Senate Banking, Housing and Urban Affairs Committee

Subcommittee on Financial Institutions & Regulatory Relief

Hearing on Bankruptcy Reform

Prepared Testimony of Mr. Robert R. Davis
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Good Morning. My name is Robert Davis. I am Director of Government Relations for America's Community Bankers. America's Community Bankers is the national trade association for 2,000 savings and community financial institutions and related business firms. The industry has more than $1 trillion in assets, 250,000 employees and 15,000 offices. ACB members have diverse strategies based on consumer financial services, housing and community development.

Let me begin by commending the Chairman for holding these timely hearings. As you are aware, Mr. Chairman, the number of bankruptcies continue to rise even in this strong economy. In 1997, for example, bankruptcies reached an all time high of 1.3 million. More than $40 billion in consumer debt was eradicated through bankruptcy last year - losses that are inevitably passed on to all consumers, resulting in a hidden tax of $400 for every American family. The losses from bankruptcy have placed major burdens on community banks, especially those with large consumer and credit card operations.

ACB believes that the bankruptcy system is fundamentally flawed because it allows the discharge of the current debts of persons who have the ability to pay at least a portion of their obligations. We believe that the most appropriate way to eliminate these current bankruptcy problems is to amend the existing bankruptcy code so that it provides protection for those individuals who really need help.

The most equitable methodology for reform is to erect a bankruptcy system that provides for relatively easy discharges for those who are truly unable to repay, and requires the remainder of the debtors in bankruptcy to repay their debt obligations to the extent possible. Bankruptcy should be the last resort, not an initial response to financial difficulty. If the bankruptcy code is structured so that filing bankruptcy and receiving a discharge becomes too easy, the bankruptcy system will encourage debtors to file for bankruptcy as soon as they incur any significant financial difficulty. The code should instead encourage alternatives such as credit counseling and payment rearrangements. We cannot allow bankruptcy to become routine for people who borrow with no real commitment to repay.

The current bankruptcy code encourages debtors to view bankruptcy as a financial management tool rather than a last resort. Bankruptcy should offer equitable relief for debtors, particularly when they face dire circumstances that often create obligations beyond their ability to pay. Lenders must also recognize that extensions of credit must be made under prudent guidelines.

General Concerns

Community bankers arc faced with a number of problems emanating from the existing bankruptcy code. The resolution of these problems include: (1) incorporation of a needs-based bankruptcy system, (21) elimination of the multiple filings provisions; (3) elimination of mandatory creditors' counsel provisions (4) reexamination of the cram down provisions; (5) refinement of the co-debtor automatic stay: (6) provision of some uniformity in the household goods area-, and (7) provision of some adjustment in existing Chapter 13 plans.

Needs-based bankruptcy

ACB believes that the principal problem with the existing bankruptcy code is that debtors that have the ability to repay all or a portion of their debts are not required to do so. They are nevertheless able to receive a discharge in Chapter 7 (liquidation) and maintain many of their assets in the process even though their future earnings may be substantial and remain unimpaired.

Therefore, ACB believes that changes should be made to the code to address this problem. All consumer debtors should be required to initially file in Chapter 13. The bankruptcy court would then determine whether the debtor has sufficient income to pay any portion of his or her debts. If the debtor has the capacity to pay all, or a portion of his or her debts, he or she would remain in Chapter 13 and a repayment plan would be established. If the court determines that the debtor is unable to pay any of his or her debts, the debtor would then be transferred to Chapter 7 and his or her debts would be discharged.

A fresh start approach -- involving a total discharge of debt obligations -- should be reserved for those genuine cases of personal or financial adversity (e.g., accumulation of medical expenses) where repayment is truly impractical. The needs-based bankruptcy approach has been largely incorporated in H.R. 2500, H.R. 3150, and S. 1301. ACB generally supports all of these legislative initiatives.

Multiple Filings

Certain debtors now elect to file their bankruptcy petitions in Chapter 13. This chapter is sometimes referred to as the "wage carriers plan" because it is contemplated that the debtor will attempt to pay all or a portion of his or her debts over a three to five year period. In turn, the debtor will receive an automatic stav which bars creditors from proceeding against the debtor in connection with anv of his or her debt obligations and which ultimately results in a discharge of these obligations.

Unfortunately, this process is frequently abused by debtors. In many instances, a debtor will file in Chapter 13 and never make anv subsequent payments under the proposed payment schedule even though the debtor continues to enjoy the benefits of the automatic stay. Under the current procedure, the creditor must generally wait until the trustee dismisses the debtors' petition before proceeding against the debtor. Once the petition is dismissed, the debtor may refile almost immediately in Chapter 13 or Chapter 7 and the process starts all over again.

Meeting of Creditors and Equity Security Holders

Section 341 of the bankruptcy code provides that, within a reasonable time after a petition for relief is filed, the United States Trustee shall convene and preside at a meeting of the creditors. The bankruptcy code specifics that the bankruptcy judge may not attend or participate in the proceeding. The debtor appears during the meeting and gives responses to creditors' interrogatories under oath. A creditor may file a complaint to bar discharge of a debt after the section 341 meeting.

