$223	$59
Gross Income of debtor	$17,923	$3,692	$21,602	$4,892
Payroll taxes and social security	$3,448	$675	$3,450	$845
Insurance	$315	$94	$315	$143
Union dues	$42	$8	$28	$10
Other	$468	$96	$419	$87
Total Payroll Deductions of Debtor	$4,272	$873	$4,212	$1,086
Net annual take-home of debtor	$13,651	$2,819	$17,391	$3,806
Income from business	$853	N/A	$3,696	N/A
Percent with positive business income	3.0%	N/A	6.6%	N/A
Percent with negative business income	0.0%	N/A	0.0%	N/A
				$0
Income from real property	$143	$28	$541	$73
Percent with positive inc. real property	1.5%	0.4%	4.2%	0.7%
Interest and dividends	$24	$0	$42	$0
Percent with positive int. income	0.2%	0.0%	0.5%	0.0%
Alimony, etc.	$239	$47	$213	$100
Percent with positive alimony	4.1%	0.9%	5.1%	1.0%
SS and other government sources	$962	$161	$818	$173
Percent with positive ss/Gov. payments	11.9%	2.7%	10.0%	2.4%
Pension or retirement income	$385	$15	$532	$43
Percent with positive pen. income	4.8%	0.3%	5.1%	0.7%
Other annual income	$874	$198	$2,062	$426
Total Net Income, Debtor and Spouse		**$19,620**		**$26,334**

Table 5
Debtor Annual Expenses
(Mean Responses)

	Chapter 7	Chapter 13
Rent or mortgage payment	$7,191	$8,267
Utilities: electricity	1,200	1,494
Utilities: water and sewer	263	309
Utilities: Telephone	713	648
Utilities: Cable TV	143	101
Utilities: Other	159	151
Home maintenance.	365	344
Food	4,052	3,582
Clothing	846	680
Laundry and dry cleaning	404	317
Medical and dental	623	454
Transport	1,425	1,360
Recreation, etc.	489	303
Charitable	126	98
Insurance – Home	97	99
Insurance – Life	163	192
Insurance – Health	234	133
Insurance – Auto	958	987
Insurance – Other	62	65
Taxes (Non-wage)	309	446
Installment payments – Auto	1,730	752
Installment payments – Other	840	372
Alimony, etc.	310	278
Payments to support add. Dependents	110	71
Business expenses	490	2,757
Other	907	957
Total expenses	$24,209	$25,217
Net expenses (total net of business expenses and installment payments)	**$21,150**	**$21,336**

However, mean values on income (and subsequent ability to pay) for both Chapter 7 and Chapter 13 debtors mask a wide range of economic circumstances. For example, if we group the sample into deciles according to gross income, the mean values by decile for Chapter 7 debtors ranged from $3,190 for the lowest decile to $60,503 for the highest decile. Similarly, mean annual gross income for Chapter 13 debtors ranged from $9,562 for the lowest decile to $76,397 for the highest decile. Figure 1 illustrates this disparity in gross income across petitioners.

Figure 1
Mean Annual Gross Income by Deciles:
Comparison of Chapter 13 vs. Chapter 7



Recall that available income refers to the dollars available out of after-tax income after subtracting living expenses (including housing) and a payment to retire priority debt (over 5 years). Re-ordering the sample of Chapter 7 debtors according to available income reveals that the lowest 5 deciles (more precisely, 56 percent of the sample) had no available income. However, mean values for annual available income on the top five deciles ranged from $38 to $9,340 (Tables 6 and 7). Clearly, any discussion of the repayment capacity of bankrupt debtors should examine the entire distribution of debtors in each chapter, as opposed to focusing on the mean values alone. Consequently, many of the following tables and charts display the data across deciles of available income. In particular, Figure 2 illustrates mean gross income across deciles of available income for Chapter 7 and 13 petitioners.

Figure 2
Mean Annual Gross Income by Deciles of Available Income: Comparison of Chapter 13 vs. Chapter 7

