

Fed Forum



Personal Bankruptcy Reform of 2005: Means-Testing or Mean-Spirited?

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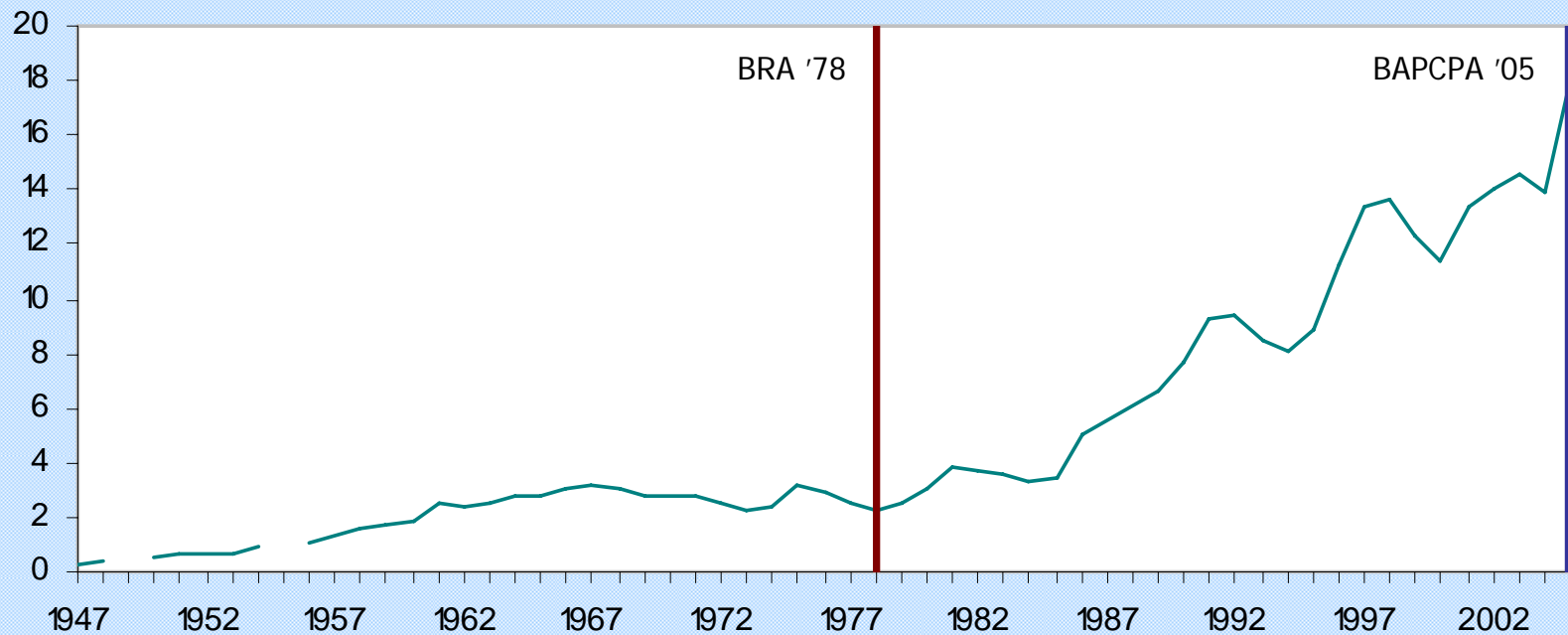
March 8, 2007

BAPCPA and means-test

- Under old law...
 - All filers eligible for Chapter 7
 - Liquidation of **nonexempt** assets
 - But remaining unsecured debt **discharged**
- Under new law...
 - Filers with income $>$ state median may be forced into Chapter 13
 - Keep all assets
 - But must repay most of debt over next five years

Rapid increase in bankruptcy filings

Annual Consumer Bankruptcy Filings
Per 1,000 households



Source: Administrative Office of the U.S. Courts; American Bankruptcy Institute

Is average Joe worse off?

