# Senate Banking, Housing and Urban Affairs Committee

## *Subcommittee on Financial Institutions & Regulatory Relief*

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## Hearing on Bankruptcy Reform

## Prepared Testimony of Mr. William E. Brewer
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### 10:00 a.m., Wednesday, February 11, 1998

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### I. - PERSONAL BACKGROUND

Good morning Mr. Chairman and Honorable Senators, I am William E. Brewer, Jr., of Raleigh, North Carolina. I am honored to be here today as a Director of the National Association of Consumer Bankruptcy Attorneys (NACBA) and as a bankruptcy practitioner with over 20 years experience in private practice. I have been a NACBA member since 1993, and was elected a Director in May 1997. I also serve on the Executive Council of the Bankruptcy Section of the North Carolina Bar Association.

I graduated from the University of North Carolina - Chapel Hill with an A.B. in Economics in 1973, and received my J.D. with honors in 1976. 1 served as law clerk to Judge R.A. Hedrick of the North Carolina Court of Appeals before beginning private practice in 1977.

Certified as a specialist in consumer bankruptcy law by the North Carolina State Bar, I represent primarily consumer bankruptcy debtors in Chapter 7 and Chapter 13 cases. In that role, I represented the debtors in a series of well-known cases against Sears in the Eastern District of North Carolina, dealing with the validity and effect of purchase money security interests in bankruptcy cases. I have litigated numerous consumer bankruptcy issues and have over 15 reported cases.

### II. - BANK CONSUMER LENDING PRACTICES
### CONTROL THE NUMBER OF
### CONSUMER BANKRUPTCY FILINGS

1. - THE INCREASE IN BANKRUPTCY FILINGS HAS BEEN CAUSED BY INCREASING NUMBERS OF OVER-EXTENDED DEBTORS

In the ten years from 1986 to 1996, outstanding revolving consumer credit increased 238% (from $136 billion to $460 billion). Over the same period, total bankruptcy filings increased just 122% (from 530,436 to 1,178,555). Therefore, although the fact that bankruptcy filings exceeded one million cases in 1996 attracted substantial media attention, the rate of increase in bankruptcy filings during that ten-year period was only about half the rate of increase in outstanding revolving consumer credit. In fact, the increase in bankruptcy filings actually slowed substantially over the last five years. While bankruptcy filings increased 78% from 1986 to 1991, they increased only 25% from 1991 to 1996. [Administrative Office of the U.S. Courts, Federal Reserve Board & Department of Commerce]

Disposable household income, however, has not experienced anywhere near such an increase over the last ten years.

Consequently, household debt-service payments have risen as a share of disposable income. It should not be surprising that non-business bankruptcy filings closely track the debt-to-income ratio over the period of 1962 to 1995. As the debtto-income ratio increases, so do bankruptcy filings. [Kim Kowalewski, Congressional Budget Office]

Similarly, personal bankruptcy filing rates track credit card delinquency rates, as documented in the work of my fellow panelist, Professor Lawrence Ausubel.

2. - CREDIT CARD DELINQUENCY RATES AND DEBT-TO-INCOME RATIOS HAVE INCREASED BECAUSE BANKS HAVE PURSUED MORE MARGINAL BORROWERS

As the cost of funds to banks decreased, credit card lending at high rates became increasingly attractive for banks. In order to expand their credit card market-base, banks loosened credit standards significantly. Higher-quality borrowers relied less on credit card borrowing and more on lower-interest forms of borrowing, leaving credit card lenders to pursue more marginally qualified borrowers.

The marketing of credit cards by banks increased drastically in the last few years. Credit card mail solicitations approached and exceeded 2.5 billion solicitations per year in the last several years. Banks also purchased increasing numbers of telemarketing hours to solicit credit card usage. Old-fashioned advertising of credit cards also increased. As evidence of this mass marketing, everyone knows of children and even pets who have received credit card offers in the last few years.