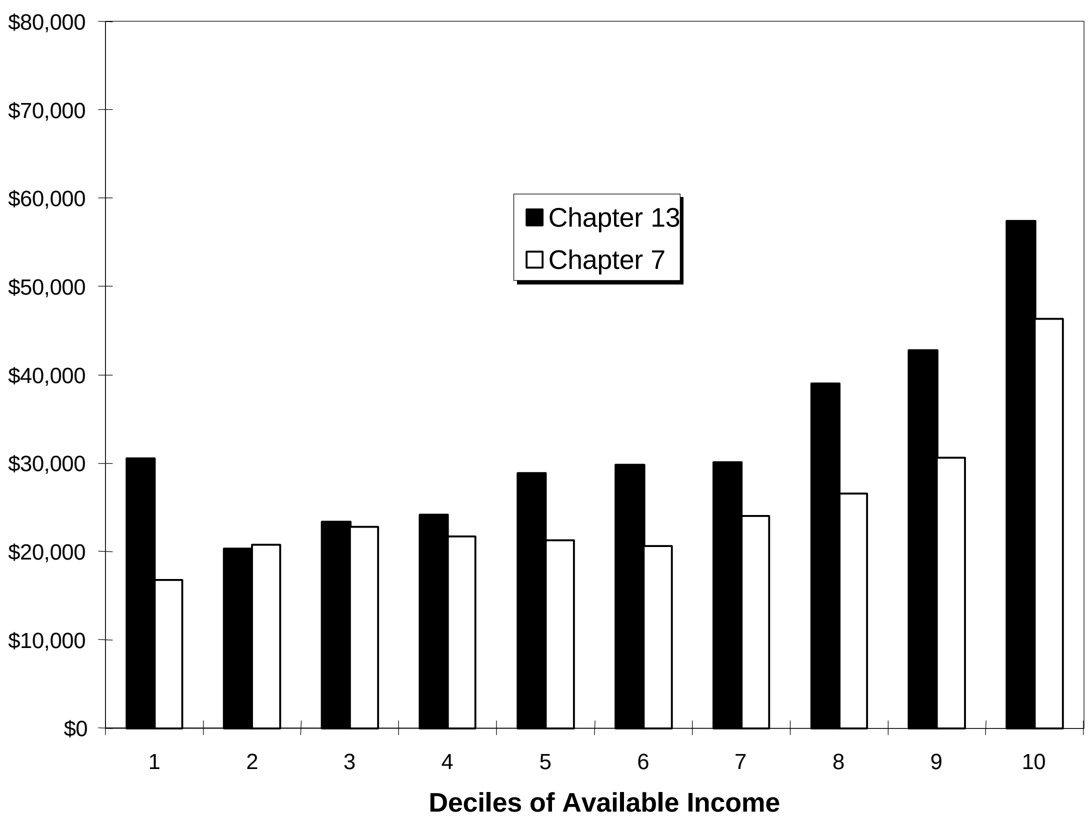


Table 6
Chapter 7: Annual Net Income, Expenses and Dollars Available To Repay Non-Housing Debt

		Means for deciles of available income									
	Chapter 7	1	2	3	4	5	6	7	8	9	10
Net income	$19,620	$13,124	$16,356	$16,356	$16,855	$16,744	$16,503	$18,654	$20,573	$24,294	$35,337
Net expenses	21,150	31,695	23,136	23,136	18,860	17,488	16,493	17,787	18,479	20,291	25,798
Available income(net of repayment of priority debt, zero if negative)	1,597	$0	$0	$0	$0	$0	$38	$758	$2,006	$3,856	$9,340
Percent with positive available income	43.6%	0.0%	0.0%	0.0%	0.0%	0.0%	36.9%	100.0%	100.0%	100.0%	100.0%
Available income conditional on being positive	$3,663	$0	$0	$0	$0	$0	$104	$758	$2,006	$3,856	$9,340

Table 7
Chapter 13: Annual Net Income, Expenses and Dollars Available To Repay Non-Housing Debt

		Means for deciles of available income									
	Chapter 13	1	2	3	4	5	6	7	8	9	10
Net income	$26,344	$23,523	$16,888	$18,831	$19,967	$23,487	$24,595	$24,093	$30,694	$34,474	$46,364
Net expenses	$21,336	30,180	15,887	16,715	17,178	19,690	20,081	18,598	23,135	24,154	27,009
Available income(net of repayment of priority debt, zero if negative)	$5,294	$0	$660	$1,660	$2,525	$3,370	$4,121	$5,316	$7,048	$9,897	$18,388
Percent with positive available income	88.5%	0.0%	87.6%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Available income conditional on being positive	$5,982	$0	$753	$1,660	$2,525	$3,370	$4,121	$5,316	$7,048	$9,897	$18,388

As Tables 8 through 10 illustrate, in terms of the amount of total debt, Chapter 7 and Chapter 13 debtors were similar, with mean values of $92,793 and $93,241, respectively. However, the two groups were quite different in terms of the composition of debt (Figures 3 and 4). For Chapter 13 debtors, 69 percent of debt was secured (mean of petitioners' percentages), and 44.0 percent of total debt was housing debt. In contrast, for Chapter 7 debtors, only 36.7 percent of total debt was secured (mean of petitioners' percentages), and 22 percent was housing debt. Credit card debt was far more prominent as a percent of total debt for Chapter 7 debtors than for Chapter 13 debtors.