- Decrease in insurance against bad luck

“America is...likely to turn into a debt-peonage society”

Paul Krugman, NYT, March 8, 2005

BAPCPA has upside

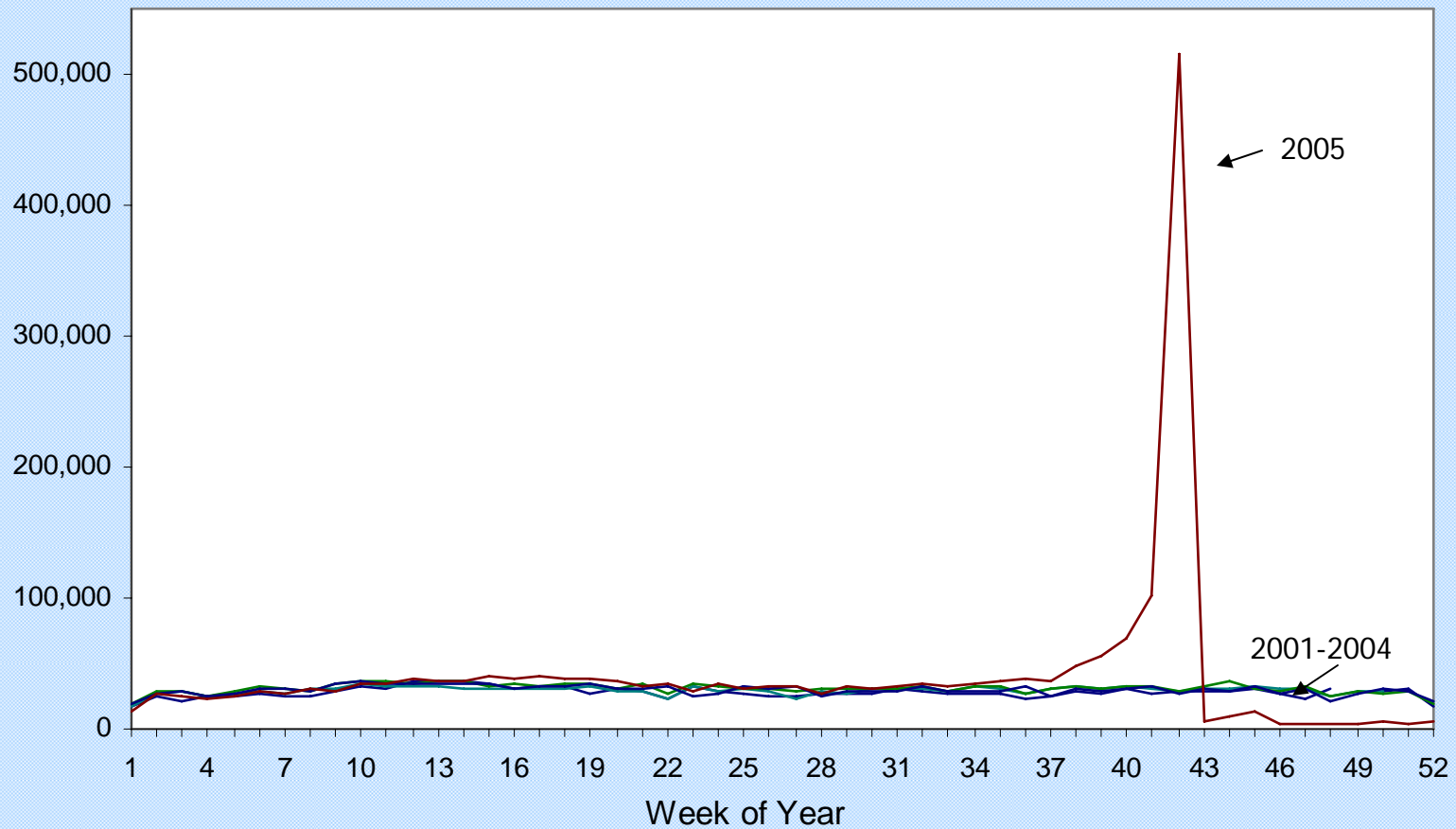
- Increased creditor protection lowers creditors' costs
- With sufficient competition, savings get passed on to borrowers
 - Over \$30 billion written off every year
- Curb strategic filings by irresponsible borrowers

