

Chapter 7 Bankruptcy Petitioners' Repayment Ability Under H.R. 833: the National Perspective

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Chapter 7 Bankruptcy Petitioners' Repayment Ability Under H.R. 833: the National Perspective¹

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Executive Summary

This study analyzes the effects of the needs-based bankruptcy provision of the “Bankruptcy Reform Act of 1999” (H.R. 833) on Chapter 7 filers. The study, and an earlier study by Ernst & Young LLP (Ernst & Young 1998b), are the only studies to date that evaluate repayment capacity on a *national basis*.

The analysis is based on a stratified random sample that is nationally representative for calendar year 1997. This sample is comprised of over 2,100 Chapter 7 bankruptcy petitions, which were selected from each of the 90 bankruptcy districts in the nation.

Key study findings are:

- 10 percent (approximately 100,000) of 1997 Chapter 7 filers are likely to have been impacted by the needs-based provision of H.R. 833 and required to file Chapter 13.³ (See Chart 1).
 - These filers would have had the ability to repay 53 percent, or almost \$3 billion, of their unsecured non-priority debts over five years. These filers could have repaid \$7 billion of total Chapter 7 debt, including secured, unsecured and priority debt. This assumes that their income remains unchanged relative to expenses and liabilities during the 60 month repayment period.
- The filers likely impacted by H.R. 833 are higher income filers:
 - The median gross income of likely impacted filers is more than twice that of Chapter 7 filers not impacted (\$51,974 vs. \$21,204), and is 46 percent higher than the 1996 US national median income for all households (\$35,492).

The needs-based bankruptcy provision in H.R. 833 is likely to impact higher income petitioners with demonstrated ability to repay their debts. For purposes of this analysis, the filers likely to be impacted and required to enter a Chapter 13 repayment plan are those who are subject to creditor motions and who meet the repayment ability presumption criteria.

¹ This study was funded by Visa U.S.A. and MasterCard International.

² Tom Neubig is Ernst & Young's National Director of Policy Economics and Quantitative Analysis, and Gautam Jaggi and Robin Lee are managers with Ernst & Young's Policy Economics and Quantitative Analysis Group.

³ The needs-based provision modeled in this report is based on H.R. 833, the “Bankruptcy Reform Act of 1999”, and is substantially different from the needs-based provision modeled in the March 1998 Ernst & Young report. See sections 2 and 3 of this report for more details.

Median Income Test

Debtors with incomes below the national median (adjusted for family size) would not be subject to creditor motions and therefore would likely not be impacted. Conversely, creditors may bring motions against petitioners with incomes in excess of the family median.⁴