Table 8
Amounts of Debt, Various Types

	Chapter 7		Chapter 13	
	Means	**Medians**	**Means**	**Medians**
Secured debt	$48,792	$10,750	$68,545	$41,500
Housing debt	39,915	0	57,839	32,000
Vehicle debt	5,992	0	7,433	3,777
Other secured debt	2,885	0	3,273	0
Priority debt	2,773	0	3,742	0
Unsecured debt	41,228	21,753	20,953	6,684
Credit card debt	19,066	11,950	6,904	731
Bank card debt (Visa, MasterCard)	11,634	5,700	3,679	0
Discover	1,054	0	422	0
Other credit cards	6,378	2,550	2,803	60
Personal loans	8,563	0	6,246	0
Medical debt	1,865	0	985	0
Student Loans	859	0	596	0
Other unsecured debt	10,875	475	6,221	392
Total debt	**$92,793**	**$43,444**	**$93,241**	**$58,784**
Number of different unsecured creditors	12.2		7.4	

Table 9
Percent with Positive Debt, Various Types

	Chapter 7	Chapter 13
Secured debt	71.7 %	92.7 %
Housing debt	35.3	58.5
Vehicle debt	47.9	59.8
Other secured debt	32.0	41.4
Priority debt	19.9	38.3
Unsecured debt	99.0	85.6
Credit card debt	89.3	58.9
Bank card debt (Visa, MasterCard)	73.5	35.2
Discover	32.1	14.5
Other credit cards	78.3	50.6
Personal loans	49.0	37.8
Medical debt	39.9	36.4
Student loans	11.0	10.5
Other unsecured debt	63.7	60.2
Non-housing, non-priority debt	99.3	92.0

Table 10
Mean Percentages of Total Debt, Various Types
(Means of Petitioners' Percentages)

	Chapter 7	Chapter 13
Secured debt	36.8 %	69.1 %
Housing debt	22.2	44.0
Vehicle debt	10.8	19.1
Other secured debt	3.8	6.0
Priority debt	2.5	5.1
Unsecured debt	60.7	25.9
Credit card debt	33.2	9.6
Bank card debt (Visa, MasterCard)	20.0	4.6
Discover	2.2	0.6
Other credit cards	11.1	4.4
Personal loans	9.9	4.8
Medical debt	4.8	2.5
Student loans	2.0	1.5
Other unsecured debt	10.9	7.5
Non-housing, non-priority debt	75.3	50.9

Figure 3

Chapter 7: Mean Percentages of Total Debt, By Type of Debt
(Means of Petitioners' Percentages)

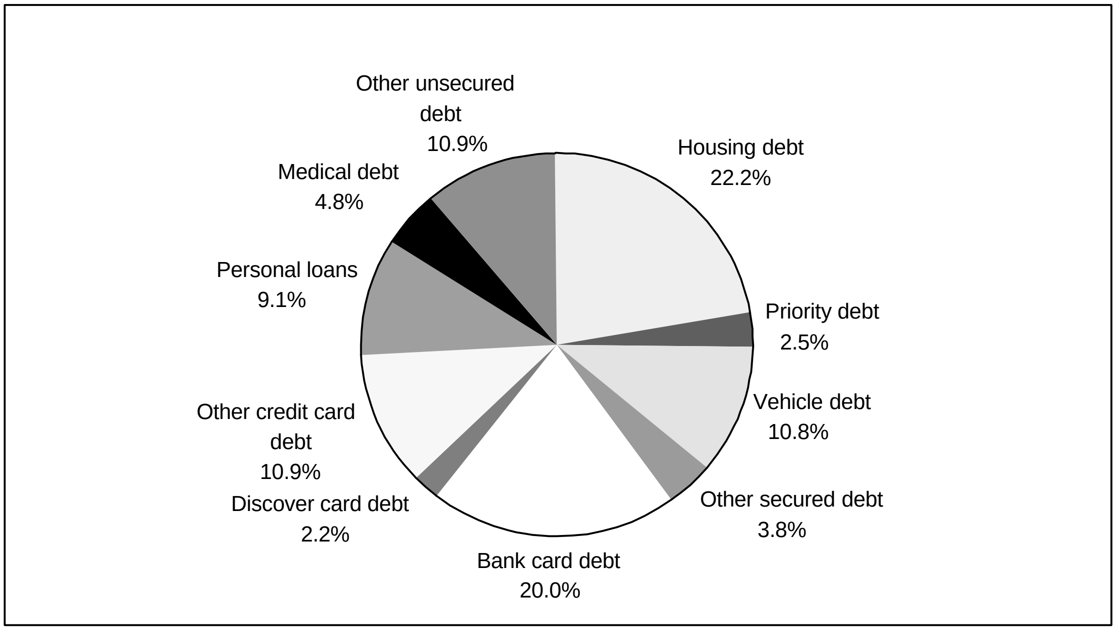
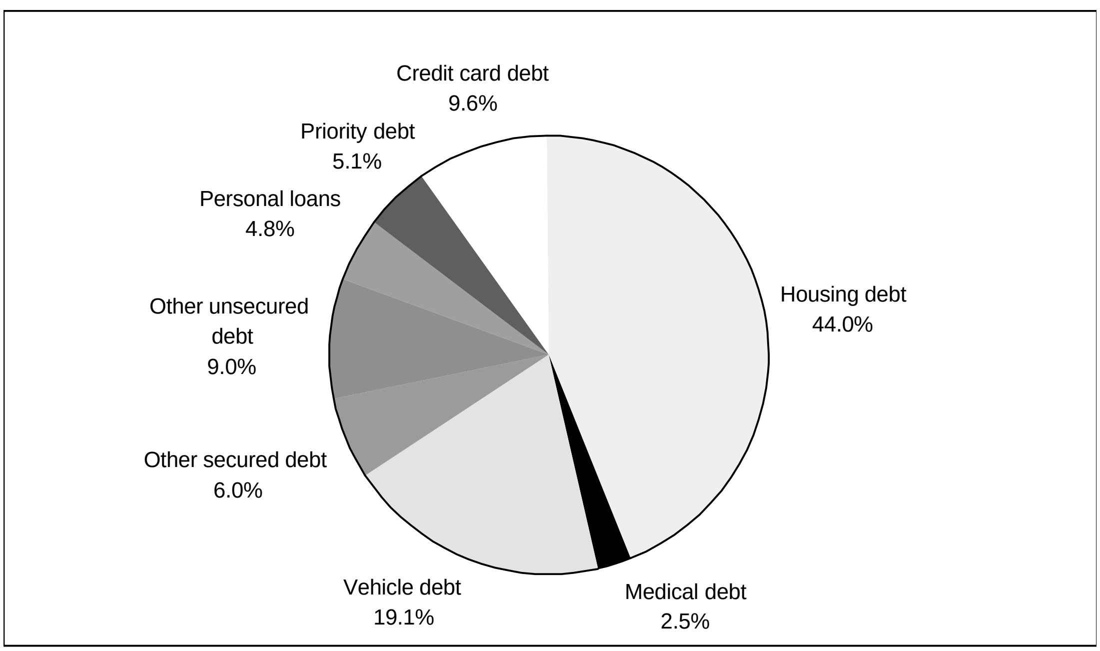


