

Senate Banking, Housing and Urban Affairs Committee

Subcommittee on Financial Institutions & Regulatory Relief

Hearing on Bankruptcy Reform

**Prepared Testimony of Mr. Bruce Hammonds
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10:00 a.m., Wednesday, February 11, 1998

Chairman Faircloth and Members of the Subcommittee. my name is Bruce L. Hammonds and I am Senior Vice Chairman and Chief Operating Officer of MBNA Corporation ("MBNA")¹, My responsibilities include overseeing MBNA's credit, loss prevention, customer satisfaction, consumer finance and loan review activities. I have 28 years of experience in consumer lending, and have been a member of the MBNA management team since 1982.

I appreciate the opportunity to appear today before the Financial Institutions and Regulatory Relief Subcommittee ("Subcommittee") of the Committee on Banking, Housing and Urban Affairs, United States Senate, to discuss our views on consumer bankruptcy issues. I hope that this statement will be helpful to the Subcommittee in its deliberations on the nature of the consumer bankruptcy reforms that are presently needed.

Overview

Despite an extraordinarily strong economy, personal bankruptcy filings in the U.S. have skyrocketed in recent years. During 1997, there were more than 1.3 million personal bankruptcy filings, an all-time record and nearly a 19% increase over the number of consumer bankruptcy filings in 1996. By comparison, the number of consumer bankruptcy filings in 1980 totaled 287,570. This means that the number of consumer bankruptcy filings in 1997 *represents an increase of more than 360% since 1980.*

These bankruptcy filings generate huge losses. While MBNA's credit card losses have consistently been among the lowest in the business, this precipitous increase in the number of consumer bankruptcy filings has impacted virtually every lender, large and small, in nearly every sector of the credit granting community. In fact, it is estimated that more than \$40 billion in consumer debt -approximately \$400 for each American family -- was erased as a result of bankruptcy in 1997, up from \$30 billion in 1996. Inevitably, these losses are passed on to all consumers in the form of higher rates and higher prices for goods and services.

Despite the magnitude of these losses, bankcard issuers and the credit granting community more broadly believe that bankruptcy is an important protection for consumers who are severely overburdened financially. It should be noted, however, that as bankruptcy losses grow, it is those American consumers who continue to pay their debts who ultimately suffer the most because it is they who bear the cost of bankruptcy losses in the form of higher credit prices. Consumers also are harmed by increased bankruptcies when creditors, in an effort to reduce losses, tighten their credit standards and thereby decrease credit availability. As the Congress considers reform of the Federal bankruptcy system, it is critically important to keep in mind the adverse consequences bankruptcy has on the vast majority of consumers who continue to pay their debts. The basic requirements of fairness demand that a balance be struck between the interests of these consumers and the interests of those consumers who need bankruptcy relief.

The Fundamental Flaw

Unfortunately, today's consumer bankruptcy system does not strike that balance. The current bankruptcy system unnecessarily harms consumers and creditors alike because of a fundamental flaw -- *it allows a debtor to discharge debts even if the debtor can repay some or all of those debts*. In fact, under the current Bankruptcy Code, an individual debtor may obtain a discharge from contractual debt obligations without ever demonstrating actual need for this relief. To put it in context, this means that in 1997 alone, the Federal consumer bankruptcy system provided an estimated \$40 billion of relief to debtors without either objective standards or systematic procedures for determining the actual relief needed by debtors.

This flaw undermines not only the integrity of the U.S. bankruptcy system, but also traditional obligations of individual responsibility. Moreover, the current bankruptcy system also fails the debtors it is intended to help, because it provides short-term relief without helping debtors avoid the same financial failure in the future. In short, the lack of objective and systematic procedures for determining debtor relief produces a bankruptcy process which, for both debtors and creditors, is needlessly costly and time consuming. The bottom line is that this flaw must be remedied if the consumer bankruptcy system is to be workable and fair to consumers and creditors alike.