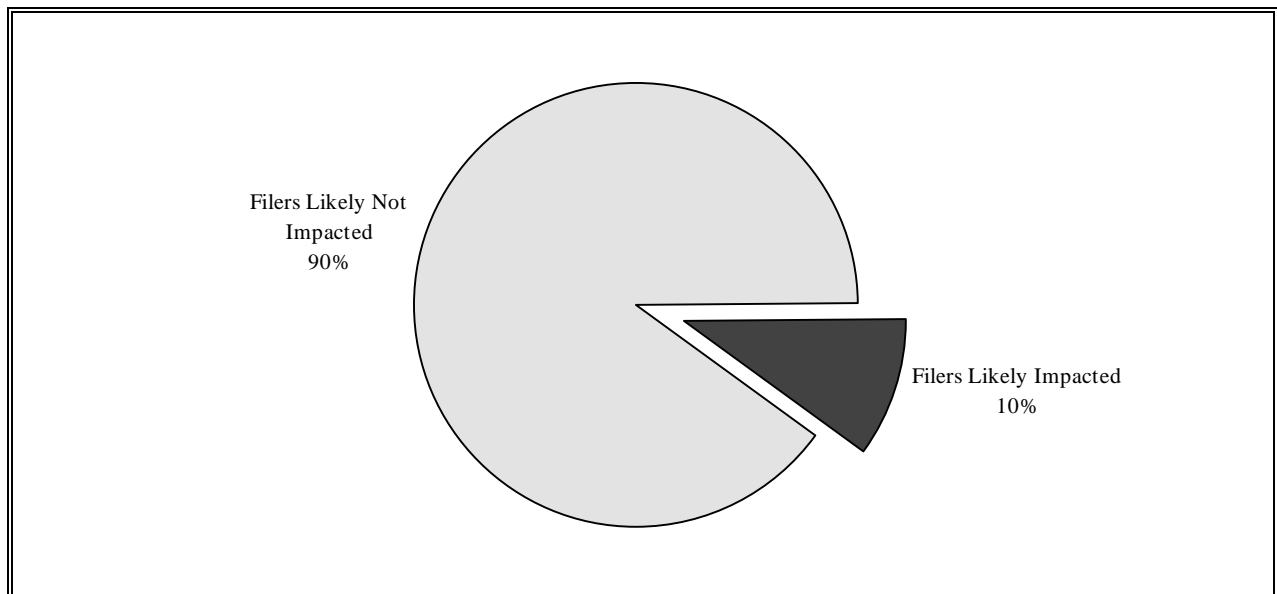
Repayment Ability Presumption

H.R. 833 assumes that "abuse exists" for Chapter 7 debtors with the ability to repay at least 25 percent or \$5,000 of their unsecured non-priority debts within five years, after paying for secured and priority debt payments and living expenses. These filings must be either dismissed or converted to Chapter 13 unless a debtor can demonstrate extraordinary circumstances that require an adjustment of income or expenses that causes the debtor's repayment capacity to fall below the lesser of 25% or \$5,000.

Thus, likely impacted filers are those making above the national median and who are presumed to be abusive.

It is important to emphasize that this analysis only measures the needs-based provision of H.R. 833. This pending House legislation contains numerous other provisions (e.g. financial counseling, random audits, verification of income, etc.) which would reduce bankruptcy losses. Quantifying the impact of these other provisions is beyond the scope of this study.

Chart 1. Chapter 7 Filers Likely Impacted by H.R. 833's Needs-based Provision



Source: Ernst & Young, "Chapter 7 Bankruptcy Petitioners' Repayment Ability Under H.R. 833: the National Perspective"

⁴ For example, the 1996 national median income for a family of four was \$51,518. (U.S. Bureau of the Census, 1997) Accordingly, families of four would not be subject to creditor motions if their gross income was under \$51,518. Families with more than four members receive an extra \$583 for each additional family member. So a family of six would not be subject to creditor motions if their gross income was under \$52,684 ($\$51,518 + \583×2).

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1. Introduction

In 1998, personal bankruptcy filings reached an all-time high of almost 1.4 million.⁵ The record levels of filings in recent years contrast sharply with the state of the overall economy, which has grown steadily and experienced low levels of unemployment and high consumer confidence. The dichotomy between the healthy economy and the number of filings has focused attention on current bankruptcy laws. Reform proposals are being considered by Congress, and their impact on the number of bankruptcy filers and debt repayment in the bankruptcy system are important factors to consider in the public policy debate.⁶

While several previous research studies have investigated petitioner repayment capacity, this study and Ernst & Young's March 1998 study (Ernst & Young, 1998b) are the only studies that evaluate repayment capacity comprehensively on a *national basis*. The national database of 1997 bankruptcy petitions, herein referred to as the "1997 Visa national bankruptcy database," includes more than 2,100 Chapter 7 bankruptcy filings. A detailed description of this database and the sampling procedures used, can be found in Ernst & Young (1998b). This study calculates the effects of the needs-based bankruptcy provision of H.R. 833, the "Bankruptcy Reform Act of 1999."

The needs-based provision of H.R. 833 would likely impact Chapter 7 petitioners and require them to file under Chapter 13 if they have incomes above the national median adjusted for family size⁷ and the ability to repay either \$5,000 or 25 percent of their unsecured non-priority debts within 5 years, after making secured and priority debt payments and paying for living expenses. If the law had been in effect in 1997, 10 percent of Chapter 7 filers would likely have been impacted by the needs-based provision and required to file Chapter 13.

This study is divided into five sections, beginning with this introduction (Section 1). Section 2 gives a general description of the 1997 Visa national bankruptcy database. Section 3 presents key findings about the impact of the needs-based provision. Calculation details on repayment ability under the needs-based provision of H.R. 833 are presented in Section 4, followed by concluding comments in Section 5.