As a result of the heavy marketing of credit cards to increasingly marginal borrowers, it is understandable that credit card delinquency rates have increased, along with the debt-toincome ratio.

3. - BANKS HAVE PURSUED MORE MARGINAL BORROWERS BECAUSE EVEN WITH THE ASSOCIATED LOSSES THEIR NET PROFITS GREATLYINCREASE

While net profits earned by banks on their credit card portfolios have decreased over the last few years, those profits remain substantially higher than other forms of bank lending. In 1993-94, credit card lending was 135% more profitable, as a percent of assets, than all forms of bank lending taken together. In 1995, credit card lending was 54% more profitable; and in 1996, credit card lending was about 35% more profitable. So, although credit card net profits have decreased somewhat, it is still substantially more profitable than other forms of bank lending. [Economic Report of the President, 1997]

4. - BANKRUPTCY FILINGS MAKE UP ONLY A PORTION OF ALL BANK CHARGE-OFFS

Charge-offs on credit card lending have increased in the last few years, now approxi- mating 5%, bringing the rate back up to the previous 1991 peak. Charge-offs due to bankruptcy filings account for only about half of those charge-offs, according to the credit card industry. In general, charge-offs result when borrowers simply cannot repay their debts. Whether the borrower files a bankruptcy to resolve the financial dysfunction legally, or merely allows the debt to be charged-off outside of bankruptcy, does not change the underlying cause of charge-offs. In either case, the debtor does not have enough money to pay his/her debts.

5. - BANKS CAN CONTROL THEIR CHARGE-OFF RATES BY CHANGING THEIR LENDING PRACTICES

Charge-off rates vary greatly among banks, depending on their lending practices. Low charge-off rates reflect more responsible lending practices [e.g., MBNA (Wilmington) 2. 1 % and Peoples (Bridgeport) - 2.4%]. On the other hand, higher charge-off rates result from riskier lending practices [Mellon (Wilmington) - 9.0% and Hurley State (Sioux Falls) 9.0%]. [Veribanc, as cited by Stephen Brobeck, *Expanding Credit Card Debt: The Role of Creditors and the Impact on Consumers*, December 16, 1997]

Common sense indicates that banks can reduce high charge-off rates by instituting more responsible lending practices. Evidence shows that banks do just that, in many cases. Jonathan McCarthy, *Debt, Delinquencies, and Consumer Spending*, Current Issues in Economics and Finance - Federal Reserve Bank of New York, February 1997.

6. - THEREFORE, BANK CONSUMER LENDING PRACTICES IN LARGE PART CONTROL THE NUMBERS OF CONSUMER BANKRUPTCY FILINGS

As banks pursue riskier borrowers in order to earn high interest from increasing numbers of issued credit cards, the debt-to-income ratio of borrowers increases, and particularly that ratio of more marginal borrowers. With more borrowers, and more marginal borrowers, on the brink of financial disaster which can be brought on by illness, divorce or unemployment, the possibility of financial dysfunction looms. An increase in bankruptcy filings is a natural consequence of the banks' riskier lending practices.

Some bank lobbyists claim that purportedly "lax" U.S. bankruptcy laws (dating back to 1978) have caused the number of bankruptcy filing to increase. If this were true, bankruptcy filings should have decreased in the mid-1980s when "means-testing" was incorporated in the Bankruptcy Code. No such decrease in fillings occurred then, and no increase in filings occurred in 1979 when the 1978 Bankruptcy Code went into effect. In fact, rates of bankruptcy filings in the U.S. track bankruptcy filings in Canada. Clearly, U.S. bankruptcy laws have no affect on bankruptcy filing rates in Canada; what is much more likely is that similar economic forces and lending practices have caused the similar bankruptcy filing rates.

## III. - CONSUMERS WHO PAY THEIR CREDIT CARD BILLS IN FULL DO NOT PAY FOR THE DEBTS DISCHARGED IN BANKRUPTCY

Bank lobbyists claim that consumers who pay their credit cards in full also pay for debts discharged by others in bankruptcy -- that those losses are passed directly through to other consumers. If this were true, when bankruptcy filings are up interest rates would increase; and when bankruptcy filings decrease interest rates would likewise decrease.