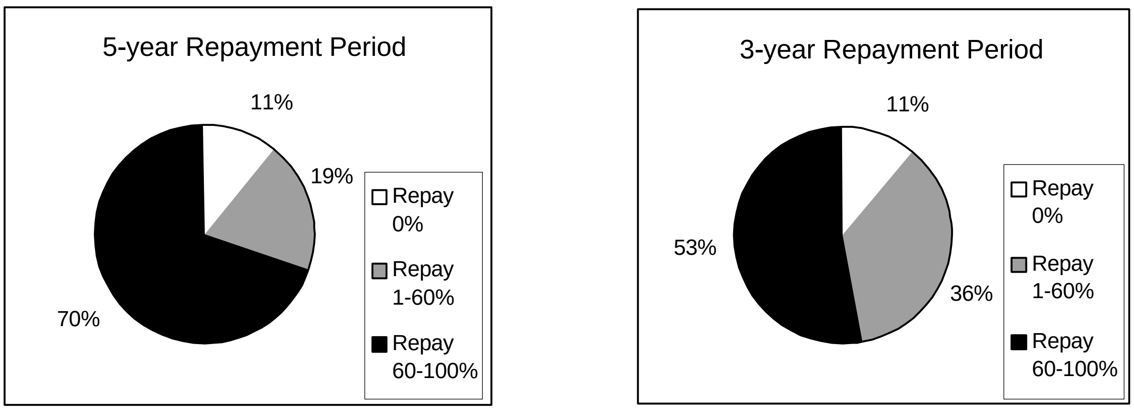
Figure 4
Chapter 13: Mean Percentages of Total Debt, By Type of Debt
(Means of Petitioners' Percentages)



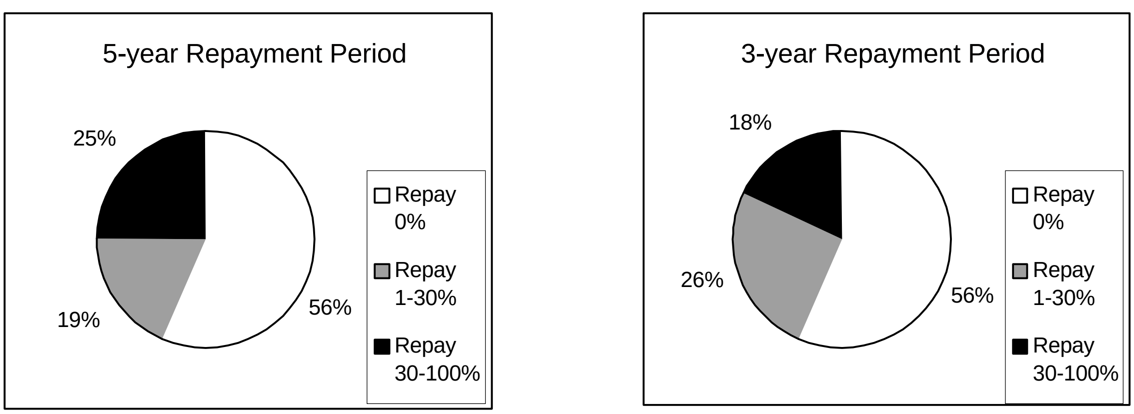
B. Repayment Capacity

Based on the information they supplied in their bankruptcy petitions, Chapter 13 debtors have a substantially greater capacity to repay non-housing debt than do Chapter 7 debtors. Slightly over 50 percent of all Chapter 13 debtors could repay 100 percent of their non-housing debt over a 5-year repayment period, given the assumptions underlying the repayment calculations. Another 19 percent of Chapter 13 debtors could pay 60 percent or more of their non-housing debt over the same period (Figure 5).