⁵ Administrative Office of the US Courts (1998). Total Fiscal Year 1998 non-business filings were 1.39 million, consisting of 997,000 Chapter 7 filings, 392,000 Chapter 13 filings, and about 1,000 Chapter 11 filings.

⁶ Needs-based bankruptcy measures were passed by the House and the Senate in 1998, but a final vote on the House/Senate Conference Report was not taken in the Senate before the end of the legislative session. H.R. 833, introduced in the 106th Congress, contains essentially the same needs-based provisions as the October 1998 House/Senate Conference Report to Accompany H.R. 3150.

⁷ For example, while the 1996 national median income was \$35,492 for all households; for a family of four, it was \$51,518. (U.S. Bureau of the Census, 1997) Accordingly, families of four would be likely impacted if their gross income exceeded \$51,518, and they had the ability to repay at least \$5,000 or 25 percent of their unsecured non-priority debt over 60 months. The income threshold for families with more than four members increases by \$583 for each additional family member. So a family of six could be subject to creditor motions only if their gross income was over \$52,684 ($\$51,518 + \583×2).

2. Description of the 1997 Visa National Bankruptcy Database

Since 1995, as a service to its member financial institutions, Visa has maintained a national bankruptcy notification service (BNS) which records virtually all non-business bankruptcy filings. This study began by taking a sample from the 1997 BNS, which included all 11 federal court circuits and 90 districts. The sample was drawn in two stages: the first stage sample was extracted into a computer file by Visa, based on Ernst & Young's specifications; the second stage sample was randomly selected from this file by Ernst & Young statisticians.⁸

The first stage sample was designed to have sample sizes of approximately 500 Chapter 7 petitioners for each of the 90 districts in the United States.⁹ This sample of 43,730 cases was drawn randomly in each district to ensure that the monthly sample was proportionate to the actual monthly volume in that district. The second stage sample consisted of about 2,200 petitions, 200 of which were Chapter 7 asset cases.¹⁰

In the second stage sample, the district sample sizes were determined by allocating the total sample in proportion to each district's volume within each month of filing. This was supplemented by sampling additional observations from the smallest districts, so that each had a minimum of about a dozen cases.¹¹ Table 1 shows the distribution of petitions by chapter that were finally selected in the first and second stages of sampling.

⁸ The sample had to be drawn separately for two time periods because data for the entire year were not available until mid-January 1998. The sample for the first 11 months of 1997 was completed during the week of January 5, 1998. The sample for December 1997 was finished on January 16, 1998.

⁹ Not all districts had 500 Chapter 7 filings. When this occurred, the available number were selected. This initial sample was for potential later use in taking larger samples in certain target districts.

¹⁰ About 95% of Chapter 7 filings nationally are "no-asset" cases. A "no-asset" case refers to the situation where there are no funds remaining to be dispersed to creditors, after the debtor is allowed to keep all exempt assets. To achieve 200 Chapter 7 "asset case" selections, the actual sampling rate was doubled over that applicable for the "no-asset" cases. This oversampling was done to draw enough cases to make comparisons between the two types of Chapter 7 filers. Petitions were weighted so that the results would reflect the appropriate mix of "asset cases" and "no-asset" cases.

¹¹ The second stage sample started out, effectively, as a stratified random sample by district with the selection probabilities all equal – that is, a self-weighting sample. The number of Chapter 7 asset cases selected was then doubled and the samples in the smaller districts were increased so that the minimum was 12. At this point, the sample was judged too large and a systematic subsample was taken after sorting by district, chapter, and month of filing -- arriving at the final counts summarized in Table 1.

Table 1. First and Second Stage Sample Sizes

Chapter 7	First Stage Sample	Second Stage Sample
Asset Cases	2,051	196
No-Asset Cases	41,679	2,024
Total	43,730	2,220

Note: The first stage and second stage samples were obtained as described in the text. The second stage sample is also referred to in this report as the “final selected sample”.