On the contrary, just the opposite seems true. With bankruptcy filing rates at an alltime high, credit card interest rates are actually somewhat lower than they were earlier in the 1990s when bankruptcy filing rates were substantially lower. In addition, if banks passed through to their customers their losses and profits, during the 1991-92 record profit years one would have expected rebates or lower interest rates to have been passed through to the customers. Of course, that did not happen.

While credit card interest rates have fallen slightly in the last few years, the cost of funds to banks has fallen even more. This spread in interest rates (between interest charged and the cost of funds) has increased from 6.1 percentage points in 1982 to I I percentage points in 1996. [Donald Morgan and Ian Toll, Bad Debt Rising, Current Issues in Economics and Finance - Federal Reserve Bank of New York, March 1997]. With this significant increase in the spread, banks could easily have passed their profits through to consumers in the form of even lower interest rates. They chose not to, however; but rather chose to assume additional risks of marketing credit cards to more marginal borrowers in hopes of further increasing their net profits.

## IV. - FIVE MYTHS ABOUT CONSUMER BANKRUPTCY FILINGS

1. - MYTH #1: THE COST OF DISCHARGING $40 BILLION IN DEBTS IN BANKRUPTCY EVERY YEAR IS PASSED DIRECTLY ON TO THE AVERAGE CONSUMER IN THE AMOUNT OF $400 PER YEAR

There are no statistics which support the bank lobbyists' claim that $40 billion is discharged in consumer debt each year. Neither the U.S. Trustee Program nor the Administrative Office of the U.S. Courts maintain any statistics on this subject. Nor does the Staten Study provide any information about the total amount of discharged consumer debt; the Study does not even clarify whether business bankruptcies were excluded from the sample.

Although obviously a substantial amount of debt is being discharged in consumer cases each year, and the discharged debt is a charge against the credit system as a whole, it is misleading to state that this charge is passed directly on the average consumer. When bank- ruptcy rates declined, in 1993 and 1994, at a time when credit card profits peaked -- consumers received no rebates from the banks.

However, banks have increased fees associated with credit card lending recently. The fees have not been charged to all credit card users across the board, however. Banks have reduced grace periods and in some cases imposed nominal annual fees for users who carry no balances and therefore pay no interest. But, the bulk of the fee increases have targeted marginal borrowers. Most notably, banks will now increase a borrowers' interest without notice if the borrower's credit report shows vulnerability -- with the result of pushing a marginal debtor even closer to filing bankruptcy.

These increased fees may be seen as ways in which the cost of consumer bankruptcies is distributed among consumers, with a heavy emphasis on consumers most likely to need bankruptcy relief in the future. But, these increases in fees to consumers could just as easily be tied to debt discharged by large businesses that file bankruptcy, or other inherent costs in our economic system such as environmental protections or highway repairs.

2. - MYTH #2: A SUBSTANTIAL NUMBER OF DEBTORS CAN PAY THE DEBTS THEY DISCHARGE IN BANKRUPTCY

The only support for this myth is in the unfounded conclusions of a bank industryfunded Credit Research Center study done by Professor Michael Staten ("Staten Study"). After being criticized by Kim Kowalewski, Economist for the Congressional Budget Office, in a report which is attached as an Appendix to the Report of the National Bankruptcy Review Commission, the Staten Study was again criticized by the GAO, in its own draft report completed in January. The GAO report charged that, among other important failures in methodology, the Staten Study did not use scientific random sampling techniques.

Putting aside for the moment its serious deficiencies, the Staten Study stated that:

1. 50% of Chapter 13 debtors could pay all nonpriority, nonhousing debt over five years;
2. 69% of Chapter 13 debtors could pay 60% + of all nonpriority, nonhousing debt over five years;
3. 5% of Chapter 7 debtors could pay all nonpriority, nonhousing debt over five years;
4. 10% or 15% of Chapter 7 debtors could pay 78% + of nonpriority, nonhousing debt five years.