<u>Figure 5</u>
Proportion of Chapter 13 Debtors,
By Percent of Repayable Non-housing Debt



<u>Figure 6</u>
Proportion of Chapter 7 Debtors,
By Percent of Repayable Non-housing Debt



In contrast, 44 percent of Chapter 7 debtors have positive available income to contribute toward repayment of non-housing debt (Figure 6). However, unlike their counterparts in the bottom half of the repayment distribution, a sizable portion of Chapter 7s could make substantial payments. More specifically, 25 percent of Chapter 7s could repay at least 30 percent of their non-housing debt over 5 years, while still maintaining their normal housing payments and other living expenses. Perhaps even more interesting from a policy standpoint, 10 percent of Chapter 7 debtors could pay at least 78 percent of such debts; 5 percent of Chapter 7s could pay 100 percent (Table 11).

Table 11
Chapter 7 Petitioners' Capacity to Repay Non-housing Debt, After Payment of Priority Debt

% of Debtors	Minimum % of Debt Repayable
5	100
10	78
15	58
20	43
25	30
30	21
35	11
40	4

The average total available income applicable to the repayment of debt, summed over a 5-year repayment period, was $6,848 for a Chapter 7 petitioner. The corresponding figure for Chapter 13 debtors was $14,891 (Table 12). Applying these dollars available for repayment to the total stock of non-housing, non-priority debt outstanding reveals that Chapter 7 debtors could have repaid, in the aggregate, 13.7 percent of such debt (in addition to continuing payments on their housing debt).

To impart economic significance to these percentages, consider that there were 137,645 Chapter 7 petitions filed in the 13 sampled courts during 1996. Our sampling procedures were adopted to generate a representative sample of all petitioners filing within those courts. On that basis, and given the assumptions underlying our repayment calculations, we estimate that the total dollars of non-housing debt repayable by debtors who filed for Chapter 7 in these courts during 1996 would have been $943 million over a 5-year repayment period. For the reasons outlined in Section III, this figure should be viewed as a lower-bound on the potential for repayment.

Projecting these results to the experience of the entire nation is more problematic. The cases sampled within courts were chosen randomly, but the courts selected for review were not. Table 1 highlighted the fact that bankruptcy courts in the sample vary considerably in terms of petition volume and the split between Chapter 7 vs. Chapter 13. Our sample also differs with respect to factors such as regional economic conditions, state-specific asset exemption rules and the laws governing creditor collection practices, each of which is likely to influence the characteristics of petitions filed. Acquisition of cases from courts with these varied characteristics was intentional in order to widen the range of issues addressable with the resulting data set.

We also intentionally selected bankruptcy courts in large cities, many (though not all) of which had relatively large caseloads. The objective was to obtain as large a cross-section of the U.S. petitioner population as possible subject to meeting other project research objectives with limited project resources. Consequently, the sample draws from only 13 of over 180 bankruptcy courts in the U.S., but these 13 courts process nearly 20 percent of the total U.S. volume of petitions.

One potential source of bias could arise if petitions in courts with relatively low caseloads differ from those in courts with larger caseloads, perhaps as a result of court resources available to monitor the filing process. We tested for this bias by using a statistical regression procedure that accommodated both the probability sampling weights and the clustering of observations within sample units (courts). For Chapter 13 debtors, the caseload of the court did not significantly influence either the probability of a petitioner having income available to repay non-housing debt or the total dollars repayable over a 5-year period. However, Chapter 7 cases exhibited a negative relationship between court caseload and the total dollars repayable over a 5-year period. In other words high volume courts appear to have lower repayable dollars per Chapter 7 case. Consequently, the "large-court" bias associated with using our sample to make national projections may be causing us to understate the repayment potential.

The Chapter 7 petitions in our sample represented 18.6 percent of all Chapter 7 petitions filed nationwide in 1996. With the above caveats in mind, if we project our sample experience to the entire nation, we estimate that Chapter 7 debtors in 1996 had the capacity to repay $5.1 billion over a 5-year period.

Table 12
Repayment Summary*
(5-year Repayment Period)

	Chapter 7	Chapter 13
Average available income (summed over 5-year repayment period) applicable to repayment of debt	$6,848	$14,891
Percentage of non-housing debt repayable from available income, full sample (after payment of priority debt)	13.7%	47.0%
Percentage of non-housing debt repayable from available income and liquidation of collateral, full sample (after payment of priority debt)	24.8%	59.6%

*Note that some individuals had more than enough income to repay 100% of their debts over 5 years (Table 11). For these petitioners the dollar repayment was capped at an amount equal to non-housing, non-priority debt.