The U.S. bankruptcy courts were the source for all of the petitions obtained for the 1997 sample database. A listing of the cases to be included in the final sample was sent to an outside vendor who obtained the designated petitions from the applicable court. The petitions obtained were then copied and transmitted for data entry at Visa, where virtually all of the information on the petitions was captured. During the data gathering process, Ernst & Young monitored all steps – including selecting a subsample of cases for independent reprocessing.

The sampling was highly successful. One indication of this is shown in Table 2, which connects the sample to the population about which inferences are to be made. Columns 1 and 2 show the total number of 1997 Chapter 7 petitions by circuit, first as obtained from BNS (Column 1), and then as obtained from official sources (Column 2).¹² Column 3 shows the universe of 1997 petition filings after eliminating cases estimated to be dismissed. Column 4, designated “Final Selected Sample,” corresponds to the “second stage sample” discussed earlier and summarized in Table 1. The last column of the table, Column 5, consists of the sample determined usable.¹³ The differences between Column 4 and 5 are quite small; on an overall basis, the usable sample was about 97 percent of the size of that selected.

¹² Administrative Office of the U.S. Courts (1998). There was a net shortfall in coverage between the Visa BNS database and the official counts. The slight discrepancy involved, under three percent, is not believed to be an important limitation to the analyses carried out in this report. In the table, the adjustments for net incompleteness have been made by circuit. See Ernst & Young (1998b) for more discussion.

¹³ A full description of the methodology for this determination is found in Appendix 2 of Ernst & Young (1998b). Basically, the usable sample consists of all original selections, except identified dismissals, for which there was enough information to do the calculations under H. R. 3150. Aside from a small number of identified dismissals, therefore, the cases excluded either were never obtained or were too incomplete to use.

**Table 2. Total and Admissible Chapter 7 Petitions by Circuit: Population and Sample Data for 1997
(Fifty States and District of Columbia Only)**

Federal Circuit	BNS Count of Petitions (Column 1)	Official Count of Petitions (Column 2)	Total Petitions, Excluding Dismissals (Column 3)	Final Selected Sample (Column 4)	Usable Sample (Column 5)
Total	925,654	952,446	941,263	2,220	2,142
First	29,632	33,059	32,406	71	63
Second	72,195	72,747	72,646	167	167
Third	55,304	61,927	61,035	131	128
Fourth	74,821	79,145	78,091	196	186
Fifth	57,276	58,142	57,205	149	139
Sixth	102,406	107,916	106,620	231	201
Seventh	87,672	93,947	93,148	199	190
Eighth	57,069	57,669	57,276	152	152
Ninth	243,528	241,167	237,256	558	556
Tenth	56,016	56,362	55,990	141	140
Eleventh	89,735	90,365	89,590	225	220

Note: The columns are derived as discussed in the text and related footnotes. The information shown for 11 circuits includes only courts in the fifty states and the District of Columbia. For display purposes, the District of Columbia has been combined with the Fourth Circuit. For this table, the First Circuit consists of the states ME, MA, NH, and RI; the Second Circuit CT, NY, and VT; the Third Circuit DE, NJ, and PA; the Fourth Circuit Washington DC, MD, NC, SC, VA, and WV; the Fifth Circuit LA, MS, and TX; the Sixth Circuit KY, MI, OH, and TN; the Seventh Circuit IL, IN, and WI; the Eighth Circuit AR, IA, MN, MO, NE, ND, and SD; the Ninth Circuit AK, AZ, CA, HI, ID, MT, NV, OR, and WA; the Tenth Circuit CO, KS, NM, OK, UT, and WY; the Eleventh Circuit AL, FL, and GA.

3. Key Findings

The analysis in this section focuses only on the needs-based provision of H.R. 833, which likely impacts petitioners with monthly income above the national median for families of comparable size and the ability to repay either \$5,000 or 25 percent of their unsecured non-priority debts within 5 years, after making secured and priority debt payments and paying for living expenses.¹⁴

Share of Filers Likely Impacted

The share of 1997 Chapter 7 filers likely to be impacted by the needs-based provision of H.R. 833 is shown in Table 3. As shown, 10 percent of 1997 Chapter 7 filers would have probably been required to file under Chapter 13, if H.R. 833's needs-based bankruptcy provision had been in effect in 1997.