In connection with claims of $5,000 or less, creditors must be represented by counsel. Understandably, it is expensive to retain counsel in an effort to obtain repayment of small claims. In many instances, the bankruptcy attorney's fee itself makes it unfeasible to pursue a substantial volume of the small claims.

Therefore, a significant portion of claims of $5,000 and under are not challenged by creditors beyond the section 341 meeting and are therefore forfeited because of cost constraints. The small claims representation issue results in large aggregate losses, especially for credit grantors catering principally to small accounts. These claims add significantly to our member institutions' total bankruptcy related costs.

Accordingly, we suggest that the bankruptcy code be amended to provide that creditors may pursue these claims throughout the bankruptcy proceeding, including proceedings against debtors with obligations of $5,000 or less. This modification to the bankruptcy code would restore some degree of equity to section 341 meetings and subsequent proceedings.

Cram Downs Revisited

Prior to the Supreme Court decision In Nobelman in 1993 and the bankruptcy Reform Act of 1994, secured lenders faced substantial uncertainty with respect to the cramming down or the diminution of the value of their secured claims in bankruptcy. During this period, many bankruptcy courts routinely reduced the value of a creditor's secured lien to an amount equivalent to the market value of the collateral (at the time of bankruptcy) and designated the remaining value as unsecured. However, the Supreme Court in the Nobleman case concluded that the cram down procedure was improper with respcct to the debtor's primary residence. The Court specified:

> "Petitioners propose to reduce the outstanding mortgage principal to the fair market value of the collateral. and. at the same time, they insist that thev can do so without modifying the hank's rights as to interest rates, payment amounts, and (other) contract terms... That appears to be impossible. The hank's contractual rights are contained in a unitary note that applies at once to the bank's over-all claim, including both the secured and unsecured components. Petitioners cannot modify the payment and interest terms for the unsecured component, as they propose to do, without also modifying the terms of the secured component."

In addition, the bankruptcy code of 1994 applied the Nobelman holding to Chapter I I proceedings. Since 1994, however, many bankruptcy courts have started to reinterpret both Nobelman and the reference in the 1994 . bankruptcy Reform Act. At the district court level, some courts have ruled that, under certain circumstances, the secured lien on residential real estate can be crammed down. Therefore. we believe that the cram down language from the Nobelman case, as well as other germane language, should be specifically incorporated into the bankruptcy code to clearly prohibit cram downs of secured residential real estate liens.

Co-debtor Automatic Stay

The bankruptcy code extends the benefits of the automatic stay achieved in Chapter 13 to co-debtors. More specifically, section 1301 provides that a creditor may not act, commence, or continue any civil action to collect all or any part of a consumer debt from an individual that is liable on such debt with the debtor unless the case is closed, dismissed, or converted to a case under Chapter 7 or 11. Section 1301 makes an exception for an individual who became liable on the debt or secured by the debt, in the ordinary course of such individual's business.

When a debtor files a bankruptcy petition, the automatic stay prohibits creditors from proceeding against the co-debtor in an attempt to collect the underlying debt obligation, even though the co-debtor has not filed a bankruptcy petition. The co-debtor may be quite solvent or may, as a matter of fact, be a multimillionaire.

It should be noted that when the co-debtor signs the underlying debt obligation, he or she is aware of the assumption of joint and several liability and the possibility, under certain circumstances, of becoming the sole obligor to the credit grantor. Section 1301 insulates the co-debtor from contractual obligations that he or she freely undertook. ACB believes it is inappropriate for an individual who has not sought the protection of the bankruptcy code to vitiate his or her contractual obligation.

Further, it is conceivable that the primary debtor could surrender his or her interest in the collateral so that the co-debtor could, in addition, have actual possession of the collateral and continue to use it without making any payments while the automatic stay is in effect. This clearly produces an inequitable result. Therefore, the bankruptcy code should be amended to provide that the automatic stay is lifted with respect to the co-debtor when the Chapter 13 plan is confirmed. This amendment would not, in anv way, adversely impact the rights of the debtor in bankruptcy; however, it would permit the credit grantors to pursue their contractual and other remedies against the co-debtor under applicable law.

Household Goods: Exemptions and Lien Avoidance

Section 522 of the bankruptcy code should be amended to provide a new definition of "household goods" to make it consistent with the definition of this term in the Federal Trade Commission's Credit Practices Rule. In addition, the federal exemption set forth at Section 522(d)(3) should be amended to be consistent with the new definition of "household goods" in order to provide uniformity in those states which permit debtors to make an election between federal and state exemptions. Finally, the reference to "household goods" in Section 522(f)(2), which permits debtors to avoid a judicial or a nonpossessory, nonpurchase-money lien on household goods, should be amended to he consistent with the new definition.