Needs-Based Bankruptcy

In order to address this flaw, the Bankruptcy Code must be amended so that a debtor who needs bankruptcy protection will receive it, but only to the extent of that need. This approach would match the bankruptcy relief provided by the Code to the debtor's actual need and is essential to ensure fairness for all parties impacted by the bankruptcy process.

This can be achieved by incorporating three very simple concepts into the Code. First, the Code must be amended to establish uniform and objective standards for determining a debtor's need for bankruptcy relief and the amount of relief needed. If the debtor has the ability to repay some portion of his or her debts above a prescribed minimum from disposable income, the debtor should be required to repay that portion through a repayment plan, such as under Chapter 13, if the debtor seeks the protection of the Bankruptcy Code. If the debtor cannot repay, the debtor's case should be handled under Chapter 7.

Second, there must be an efficient mechanism for determining whether the income and expense information filed by the debtor is reliable. With respect to income information, this can be accomplished with relative ease by requiring the debtor to file recent tax returns and pay stubs. For purposes of assessing the accuracy of expense numbers filed by debtors, there are a number of options which could be considered. For example, we believe that random audits would be helpful in this regard. In order to ensure the integrity of the process, however, some additional checking for accuracy also must be required, and I would like to mention just one possible approach.

The Department of Labor already gathers substantial information on the cost of living throughout the country. This information includes costs for food, clothing, shelter, fuel, transportation, charges for doctors and dentist services, medicine, and other costs of day-to-day living. This information can be used to develop expense models which show some base-line measure of expenses appropriate for different geographic regions. These expense models could then be used as a reference point to assess the accuracy of expenses filed by a debtor, and to highlight expense categories on a debtors' filing which may warrant further investigation. Under this approach, disputes about the accuracy of information would be limited to the exceptional case. This is just one example of how the system could efficiently ensure that there is some integrity with respect to the information filed in bankruptcy cases,

Third, based on the statutory eligibility standards and the reliable information filed by the debtor, the Code should be amended to prescribe efficient administrative procedures for assigning debtors to the appropriate chapter -- that is, to Chapter 7 or to Chapter 13 -- at an early point in the process. This would drastically reduce the number of costly and time consuming disputes that occur in today's system, in which a debtor's Chapter 7 filing usually may be challenged only after the case is well under way and only through a separate judicial procedure. Once these three concepts are incorporated into the Code and a needsbased bankruptcy system is established, the Federal bankruptcy system will largely run itself and disputes will be limited to exceptional cases.

Needs-Based Bankruptcy Promotes Systemic Efficiencies

This brings me to a very important point. While fundamental fairness alone dictates that a needs-based bankruptcy system be adopted, it should be noted that the implementation of a needs-based bankruptcy approach also would introduce enormous efficiencies into the bankruptcy system. A needs-based bankruptcy approach would actually reduce the overall costs of consumer bankruptcy by decreasing the litigation and disputes that result from today's arbitrary bankruptcy system. Under needs-based bankruptcy, based on a simple calculation performed by the debtor and easily verified by the trustee, individuals who can repay some portion of their debt would automatically enter a Chapter 13 repayment plan, and those who cannot would automatically enter into Chapter 7. As noted above, a needs-based bankruptcy system will largely run itself- the vast majority of bankruptcy cases will travel routinely and efficiently through the system, and disputes will be limited to exceptional cases.

In short, a needs-based bankruptcy relief system can be implemented efficiently and effectively. Without needs-based bankruptcy relief, the system will continue to be arbitrary, wasteful and fundamentally unfair to the great majority of consumers who pay for the system but do not use it. Unless this flaw is addressed, controversy surrounding consumer bankruptcy will intensify, not diminish.