The initial Staten Study did not take into consideration that the debtor would be repaying certain debts that would be reaffirmed or debts that would not be discharged but were also not priority debts, such as assigned child support and most student loans.

The Staten Study reported widely varying average dollar amounts which the debtors stated their intention to reaffirm in Chapter 7 cases: $1,3 1 0 in Dallas to $6,706 in Memphis; and wide variations in percentages of debtors who stated their intention to reaffirm debts: I 1% in Dallas, 57% in Houston, and 73% in Indianapolis. The initial Staten Study did not reduce the amount it estimated the debtors could pay on nonhousing debt by the amount the debtors indicated they would reaffirm. In a subsequent revision of his Study, Staten claimed to have accounted for monthly payments on reaffirmed secured debt. This is extremely hard to believe because it is only rarely that expected monthly payments on reaffirmed debts are disclosed anywhere in the debtors' bankruptcy schedules.

According, a major problem with the Staten Study's conclusion is that it did not seriously purport to determine the amount of discharged and unreaffirmed nonhousing debt the debtor could afford to repay. Staten does not address the fact that nonpriority nondischargeable debts are rarely identified as such in the schedules. A conclusion that a debtor can afford to repay a certain percent of nonhousing debt is without any import whatsoever, if the debtor will indeed be repaying an equivalent amount because it is nondischargeable or reaffirmed. Because the Staten Study has not calculated how much of the debtors purported ability to pay will be consumed by reaffirmed and nondischarged debt, the Study completely fails to prove that any debtors, much less a substantial number of bankruptcy debtors, can repay their discharged debts.

Using my twenty years of experience, I can conclude that the vast majority of consumer bankruptcy debtors are honest and conscientious. As such, rather than strategically hiding or undervaluing assets and projected income, they often err in the opposite direction. They are, really, much like the rest of us in terms of being generally unable to accurately estimate their financial situation -- and, if anything, they are more optimistic than they should be:

- They tend to underestimate the amount of their total outstanding debt;
- They tend to overestimate their ability to pay off their outstanding debt by assuming that paying the minimum payments will substantially pay down those debts over a reasonable period of time;
- They tend to overestimate the value of their assets;
- They tend to overestimate their past and future average income; and
- They tend to underestimate their living expenses.

These characteristics of bankruptcy debtors are reflected in statistics regarding the outcome of Chapter 13 cases, according to the Administrative Office of the U.S. Courts:

- Only 36% of Chapter 13 cases are actually completed;
- 14% of Chapter 13 cases are ultimately converted to Chapter 7; and 49% of Chapter 13 cases are ultimately dismissed as incomplete.

As a practitioner, I can say that my clients are indeed anxious to repay their debts to the full extent of their perceived ability -- and their perception of their ability sometimes results in their embarking on a Chapter 13 plan which I fear may not ultimately be successfull.

3. - MYTH #3: THE STIGMA OF FILING BANKRUPTCY IS GONE & DEBTORS FILE BANKRUPTCY AS A FINANCIAL PLANNING TOOL RATBER THAN AS A LAST RESORT

In the perception of most of my clients, the stigma of filing bankruptcy remains very strong. I am very often asked questions such as, "Will my employer or family have to know about this?" and "Will it be published in the newspaper?" In fact, most of my clients (75%) contact me through my telephone directory advertisement. Unlike other areas of the law in which people inquire of friends, family or coworkers about attorneys, when it comes to financial difficulties and the need to consider bankruptcy, people are so embarrassed and ashamed of their situation that they retain their anonymity by finding an attorney through the telephone directory.

