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PERSONAL BANKRUPTCIES BEGIN SHARP DECLINE: MILLENNIUM DATA UPDATE

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Executive Summary

Personal bankruptcy filings began a sharp drop in 1999, after leveling off in 1998. The U.S. per capita personal bankruptcy rate dropped by 8.9 percent in 1999 and, in the fourth quarter, personal bankruptcies per person were running at 9½ percent below the level of the corresponding period of the previous year. There were about 112,000 fewer personal bankruptcies in 1999 than in the prior year, the largest one-year decline on record. Other related indicators are also improving: for example, default rates on credit cards peaked 2½ years ago and are now also declining.

Sponsors of the bankruptcy reform act currently before the U.S. Congress have justified the legislation by arguing that — even if the treatment of overextended consumers is somewhat draconian — the bill is necessary because we are in the midst of a "bankruptcy crisis." However, the year-end 1999 numbers show that, to the extent that there ever was a bankruptcy crisis, the crisis is now over. Not only have personal bankruptcies stopped their explosive growth, but the trend has reversed, and the per capita bankruptcy rate is actually lower than it was at the time that the bankruptcy bill was introduced.

Indeed, if the bankruptcy reform act had already been enacted into law in 1998 or 1999, the sponsors would undoubtedly now be taking credit for this turnaround in the bankruptcy numbers. However, the current decline came about despite the inaction of Congress. Thus, the spontaneous improvement supports the view that the legislative changes approved by the House of Representatives in 1999 and back for consideration by the Senate next week are unnecessary and counterproductive. There is time for the Congress to take a more compassionate and thoughtful approach to reforming the bankruptcy system.

Solving the bankruptcy crisis does not require harsh legislation; the bankruptcy crisis is self-correcting. The reason is that lenders are profit-maximizing institutions which select their own credit criteria. Lenders respond to an unexpected increase in personal bankruptcies by curtailing new lending to the consumers teetering closest to bankruptcy, with or without new legislation. The high rates of default at the peak of the bankruptcy crisis began to impinge on the profitability of lending and — as a result — lenders tightened their underwriting standards. This is the non-legislative, free-market response that made the crisis abate.

Conversely, the bankruptcy bill would have the effect of denying a fresh start to many beleaguered debtors, permitting their creditors to press harder for repayment. Lenders could more likely collect on their riskiest accounts. Seeing the profit opportunity, lenders would respond by again lowering their credit standards and soliciting riskier customers. Thus, the predictable but unintended consequence of the bill is that within a few years we would see a resurgence in the incidence of badly-overextended consumers.

Background

During the period 1995–97, the United States witnessed a sharp explosion in the rate of personal bankruptcies. In the final quarter of 1997, the (seasonally-adjusted) quarterly personal bankruptcy rate stood at 1.280 per thousand population, up 71% from the rate only three years earlier. [See the Table at the end of this report.] Sharp jumps also occurred in other measures of consumer default, such as delinquencies and chargeoffs on MasterCard and Visa cards. The increase in bankruptcies provoked considerable alarm, especially as it occurred during a period of relative economic prosperity.

Legislators concerned with the "bankruptcy crisis" — at the urging of lobbyists for lender organizations concerned with their profits — introduced bills into the 105th Congress proposing broad restrictions on consumer bankruptcy protection. Their proposal, self-styled as "needs-based bankruptcy," was incorporated into several bills, including H.R. 2500, H.R. 3150, and S. 1301. The "Bankruptcy Reform Act of 1999," introduced as H.R. 833 and S. 625 in the 106th Congress, incorporates similar restrictions. The harsh proposal would have the effect of forcing many debtors, who are currently eligible for Chapter 7 bankruptcy filings, instead into Chapter 13 filings.

The Recent Data

Three separate sources of personal bankruptcy statistics are available, and all paint a similar encouraging picture. First, the official government figures from the Administrative Office of the U.S. Courts are the most authoritative, but also the most delayed. Data for the third quarter of 1999 is available at http://www.uscourts.gov/Press_Releases/fy99bk.pdf. Second, the number of bankruptcy filings each quarter has now begun to be privately compiled and posted rather quickly on the Internet by the Chicago Mercantile Exchange (CME) at http://www.cme.com/cgi-bin/qbidata.cgi, in connection with the Quarterly Bankruptcy Index contract which it recently introduced. The CME posts a 13-week "rolling total" of national bankruptcy filings, which represents the total filings for the 13 weeks prior to a given day, and which can be interpreted as a surrogate spot price for the expiring Quarterly Bankruptcy Index contract. Third, the VISA Bankruptcy Notification Service compiles weekly reports of the number of personal bankruptcy filings. Both the CME rolling total and the Bankruptcy Notification Service weekly compilation have in the past proven to be good indicators of trends in the number of bankruptcy filings later released by the Administrative Office of the U.S. Courts. Their reporting already covers the period through year-end 1999.

