NATIONAL BUREAU OF ECONOMIC RESEARCH, INC.

Household Finance: Research Findings and Implications for Policy

Brigitte Madrian and Stephen Zeldes: Organizers

November 21, 2014

National Press Club
529 14th Street, NW
Washington, DC

Insolvency After the 2005 Bankruptcy Reform[1]

Stefania Albanesi, FRBNY and CEPR
Jaromir Nosal, Columbia University

Executive Summary

The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) is the single most important piece of legislation regarding personal bankruptcy since the Bankruptcy Reform Act of 1978. It introduced more stringent eligibility requirements for bankruptcy protection, and substantially increased the monetary and non-monetary costs of filing. Notable features of the law include an income-based means test for Chapter 7 eligibility, elimination of the option for Chapter 13 filers to propose their own repayment plans, new standards against fraud which render attorneys liable for accuracy of claims, and mandatory credit counseling classes for filers. These requirements increased both the hassle costs associated with filing for bankruptcy as well as the monetary costs, with median attorney fees rising by 38%.

BAPCPA was followed by a large and permanent reduction in bankruptcy filings. We study the mechanism behind this decline and the consequences for households. Our main finding is that the drop in bankruptcy filings was driven by liquidity constraints—the inability of potential filers to afford the higher bankruptcy filings fees associated with the reform. We show that persistent insolvency and foreclosure replaced bankruptcy. We also show that insolvency is associated with worse outcomes than bankruptcy. These consequences of BAPCPA are potentially welfare reducing for households.

Mechanism Behind the Drop in Bankruptcies

To uncover the mechanism behind the changes following BAPCPA, we use a comprehensive panel of individual credit files from 1999-2012. This allows us to study not only the behavior of bankrupt individuals, but also the impact on the individuals who

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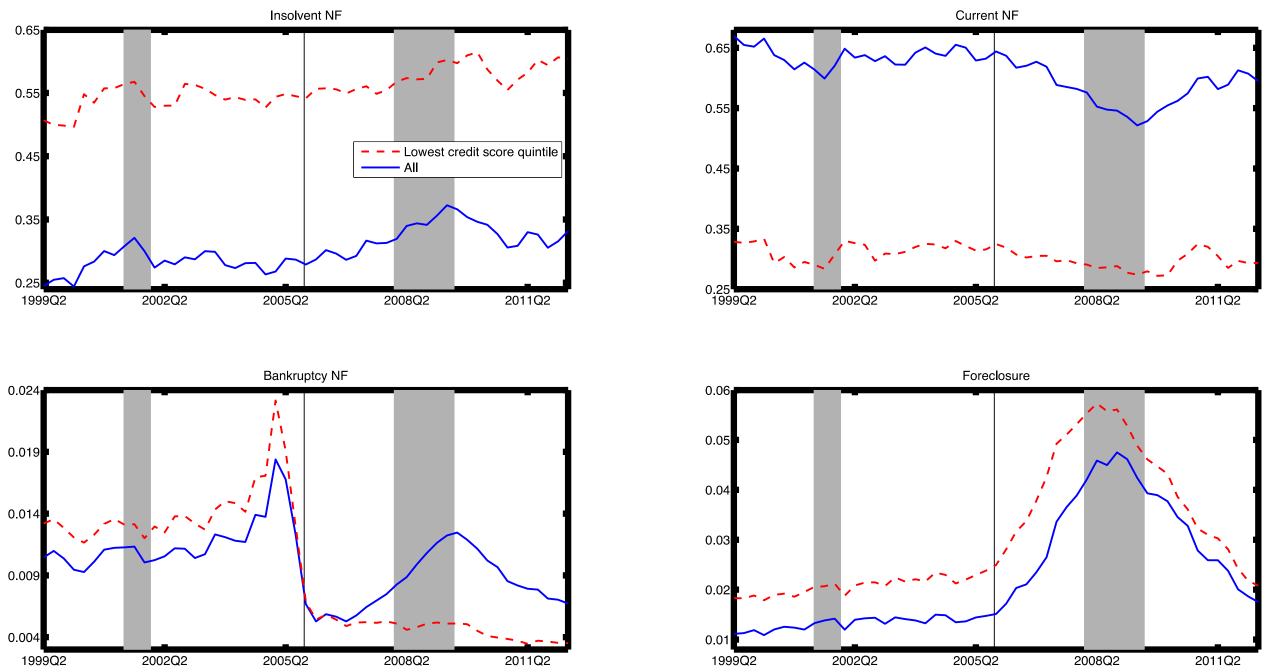
[1] The views expressed here are those of the authors and do not necessarily reflect the views of the Federal Reserve Bank of New York or the Federal Reserve System.