Evidence on strategic filing

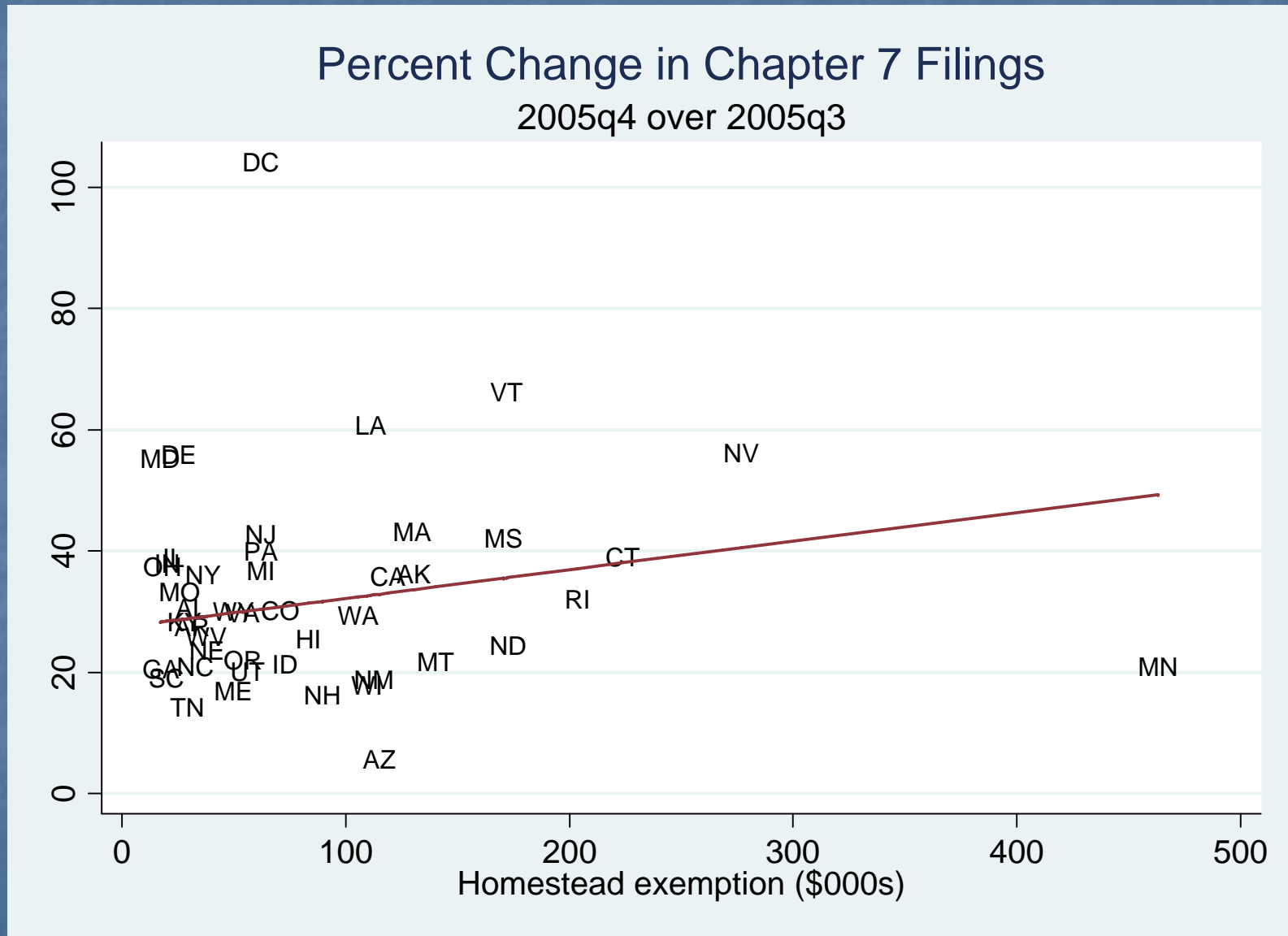
- Reduced stigma
- Forum shopping: consumers move to high exemption states before filing
- Financial incentives are main driver in decision to file