For purposes of this analysis, Chapter 7 filers are considered to be likely impacted by H.R. 833 if they are eligible for creditor motions (that is, they have income above the national median) and they meet the abuse presumption. Chart 2 shows the cumulative percentage of filers likely impacted by each of the criteria used to determine a petitioner's need for relief under the proposed legislation. As shown:

- 19 percent of 1997 Chapter 7 filers had income above the national median, adjusted for family size;
- 10 percent of filers had income above the national median *and* the ability to repay either \$5,000 or 25 percent of their unsecured non-priority debts within 5 years after making secured and priority debt payments and paying for living expenses.

The estimate that 10 percent of filers are likely to be impacted under the needs based provision is based on petitioners' reported 1997 income at the time of filing. If reported 1996 income were used instead, the share of likely impacted filers would rise to 14 percent. Accordingly, the likely impacted estimate of 10 percent is conservative. More details are provided in Section 4.

¹⁴ A detailed description of the methodology used for the repayment calculations is provided in Section 4.

Table 3. Ability to Repay Debt under H.R. 833's Needs-based Bankruptcy Provision: 1997 Chapter 7 Filers Likely Impacted by the Provision

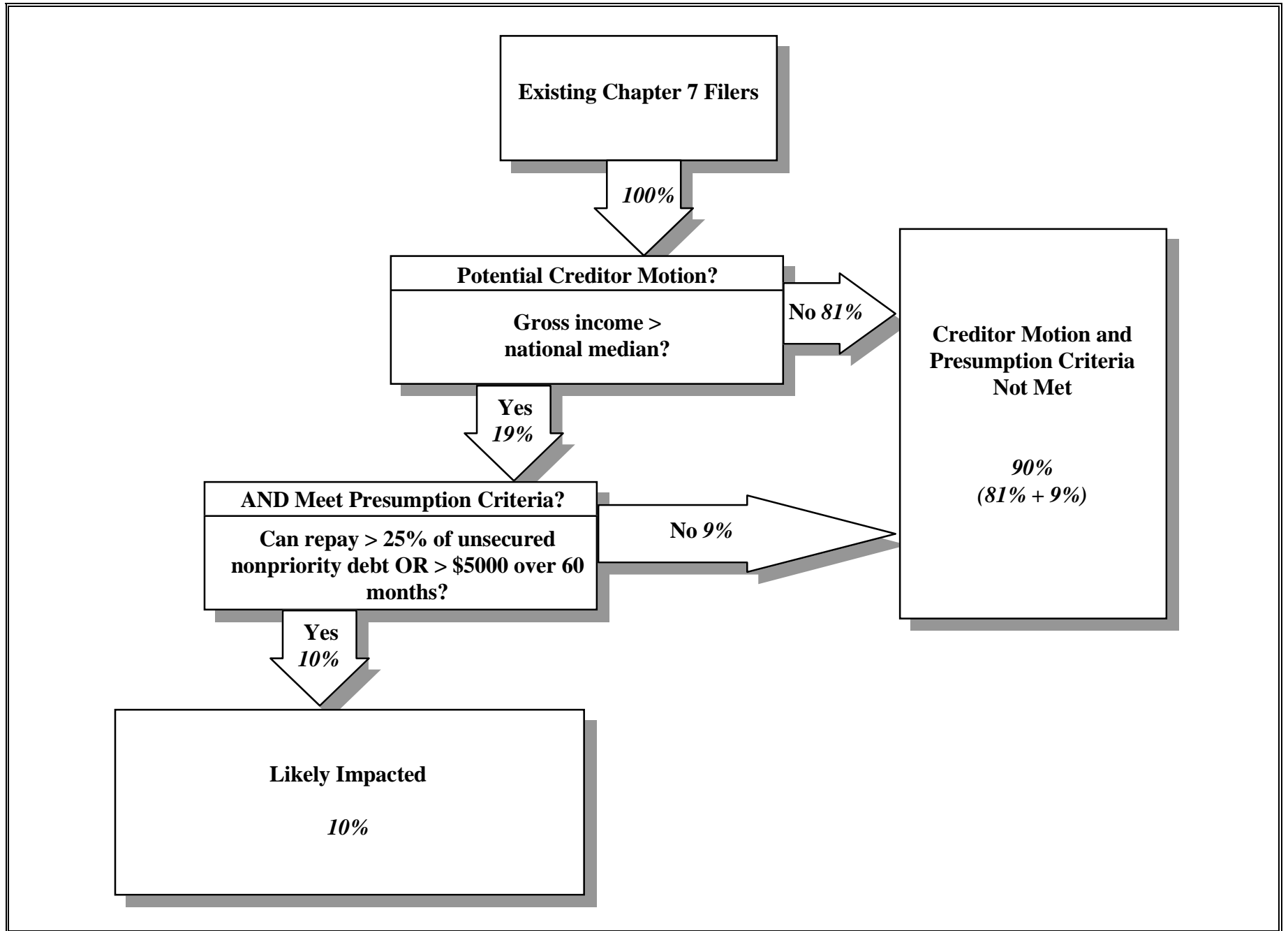
	1997 National Average
Chapter 7 Filers Likely Impacted ^{1/}	10 %
Debt Repayable over 5 yrs. by Ch. 7 Filers Likely Impacted: ^{1/}	
Total Debt ^{2/}	55 %
Secured and Priority Debt ^{2/}	56 %
Unsecured Non-priority Debt	53 %