do not to file for bankruptcy protection post-reform. Our analysis also allows us to pin down the precise timing of changes relative to the introduction of the new law in Q3 of 2005.

To identify the response to the reform, we estimate the frequency transition probabilities of individuals across different financial states over time. For individuals initially classified as being Delinquent without Foreclosure (has accounts 30, 60, 90 days late and not Insolvent), the figure below presents the estimated 4 quarter ahead transition probabilities into the financial states of being Insolvent (has accounts 120+ days late or charged-off), Current, in Bankruptcy without foreclosure, and in Foreclosure.

For the overall population (the solid line), there is a large and persistent drop in the transition into Bankruptcy, and a sharp rise of the transition into Insolvent without foreclosure, after the reform. There is also a sharp rise of the transition probability into Foreclosure. All of these effects begin at the first quarter of implementation of the reform (vertical line).



For the bottom quintile of the credit score distribution (the dotted line), the decline in the transition into Bankruptcy is steeper than for the overall population and does not respond to the 2007-09 recession. At the same time, the transition into being Insolvent follows a similar pattern for both the overall population and the bottom quintile of the credit score distribution. This suggests that those with low credit scores face similar changes in the likelihood of financial distress, but are less likely to file for bankruptcy.

We document that individuals with low credit scores are concentrated at the bottom of the income distribution. Their more pronounced response to the bankruptcy reform, together with the large rise in the monetary cost of bankruptcy, suggest that liquidity constraints may have driven their response to the reform. We provide more evidence on this mechanism by exploiting the variation by court district in the filing cost changes implied by the law. Using regression analysis, we show that the median increase in filing costs decreases filings by 11 percentage points—an effect that explains 20% of the 52% median drop in bankruptcy filings.

Additionally, we quantify the substitution of insolvent individuals away from bankruptcy. We find that the median drop of flows into bankruptcy implies:

- 27% of the increase in the rise of flows into Foreclosure
- 3% of the increase in the rise of flows into Insolvency

Insolvency vs. Bankruptcy: Does it Matter?

If insolvency is equivalent to bankruptcy, then the substitution from bankruptcy to insolvency is inconsequential. We show that this is not the case. To that end, we compare additional indicators of financial distress, as well as access to new lines of credit, for insolvent individuals who eventually go bankrupt and who remain insolvent.

We consider cohorts of individuals who become insolvent at a given quarter after a two-year spell with no insolvency. We find that the balances in collection and the fraction of individuals with court judgments grow after insolvency, while bankruptcy filing immediately stays collection efforts and court judgments.

Additionally, relative to those who remain insolvent:

- 50% more individuals who go bankrupt open new unsecured accounts after bankruptcy while the number of inquiries is very similar, hence this outcome is driven by difference in access to credit.
- Individuals who eventually go bankrupt initially have 10% lower credit scores. However, 4 quarters after bankruptcy they have a credit score that is 10% higher relative to the relevant non-bankrupt group.

Conclusions

Taken together, these findings suggest that the 2005 bankruptcy reform led to a substitution from bankruptcy into insolvency and foreclosure; these effects are concentrated among low income individuals and in court districts with the largest rise in filing costs. This is consistent with the notion that the response to the reform was driven by liquidity constraints. Since insolvent individuals who do not go bankrupt display more signs of financial stress than those who do, they would likely prefer to file for bankruptcy if they could.