Rush to file

Bankruptcy filings per week



Higher rush in higher exemption states



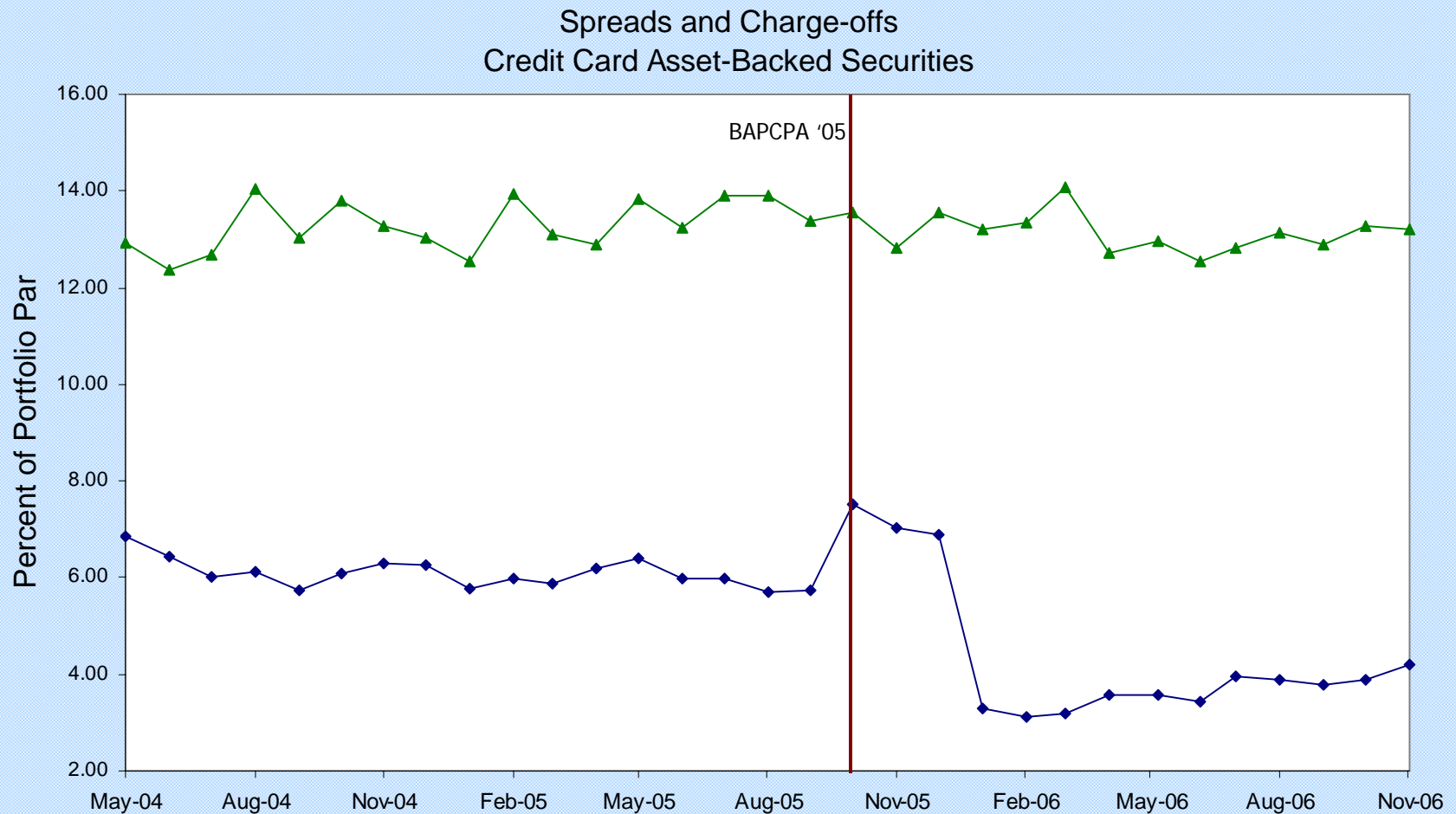
Strategic filings restrict access to credit and increase costs

- More likely to be turned down for credit in high exemption states
- Higher APRs in high exemption states
- Countries with more creditor protection have greater private debt/GDP ratios
- BAPCPA reduces strategic filings → lower costs of credit