The following table gives year-end 1999 personal bankruptcy figures, compared with 1998:

	1999	1998	Decrease
Administrative Office of the U.S. Courts (through 9/30/99) + author's estimate (10/1/99 – 12/31/99)	1,285,801	1,397,695	– 8.01 %
Per Capita Bankruptcies (AO of the U.S. Courts + author's estimate)	4.712	5.171	– 8.88 %
VISA Bankruptcy Notification Service (through 12/31/99)	1,260,796	1,378,140	– 8.51 %

As can be seen, personal bankruptcies in 1999 ran at least 8% below 1998 levels, and per capita personal bankruptcy rates in 1999 ran about 8.9% below 1998 levels.

Next, in order to see the spot trends, let us compare Fourth Quarter 1999 filings with Fourth Quarter 1998 filings. The following are the most recent numbers from the CME Internet site and the Bankruptcy Notification Service, along with the corresponding numbers from the year-earlier period:

	Fourth Quarter 1999	Fourth Quarter 1998	Decrease
Chicago Mercantile Exchange QBI Index	313,176	348,266	– 10.08 %
VISA Bankruptcy Notification Service	309,744	341,272	– 9.24 %

Now, let us look at the current sharp downturn within the context of a longer time period. As can be seen from the Table at the end of this report, the "bankruptcy crisis" began in the first quarter of 1995, as the (seasonally-adjusted) quarterly personal bankruptcy rate per thousand population — which had broadly been in decline since 1992 — began to accelerate. The crisis peaked from the third quarter of 1995 to the third quarter of 1996, when the bankruptcy rate increased at a 30% annual rate. It then began a pronounced deceleration in the second half of 1997, with growth in the per capita filing rate in only the single-digit annual rates, and then leveling off completely.

The current sharp decline in personal bankruptcies began at the very end of 1998. Personal bankruptcies declined from a seasonally-adjusted 1.297 filings per thousand population in the fourth quarter of 1998 to 1.175 in the fourth quarter of 1999, an annual rate of change of –9.4%. Today, there looks to no longer be any immediate crisis: 1999 closed with a one-year decline of about 112,000 personal bankruptcies.

[For U.S. population, I use the most recent estimates of the U.S. Census Bureau at http://www.census.gov/population/estimates/nation/intfile1-1.txt for the first day of the middle month of each quarter. The quarterly personal bankruptcy filing rate per thousand population is merely the number of personal bankruptcy filings divided by the U.S. population in thousands, seasonally adjusted. The unadjusted number of personal bankruptcy filings, the seasonally-adjusted number of personal bankruptcy filings, the seasonally-adjusted quarterly personal bankruptcy rate per thousand population, and the annualized growth rate in the seasonally-adjusted quarterly personal bankruptcy rate per thousand population are reported in the Table at the end of this report.]

One piece of the explanation for the sharpness of the quarter-to-quarter decline from fourth quarter 1998 to first quarter 1999 comes from the looming bankruptcy bill. October 1998 saw the largest number of personal bankruptcies ever recorded in a single month and, undoubtedly, part of this reflects individuals who accelerated their Chapter 7 filings in anticipation that they might become ineligible under the new legislation. Thus, there was probably a shift of bankruptcy filings into October 1998 from November and December, and into fourth quarter 1998 from first quarter 1999. This acceleration of filings would tend to overstate the drop from fourth quarter 1998 to first quarter 1999.

At the same time, there remains the striking fact that filings in the Fourth Quarter of 1999 are still running quite substantially below the corresponding periods of both 1998 and 1997. Indeed, it is abundantly clear that the drop in bankruptcies from 1998 to 1999 has been part of a somewhat bumpy but still evident transition from bankruptcy growth to bankruptcy decline. This is made most transparent by Chart 1 at the end of this report, which is taken from the VISA Bankruptcy Notification Service. Chart 1 plots the annual growth rate in personal bankruptcy filings per court day, by comparing the number of filings per court day in each month with the corresponding number from the same month of the previous year. Observe that this growth rate first turned negative in August 1998 and — after a notably bumpy few months — settled in at a steady decline of 4% or better every month of 1999.