Proposed Legislation

Chairman Faircloth also has asked me to comment on proposed bankruptcy legislation. Bankcard issuers believe that the needs-based approach contained in H.R. 3150, recently introduced in the House of Representatives by Representatives Gekas, McCollum, Boucher and Moran, would efficiently, effectively and fairly implement the kind of needs-based bankruptcy approach that is necessary. In addition, H.R. 3150 contains a number of other amendments to the Bankruptcy Code that address specific inequities and other problems in the Code. We are joined in our strong support for H.R. 3150 by representatives of virtually every segment of the consumer credit granting community.²

Furthermore, we are concerned that other proposed approaches which do not contain specific guidelines for determining a debtor's need at the time of filing may not adequately address the current bankruptcy problem. Moreover, we believe that these other approaches would not introduce the same administrative efficiencies as a more systematic needs-based bankruptcy approach, such as that contained in H.R. 3150.

Two Myths

Finally, I would like to take a moment to address a couple of myths that you are likely to hear repeated, possibly today and certainly in the coming months. One is that bankruptcy reform legislation is unnecessary because the system is not broken. Some will claim that credit cards are the real cause of the explosion in personal bankruptcies, and that restricting the availability of credit through credit cards would solve this nation's bankruptcy crisis. I understand that for many this is a tempting and popular position, but it is false. The evidence simply does not support such a contention.

Instead, let's look at the facts. More than 96% of credit card accounts pay as agreed, and only about 1% end up in bankruptcy. Moreover, bankcard debt represents less than 16% of total debt on the average bankruptcy petition and, according to a Federal Reserve Board survey last year, credit cards account for a mere 3.7% of consumer debt -- hardly large enough figures to be the cause of the bankruptcy crisis.

Another popular myth is that credit grantors are intentionally offering credit willy-nilly to people who cannot handle it. Once again, this contention simply is not true. Card issuers use highly sophisticated and expensive "prescreening" underwriting techniques, which involve consideration of as many as hundreds of factors about a consumer, to ensure that consumers who receive "pre-approved" offers of credit have a demonstrated ability and willingness to repay their debts.

Let me tell you specifically how we do it at MBNA. MBNA is the second largest lender through credit cards in the world. We receive an application from every customer, pull a full credit report on that customer, and do a debt-to-

income analysis. We call back over 20% of the customers to develop additional information. A credit analyst will then make a decision to approve or decline the account. If the account is approved, a risk rating is applied and, in many cases, a senior lender sign-off is also required. We believe we are making the right decision every time. The majority of bankruptcies in our file are on customers who have been on the books for more than three years and have had some significant change in their financial condition. Less than 5% of our bankruptcies occur in connection with accounts that have been opened within the past twelve months.

The fact is, the overwhelming majority of Americans use credit wisely and successfully. Americans use their cards to pay at the gas pump, the grocery store and literally millions of other places. With the advance of on-line security systems, consumers are increasingly using their cards to conduct business and make purchases over the Internet. And credit has made opportunities available for millions of Americans who might not otherwise have had them, across a huge range of income levels.

In addition, the lending industry spends millions of dollars every year on education programs designed to help consumers use credit wisely. The bankcard industry works particularly closely with the more than 1,200 Consumer Credit Counseling Services offices around the country, which help many thousands of consumers get control of their finances and repay their debts. We are proud of the lending community's far-reaching efforts to inform, educate and assist consumers.

Once again, I want to thank you for the opportunity to appear before you today. Please let me know if we can be of any further assistance to the Subcommittee or its staff.

Notes:

¹ MBNA Corporation is a bank holding company. Its principal subsidiary is MBNA America Bank, N.A., a national bank. MBNA America Bank is the largest independent credit card lender in the world and one of the two largest credit card lenders overall. MBNA has \$49.4 billion in managed loans outstanding and almost 20,000 employees in 28 offices located in the U.S., the United Kingdom and Canada.

² For instance, H.R. 3150 is strongly supported by the National Consumer Bankruptcy Coalition, which is comprised of the American Bankers Association, America's Community Bankers, American Financial Services Association, Consumer Bankers Association, Credit Union National Association, Independent Bankers Association of America, MasterCard International Incorporated, National Retail Federation and VISA U.S.A. Inc.