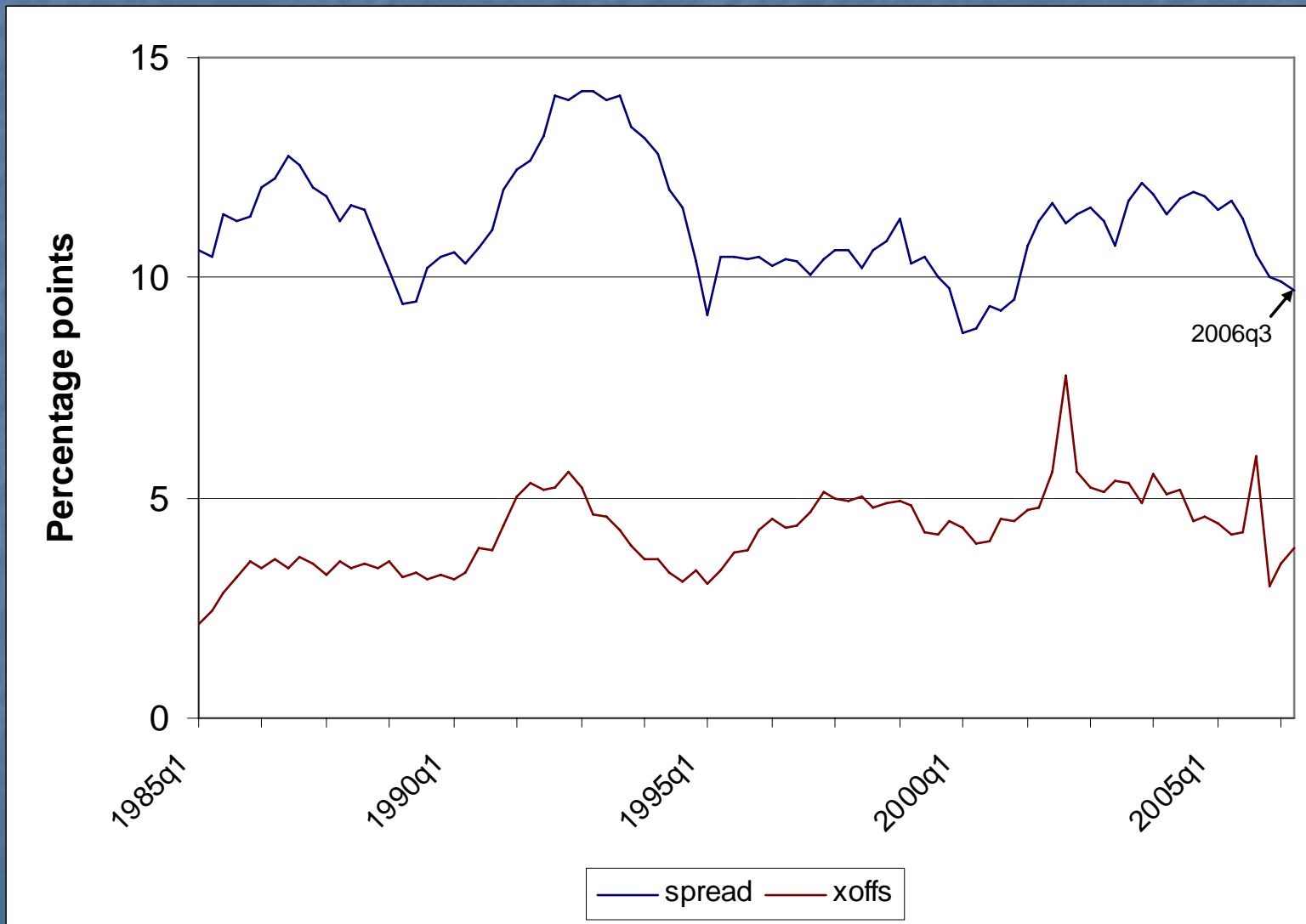
Credit card competition is crucial

- Without it, lower creditor costs are not passed on to consumers
- Doubts...
 - Credit card interest rates sticky
 - High profits
 - Complex pricing may confuse consumers about true cost
 - Creditors gain with BAPCPA passage

Costs of credit have not fallen yet...



...but they may: spreads rise and fall with charge-offs



Potential downsides from BAPCPA

BAPCPA

- reduces insurance
 - Half of filers cite medical causes
- reduces entrepreneurship
- reduces labor supply?