Similar trends are apparent in default rates on credit card lending, which peaked 2½ years ago and are now in decline. For example, Standard & Poor's measure of charge-offs (i.e., the percentage of balances written off annually as uncollectible) on securitized credit card debt stood at 5.6% in November, as compared to 6.3% in November 1998 and 6.8% in November 1997. (See: http://www.standardandpoors.com/ratings/structuredfinance/creditcardindex.htm.) Credit card delinquencies stood at 4.8% in November 1999, as compared to 5.0% one year earlier and 5.4% two years earlier. Similarly, Moody's measure of charge-offs on securitized credit card debt stood at 5.34% in October 1999 (the most recent month available), as compared to 6.11% in October 1998 and 7.10% at its peak in April 1997. Credit card delinquencies stood at 4.94% in October 1999, as compared to 5.17% one year earlier and 5.64% at its peak in February 1997. See Chart 2 at the end of this report for Moody's measures of chargeoffs and delinquencies over the period 1989–99.

It is also worth recognizing that, while the current bankruptcy rate today stands 57% above where it stood six years ago (at the start of the "bankruptcy crisis"), it stands a less-shocking 27% above where it stood eight years ago. The smaller increase over the longer time comes from comparing the current bankruptcy rate with its previous cyclical peak (first quarter 1992) versus its previous cyclical trough (second quarter 1994).

Economic Analysis

Generally speaking, the long-term increase in the personal bankruptcy rate over time appears to have arisen from a long-term increase in the household debt burden. There has been a close statistical connection between the bankruptcy rate and the debt burden, and it only stands to reason that more debt leads to more bankruptcies.

More specifically, the severe nature of the "bankruptcy crisis" of 1995–97 appears to have arisen from an unfortunate combination of a sharp increase in the household debt burden beginning in 1993 and a misappreciation, by some lenders, of the importance of debt burden in predicting the probability of bankruptcy. With 20-20 hindsight, one can today say that consumers with heightened debt-to-income ratios often have dramatically higher incidence of default and bankruptcy. However, the magnitude of this effect was less apparent earlier in the 1990's. In the period beginning 1993, some lenders went about extending large amounts of additional credit to consumers who were already significantly borrowed up, unaware of the extent to which these consumers were rapidly becoming major default risks. These lenders then appear to have been genuinely surprised by the upward spike in defaults and bankruptcies in 1995–97. This aspect of the "bankruptcy crisis" is unlikely to be repeated, as these lenders have now updated their lending formulas to reflect the importance of debt burden in predicting default.

Indeed, the "bankruptcy crisis" is self-correcting. Lenders choose the amount of credit that they are willing to extend, and the riskiness of the consumers to whom they are willing to lend. In turn, the willingness of lenders to tolerate default risk is determined by the profitability of lending. For example, in the current lending environment, a typical credit-card interest rate is more than 15%, while the cost of funds is only about 6½%. This rather large interest-rate spread makes it profitable for issuers to extend credit to consumers with rather high probabilities of default.

But observe that this economic story does *not* lead one to expect continuing unmitigated and exponential growth in the rate of bankruptcies. Lenders will only extend credit to the extent that it remains profitable. The high rates of default at the peak of the bankruptcy crisis began to impinge on the profitability of lending and — as a consequence — lenders tightened their underwriting standards. This is what made the "bankruptcy crisis" self-correcting.

By the same token, one should not expect that a harsh revision of the bankruptcy law — as in H.R. 833 and S. 625 — will lead to a sharp reduction in the bankruptcy rate. As we have already said, lenders determine the level of default risk they are willing to tolerate according to the expected profitability of lending. A tightening of the bankruptcy law will be viewed by lenders as improving the probability that they are able to collect on risky accounts, i.e., it will increase the expected profitability of lending. As a consequence, lenders will extend credit to inherently riskier consumers than they do today, tending to reverse any potential improvement in the bankruptcy rate.