C. Repayment from Income and Liquidation of Collateral Assets

Not surprisingly, if Chapter 7 debtors liquidated the non-housing assets acquired via their loans, to the extent those assets served as collateral to those loans, then repayment capacity improves, since some debt is liquidated without having to tap income. Table 13 summarizes the average amount of collateral for secured debt, as well as real property cited by Chapter 7 and Chapter 13 petitioners.

Table 13
Property and Collateral

	Chapter 7 (Means)	Chapter 13 (Means)
Housing secured debt (for those with debt)	$111,852	$97,458
Housing collateral (for those with debt)	$105,218	$93,765
Average percent of housing debt backed by collateral	92.2%	93.9%
Non-housing secured debt (for those with debt)	$14,618	$15,130
Non-housing collateral (for those with debt)	$10,775	$11,889
Average percent of non-housing debt backed by collateral	71.8%	76.2%
Amount of real property (for those with property)	$106,689	$120,204
Percent with positive real property	37.4%	60.9%
Amount of personal property	$15,339	$14,373
Percent with positive personal property	99.1%	98.7%

As Table 14 illustrates, by applying the procedure described above in part III, section C, the top 10 percent of all Chapter 7 debtors could repay 100 percent of their non-housing debts if they liquidated non-housing collateral assets. The top 20 percent could repay over half of their non-housing debts. As a percent of all non-housing debt in the Chapter 7 sample, 25 percent could be repaid, out of income and through liquidation of collateral assets (Table 12). This translates into $1.83 billion of repayable debt for the thirteen sampled courts, out of which $943 million was from income and $882 million was debt retired through liquidation.

Table 14
Chapter 7 Petitioners' Capacity to Repay Non-housing Debt, After Payment of Priority Debt and Liquidation of Non-housing Collateral Assets

% of Debtors	Minimum % of Debt Repayable
5	100
10	100
15	73
20	53
25	35
30	24
35	13
40	5

Of course, some Chapter 7 debtors do commit to maintaining payments on their debt through voluntary reaffirmation agreements. As noted previously, 52.7 percent of Chapter 7 debtors intended to reaffirm secured, non-housing debt (Table 15). In total, these intended reaffirmations represented an average of 45.7 percent of the dollar amount of secured, non-housing debt. Interestingly, Figures 7-9 reveal less-than-expected correlation between a Chapter 7 debtor's intention to reaffirm and either net income or available income, especially with respect to non-housing debt.

Table 15
Intended Reaffirmations
(Percent of Petitioners Holding Each Type of Debt)*

	All Chapter 7s
Percent indicating reaffirmation of some debt	40.2 %
Percent indicating reaffirmation of some secured debt	54.7
Percent reaffirming secured housing debt	43.6
Percent reaffirming secured non-housing debt	52.7
Percent indicating reaffirmation of unsecured debt	3.1
Average percent of total debt reaffirmed	15.8
Average percent of secured debt reaffirmed	45.2
Percent of secured housing debt reaffirmed	43.9
Percent of secured non-housing debt reaffirmed	45.7
Average percent of unsecured debt reaffirmed	0.4

*Excludes Dallas cases, for which the schedules listing intended reaffirmations were not yet available.

Figure 7
Percentage Who Reaffirm Any Debt by Available Income Deciles

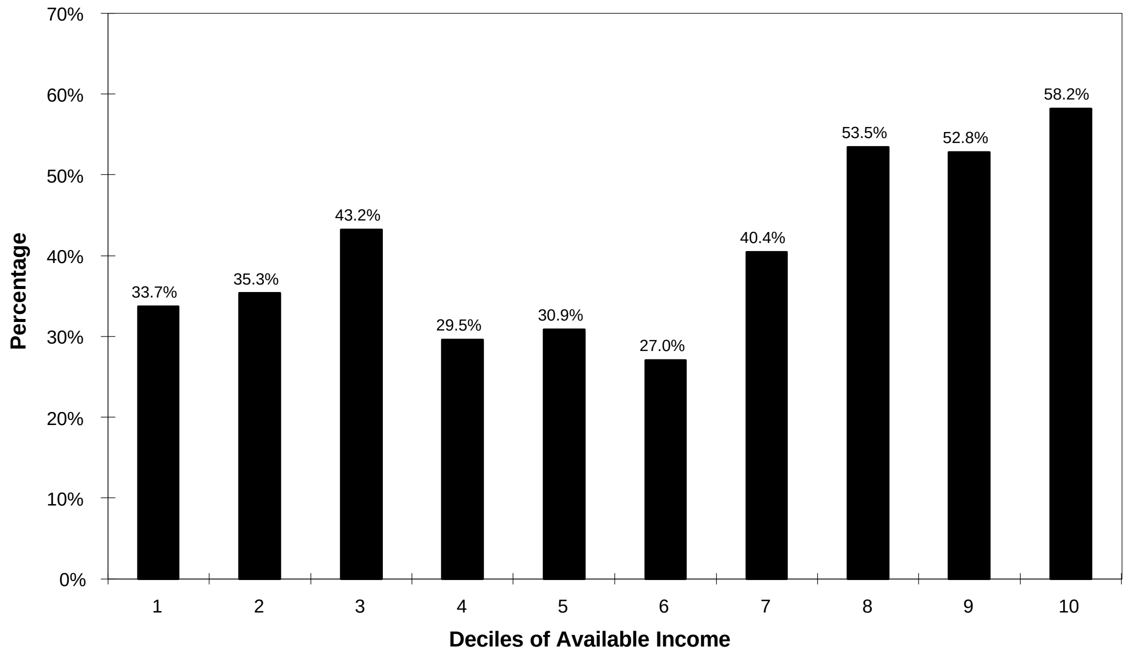


Figure 8
Percentage Who Reaffirm Secured Non-housing Debt by Available Income Deciles