Most of my clients file bankruptcy only as a last resort. Many have unsuccessfully tried consumer credit counseling. Many are working two job and are at the point of nearexhaustion, in an attempt to pay their debts. Some even forego medical insurance in the misguided notion that it is more important to pay the VISA bill than to cover themselves and their children with medical insurance. To the vast majority of my clients, and consumer bankruptcy debtors in general, being forced to file bankruptcy is a truly humiliating experience.

4. - MYTH #4: THE INCREASE IN BANKRUPTCY FILINGS IS DUE TO INCREASED ATTORNEY ADVERTISING

My personal experience contradicts the notion that attorney advertising plays a significant role in creating the increase in bankruptcy filings. The numbers of cases I have filed in the past years are as follows:

| Year | Number |
|---|---|
| 1993 | 240 |
| 1994 | 284 |
| 1995 | 324 |
| 1996 | 384 |
| 1997 | 440 |

The increase in the number of my case filings during this time period has occurred with no change in my advertising, which consists primarily of a three-quarter page adver- tisement in the telephone directory. My increase in filings is reflective of the increases in the Eastern and Middle Districts of North Carolina over this period of time. There have not been any significant changes by other bankruptcy attorneys in their advertising practices either. Therefore, the increases in filings cannot be tied to attorney advertising.

5. - MYTH #5: IF SUBSTANTIAL NUMBERS OF A-WRICANS WERE PREVENTED FROM FILING, THEY WOULD BE ABLE TO PAY THEIR BILLS

Bank lobbyists and Professor Staten state or imply that if a significant number of debtors who now file bankruptcy were prevented from doing so, they would be able to pay their bills. They claim that with a little more pressure and fewer alternatives, debtors could refocus their priorities and pay their bills. Nothing could be further from the truth.

It is perhaps difficult for middle and upper-income Americans to perceive of one million families being unable to pay their bills -- each year. But, that is in fact the case. It is also difficult, as members of the general public, to comprehend the real distance between stars or the size of an atom. But, our difficulty in imagining these things does not prevent them from being true. Similarly, there really are a million families who have suffered tremendous pain and guilt over their financial problems, and they deserve our respect and assistance rather than disbelief.

## V. - PENDING BANKRUPTCY LEGISLATION

**1. - H.R. 2500 (McCollum-Boucher) & H.R. 3150 (Gekas-McCollum-Boucher-Moran)**

These two bills propose a radical restructuring of the consumer bankruptcy system. They would prevent many honest, hard-working Americans from obtaining relief from the incessant hounding of collection agencies, the garnishment of wages, the foreclosure of homes, and the repossession of vehicles. Bankruptcy relief affords a way of comprehensively and fairly managing a convergence of financial demands upon the debtor, demands which the debtor has no way of paying.

Under either of these two bills, many homes would be foreclosed, cars repossessed, and many hard-working Americans would lose or abandon their jobs because of the hopelessness of their situation. Although banks claim that they would recover more money from financially-distressed debtors under the systems proposed by these two bills, the huge increases in administrative and legal costs which would be required would likely consume any nominal increases in funds extracted from the debtors.

**2. - S. 1301 (Grassley-Durbin)**

While not quite as radical as H.R. 2500 and H.R. 3150, S. 1301, would still shift the bankruptcy balance too far in favor of creditors, and would also impose substantial additional costs on the system.

For example, S. 1301 would, like H.R. 3150, require debtors to redo their budgets each year they are in a Chapter 13 payment plan and would also require Chapter 13 trustees to do a detailed review of these budgets. The increased cost of such a review in both attorneys'fees and trustees'administrative expenses would, like H.R. 3150, almost certainly far outweigh any small revenues realized.

Also, S. 1301 would require debtors to file their tax returns in the open files of the Bankruptcy Court Clerk, thus creating enormous potential for violations of the debtors' privacy rights.

**3. - H.R. 3146 (Nadler-Conyers-Hilliard)**

This bill is a balanced approach which will address abuses by creditors as well as debtors. This bill would retain and improve the "needs-based" approach to bankruptcy currently in the Code, and will require debtors and creditors to share the responsibility to make the bankruptcy system work fairly.

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