For a fuller discussion of the economic issues, see the prior articles and testimony of the author, available for download at http://www.bsos.umd.edu/econ/bankruptcy:

"The Failure of Competition in the Credit Card Market," *American Economic Review*, Vol. 81, No. 1, March 1991, pp. 50-81.

"Credit Card Defaults, Credit Card Profits, and Bankruptcy" *American Bankruptcy Law Journal*, Vol. 71, Spring 1997, pp. 249-270.

Testimony before the Subcommittee on Financial Institutions and Regulatory Relief of the Committee on Banking, Housing, and Urban Affairs of the United States Senate, Hearing on Bankruptcy Reform, Wednesday, February 11, 1998.

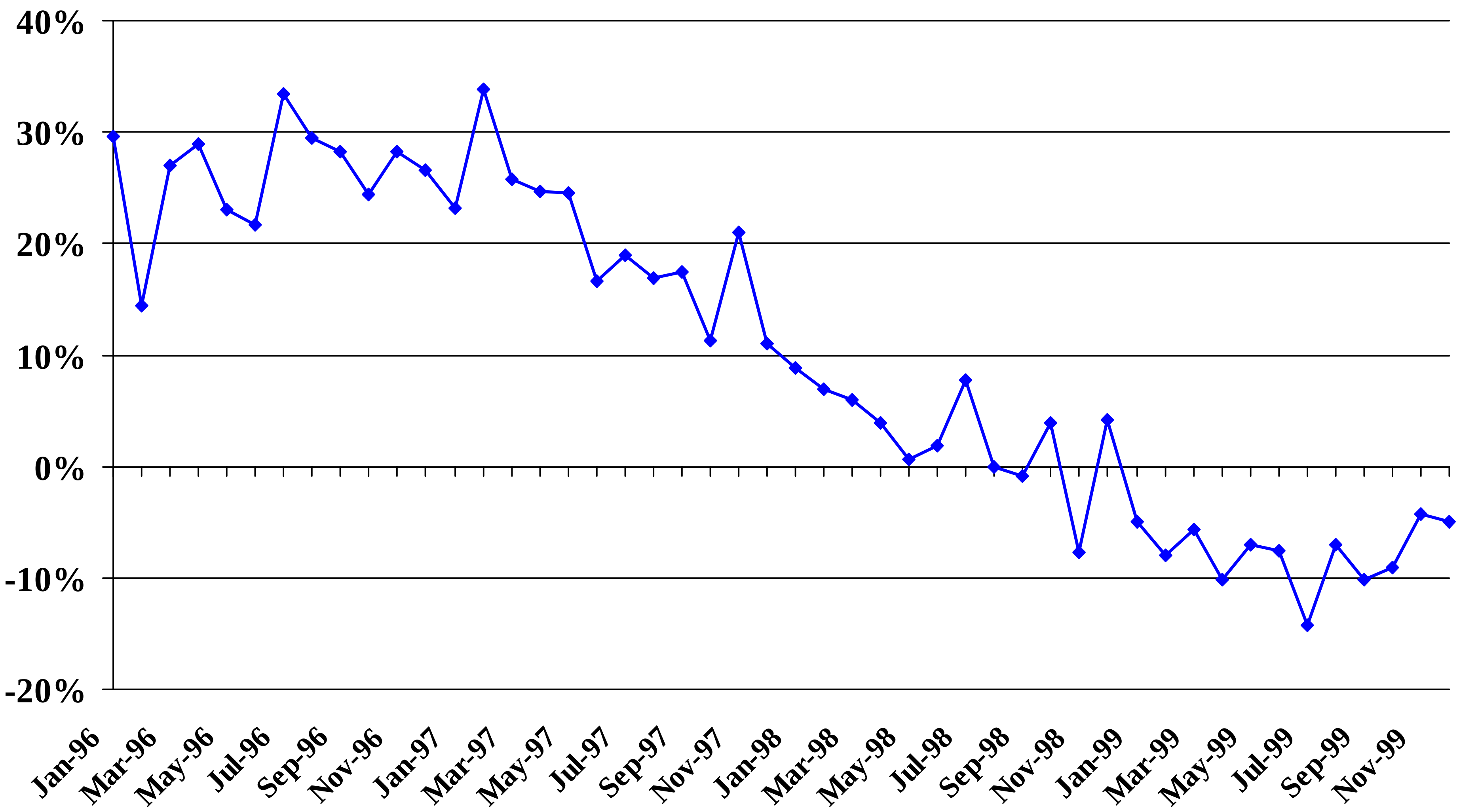
Testimony before the Subcommittee on Commercial and Administrative Law of the Committee on the Judiciary of the United States House of Representatives, Hearing on Consumer Bankruptcy Issues, Tuesday, March 10, 1998.