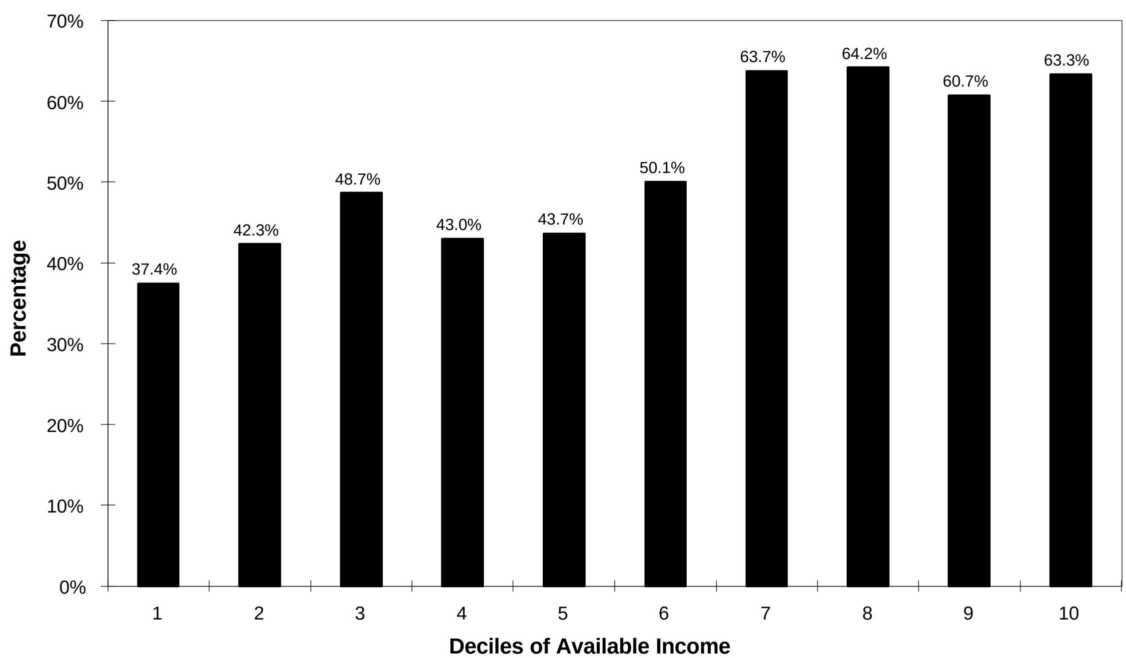
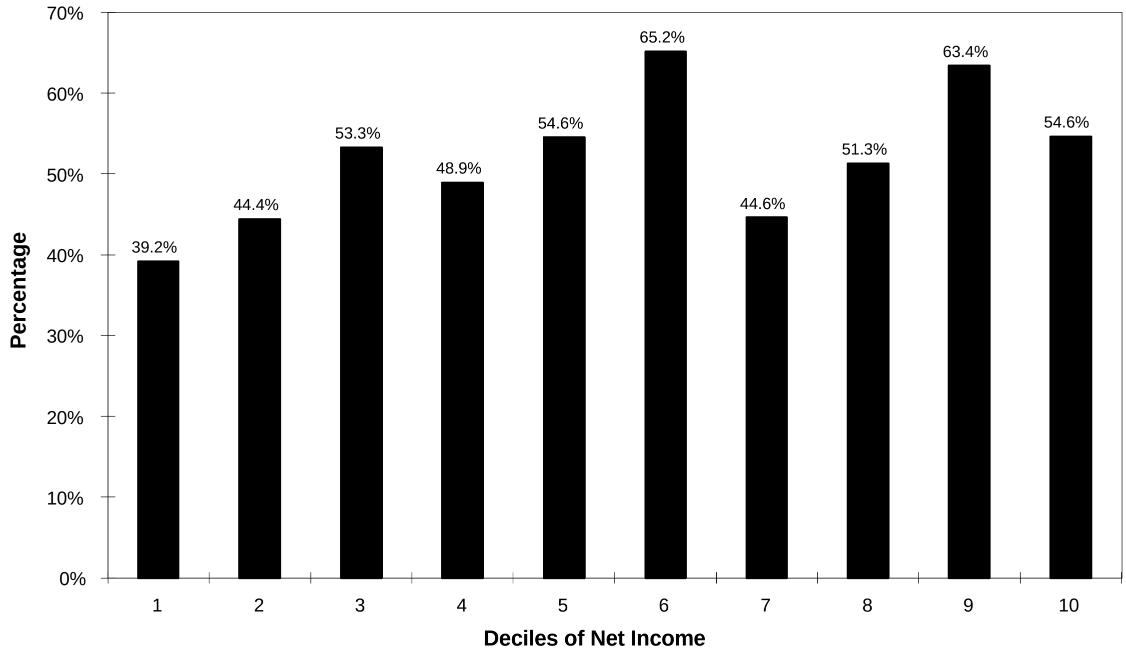