Accommodating Defaults in Plan Payments

A debtor's confirmed Chapter 1 1 or Chapter 13 plan should represent equitable "recontracting" of the debtor's obligations with his or her creditors. It should reflect the debtor's best efforts and also protect the creditor's interest so that the creditor will receive more than in a liquidating bankruptcy. Section 1326 of Title I 1 specifies that the debtor must "commence making the payment proposed by a plan within 30 days after the plan is filed," and Section 1302(b)(5) requires the trustee to "ensure that the debtor commences making timely payments" under section 1326 of the code. In addition, 1307(c)(4) states that a case may be dismissed or converted based on the debtor's failure to maintain the payment plan. Due to a variety of factors, however, debtors are sometimes unable to maintain regular and prompt plan payments. A large percentage of confirmed Chapter 13 cases are ultimately dismissed, mostly for nonpayment. The bankruptcy court should have the power to reexamine and refashion plans consistent with fluctuations in the debtor's income.

Credit Card Issues

It has been suggested by some observers that the issuance of credit cards by lenders is a major cause of bankruptcy. This suggestion ignores the fact that more than 96 percent of credit card holders pay their bills as agreed, and only I percent ever end up in bankruptcy. In addition, bank credit cards represent less than 16 percent of total debt on the average bankruptcy petition.

Of course, lenders also have responsibilities to accurately underwrite consumer credit. ACB believes that lenders should extend credit only when there is a reasonable expectation that the borrower can repay the debt obligations in good faith and in a timely manner. We oppose, however, the concept incorporated in the Nadler-Conyers bill in the House of Representatives that attempts to limit a creditor's claim in bankruptcy based on the of the creditor's underwriting methodology.

Credit Quality and the Role of Supervision

Balanced against changes to the bankruptcy code necessary to establish proper incentives for discharge of debts within a debtor's ability to pay, ACB supports continued rigorous enforcement by bank regulators of svervisorv standards designed to maintain prudent loan underwriting standards. These standards arc essential to maintain the safety and soundness of the banking system. The potential for emerging problems connected with consumer credit quality, often involving non-bank lenders. is best addressed by ensuring that appropriate credit policies are followed.

The necessary statutory and regulatory apparatus is currently in place to oversee credit standards and direct corrective action through the supervisory process where warranted. ACB believes that the banking regulators have been especially mindful of their obligations in this regard, and have indicated that credit standards will be maintained at appropriate levels throughout the business cycle. We encourage this Committee to continue its strong oversight role as it monitors these ongoing efforts by the regulators.

Community banks are closely supervised by an extensive bank regulatory mechanism that monitors and supervises credit extension criteria and examines the institutions to make certain that they are in compliance with applicable credit extension policies. For example, some of the bank regulatory and operational guidelines provide:

- lending limits -- Banks and thrifts generally follow the national bank standard codified in the Office of the Comptroller of the Currency's regulation at 12 CFR Part 32 providing for a per borrower lending limit of 15 percent of an institution's capital and surplus and an additional 10 percent if totally secured by readily marketable securities. Savings associations have additional flexibility to finance domestic housing or for other loans, generally mortgages, up to $500,000.

- loan underwriting guidelines -- Loan underwriting standards such as the interagency guidelines for real estate lending address the overall creditworthiness of a borrower. For example, see the Office Thrift of Supervision's (OTS) real estate lending regulations at 12 CFR PART 560.

- creditworthiness standards -- Banks and thrifts obtain credit reports and evaluate other data to determine a borrower's creditworthiness in terms of debt load and ability to repay. This standard procedure ensures safety and soundness and prudent underwriting standards.

Furthermore, the OTS examination guide specifically instructs examiners to scrutinize extensions of credit by the community bankers that it regulates. For example, the OTS manual (a portion of which is attached) provides that a savings institution's loan policy should: (1) approve and service loans on a safe and sound basis-, (2) serve the legitimate needs of the community; (3) address the servicing, collection and charge-off of loans; and (4) be reviewed periodically by the board of directors to ensure that the policy remains appropriate as market conditions change.

The OTS examination procedures also specifically mandate that the regulated institutions maintain precise credit underwriting standards. Each institution must establish and maintain prudent credit underwriting practices that:

- are commensurate with the types of loans the institution will make and consider the terms and conditions under which thev will he made;

- consider the nature of the markets in which loans will be made;

- Consider, prior to credit commitment, the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed;

- establish a system of independent, ongoing credit review with appropriate communication to management and to the board of directors;

- take adequate account of concentration of credit risk; and

- make certain that loans are appropriate to the size of the institution and the nature and scope of its activities.

ACB believes that the propriety of loan underwriting has been thoroughly covered by the regulatory agencies. Therefore, it would be wholly inappropriate to limit a community bank's subsequent claim in the bankruptcy courts based upon some initial loan underwriting criteria. The historical propose of the bankruptcy code has been to examine the present condition of the debtor and make a determination as to "what is his or her current financial posture" -- not whether the debtor should have managed his or her financial resources properly or whether the creditors with whom the debtor has a relationship erred in developing credit underwriting models. We do not believe that this fundamental bankruptcy code concept should be altered.

ACB is grateful to you, Mr. Chairman, and other members of the Committee for the opportunity you have provided us to make our views known with respect to various facets of bankruptcy.