Year	Quarter Ending	Bankruptcies Unadjusted	Bankruptcies Seasonally Adjusted	Bankruptcies Per 1,000 Population, Seas. Adjust.	Annual Growth Rate (Over Previous Four Quarters)
1984	March	71,697	72,799	0.3097	
	June	71,955	70,036	0.2974	
	September	71,201	71,061	0.3011	
	December	69,554	70,607	0.2985	
1985	March	72,887	73,909	0.3117	0.64%
	June	84,243	82,018	0.3452	16.09%
	September	87,727	87,636	0.3680	22.23%
	December	96,376	97,842	0.4099	37.33%
1986	March	103,088	104,421	0.4364	39.99%
	June	114,384	111,205	0.4637	34.34%
	September	116,037	116,355	0.4841	31.55%
	December	116,204	117,879	0.4894	19.39%
1987	March	116,578	117,827	0.4880	11.83%
	June	122,689	119,087	0.4922	6.13%
	September	123,868	124,813	0.5147	6.31%
	December	127,409	129,218	0.5317	8.64%
1988	March	133,712	134,769	0.5532	13.35%
	June	138,245	133,804	0.5480	11.35%
	September	136,561	138,435	0.5657	9.91%
	December	139,215	141,265	0.5759	8.32%
1989	March	144,711	145,317	0.5910	6.84%
	June	157,955	152,541	0.6190	12.94%
	September	152,696	155,431	0.6292	11.22%
	December	161,404	164,027	0.6622	14.99%
1990	March	166,694	167,141	0.6730	13.88%
	June	179,943	173,179	0.6954	12.35%
	September	177,351	180,975	0.7249	15.21%
	December	193,872	197,346	0.7885	19.06%
1991	March	212,913	213,576	0.8512	26.47%
	June	227,853	218,746	0.8694	25.02%
	September	214,174	218,272	0.8649	19.32%
	December	217,160	221,641	0.8757	11.06%