Figure 9
Percentage Who Reaffirm Secured Non-housing Debt by Net Income Deciles



V. Conclusions

Based on our study of nearly 4,000 bankruptcy petitions filed in 1996 we offer the following observations:

1. Consumers who file under Chapter 7 carry about 3% less total debt than those in Chapter 13. However, they have far less secured debt and collateral assets to protect through the bankruptcy process. Conversely, Chapter 13 is dominated by consumers with secured debt (much of it housing debt) backed by assets which they wish to retain by filing for a court-approved repayment plan.

2. Chapter 7 debtors, on average, have net annual incomes about 25% lower than debtors in Chapter 13, although average living expenses are nearly identical. However, average income (and expense) levels mask a wide range of economic circumstances across individual debtors. About 56% of the Chapter 7 sample had zero dollars of income left after subtracting their declared living expenses each month. In contrast, the mean annual income net of living expenses (including mortgage payments) for the top 10% of all Chapter 7 debtors was $9,340, an amount which presumably could be applied toward payment of non-housing debt.

3. Our calculations of debtor capacity to repay non-housing debt are conservative in that they incorporate simplifying assumptions that are likely to understate repayment potential for at least two reasons:

    a. We accept the debtor's statement of monthly housing cost (mortgage or rental payment) as a component of monthly living expenses, although it preserves a level of housing expenditure, relative to income, which may have been partly responsible for the debtor's over-extension. Moreover, we make no attempt to deflate or otherwise adjust living expenses in any category, although such lifestyle adjustments are often recommended to reduce the burden of debt service.

    b. Debtors in some jurisdictions have an incentive to understate their capacity to service debt in order to obtain their Chapter 7 discharge. The bankruptcy statutes do not require auditing or verification of the debtor's income or expense schedules.

    Offsetting these effects to some degree is our assumption that debtor income remains uninterrupted for the duration of the repayment period. Of course, income interruptions will reduce the amount repayable. On the other hand, we have also not incorporated the possibility of rising incomes into the repayment calculations.

4. A sizable minority of Chapter 7 debtors could make a significant contribution toward repayment of their non-housing debt over a 5-year period. In particular, approximately 25% of Chapter 7 debtors declared income sufficient to repay at least 30 percent of their non-housing debt over 5 years while still maintaining their mortgage or rental payments on their homes. Ten percent of Chapter 7 debtors declared income sufficient to repay at least 78% of their non-housing debt over 5 years. Five percent of Chapter 7 debtors could have repaid 100% of their debts over 5 years.

5. To put these proportions in perspective, if we apply them to the total number of bankruptcies filed in the U.S. during 1996 they imply that about 185,000 Chapter 7 debtors (25% of the total) had capacity to repay over 30 percent of their non-housing debt over a 5-year repayment period. About 74,000 had the capacity to repay over three-quarters of their non-housing debt. Close to forty thousand Chapter 7 petitioners had the capacity to repay all of their non-housing debt over a 5-year period.

6. The large majority of Chapter 13 debtors had income at the time of filing that was sufficient to repay two-thirds or more of their non-housing debt over 5 years. Fifty percent could have repaid all of their debts. The financial information that debtors gave the courts contradicts the oft-heard assertion that Chapter 13 imposes excessive hardship on over-extended debtors. It also suggests that the observed failure rate for Chapter 13 payment plans may be due to lack of debtors' incentives to stay with a plan rather than to the lack of ability to repay the debt.

Between 1990 and 1996, the number of Chapter 7 petitions rose by approximately 70 percent. Continued growth at such a rate, and the implied losses to creditors, will result in an increase in the cost of credit. A large body of research has established that these increased costs will be disproportionately borne by individuals with fewer alternatives (e.g. young borrowers and households with low incomes). Our results imply that the bankruptcy system itself is contributing to these rising costs by offering the opportunity to wipe out debt with a single signature to many borrowers that have the capacity to repay.

To the extent that bankruptcy provides a social safety net for borrowers with financial problems, the current system resembles insurance, with creditors serving as the insurance companies. But, if creditors must play the role of insurers, then the system should adopt policies for loss control that are routine among private insurers; namely, sufficient "deductibles" to induce individuals to manage their financial house well and sufficient "claims processing" (repayment evaluation) to assure that those who claim their financial house has been destroyed are providing an accurate assessment of the damage.