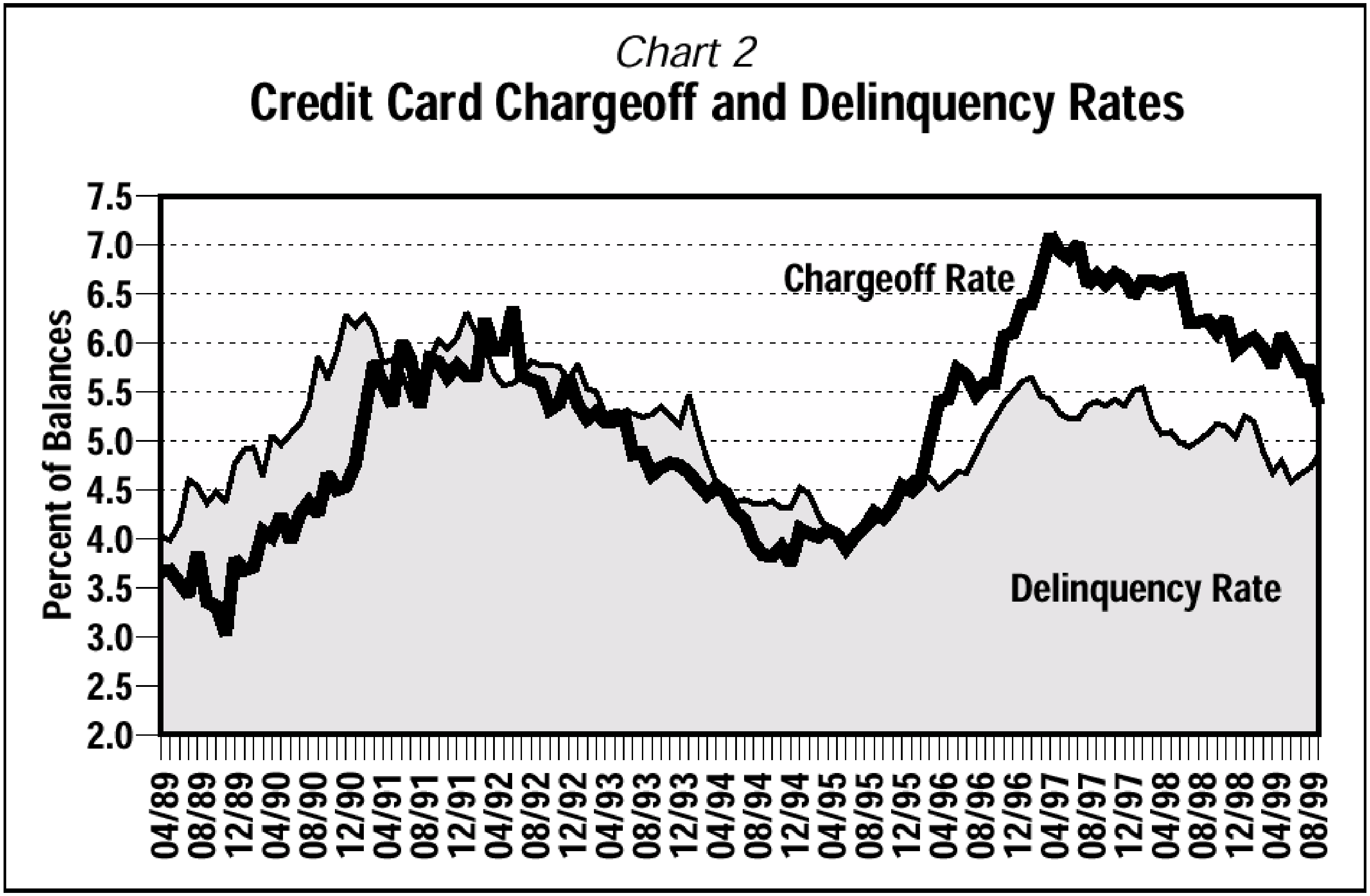
Year	Quarter Ending	Bankruptcies Unadjusted	Bankruptcies Seasonally Adjusted	Bankruptcies Per 1,000 Population, Seas. Adjust.	Annual Growth Rate (Over Previous Four Quarters)
1992	March	233,973	235,137	0.9264	8.83%
	June	232,657	222,967	0.8759	0.75%
	September	220,021	223,425	0.8753	1.20%
	December	212,112	217,177	0.8484	-3.11%
1993	March	206,271	207,704	0.8091	-12.66%
	June	212,982	204,047	0.7929	-9.48%
	September	200,329	202,410	0.7846	-10.36%
	December	192,617	197,798	0.7648	-9.86%
1994	March	192,707	194,523	0.7503	-7.27%
	June	202,596	193,987	0.7464	-5.87%
	September	195,308	196,597	0.7547	-3.81%
	December	189,695	195,123	0.7473	-2.29%
1995	March	199,503	201,751	0.7707	2.72%
	June	222,086	212,717	0.8107	8.62%
	September	220,945	221,770	0.8433	11.74%
	December	231,603	238,417	0.9044	21.03%
1996	March	252,761	255,866	0.9684	25.66%
	June	283,170	271,299	1.0245	26.37%
	September	290,111	291,079	1.0967	30.04%
	December	298,244	306,684	1.1527	27.45%
1997	March	321,242	325,283	1.2196	25.94%
	June	353,177	338,797	1.2672	23.69%
	September	340,059	341,150	1.2730	16.08%
	December	335,032	343,923	1.2803	11.07%
1998	March	341,708	346,205	1.2857	5.42%
	June	361,908	347,446	1.2873	1.58%
	September	350,859	352,197	1.3018	2.26%
	December	343,220	351,652	1.2968	1.29%
1999	March	321,604	326,002	1.1992	-6.73%
	June	335,578	322,403	1.1832	-8.08%
	September	314,564	315,704	1.1559	-11.21%
	Dec. (est.)	314,055	321,519	1.1745	-9.43%

Chart 1

Growth in Personal Bankruptcy Filings per Court Day



Source: VISA Bankruptcy Notification Service



Source: Moody's Investors Service, Dec. 1999, "Credit Card Indexes: September 1999 - The Improvement in the Credit Quality of the Average U.S. Credit Cardholder Continued to Gain Momentum in September 1999," at: http://www.moodys.com/research.nsf/index/4087FA88ED705B9485256855005DF0C6?OpenDocument.