Note: Repayment rates from the 1997 Visa national bankruptcy database were calculated on the basis of: petitioners' reported income; a combination of petitioners' reported expenses and IRS allowances as proposed under H.R. 833; and priority and secured debt payments. See assumptions in text, and repayment methodology described in Section 4.

1/ Chapter 7 filers are likely impacted by H.R. 833's needs-based bankruptcy provision if they have: income greater than the national median for families of comparable size and can repay either \$5,000 or 25 percent of their unsecured non-priority debts within 5 years, after making secured and priority debt payments and paying for living expenses. The 1996 national median income data by family size were obtained from the U.S. Bureau of the Census for families with more than two members (1997a) and for families of one (1997b).

2/ Repayment of secured debt is shown over 60 months. For housing debt, repayment is taken as stated by the petitioner unless the outstanding balance would have been paid off in less than 60 months. All other non-housing secured and priority debt is amortized over 60 months. In practice, petitioners may continue to repay outstanding secured debts beyond the 60 month repayment plan, which would increase the share of secured and total debt repaid.

Chart 2. H.R. 833 Needs-Based Process



Source: Ernst & Young, "Chapter 7 Bankruptcy Petitioners' Repayment Ability Under H.R. 833: the National Perspective"

Debt Repayment Capacity

The 1997 Chapter 7 filers likely impacted by H.R. 833 would have had the ability to repay 55 percent of their total debts, if income remained unchanged relative to expenses and liabilities during the 60 month repayment period.¹⁵ When broken down by type, the corresponding repayment figures are 56 percent for secured and priority debt owed and 53 percent for unsecured non-priority debt owed. These figures are shown in Table 3.

In dollar terms, the estimated amounts of debt repayable by filers likely impacted by the needs-based provision in 1997 are \$4 billion in secured and priority debt, and \$3 billion in unsecured non-priority debt, over the five year repayment period.

In other words, the 10 percent of Chapter 7 filers likely to be impacted could repay about \$7 billion of the \$75 billion (or 9 percent) of total Chapter 7 debt at risk within 5 years. Of the \$7 billion repayment, trustees would receive between \$93 and \$249 million, with the remaining funds to be received by creditors.¹⁶

More details on the distribution of repayment ability across debtors are provided in Table 4. As shown, about 5 percent of Chapter 7 filers could repay all their unsecured non-priority debts, even after allowing for secured and priority debt repayments and living expenses. About 4 percent had the ability to repay all their debts, and also had incomes above the national median adjusted for family size.

¹⁵ These figures understate the total debt repaid over the life of the loan. For example, a petitioner with a mortgage would likely continue to make payments after the five year period called for in the needs-based proposal.

¹⁶ The impact of trustee fees is difficult to estimate because of widely different practices in different districts. Fees typically vary, with mortgage debts (and sometimes car payments) generally not included as part of repayment plans. Given the uncertainty associated with Chapter 13 trustee fees, the impact of such fees was estimated using different assumptions, and presented as a range. Fees were estimated at 5.6 percent of debt payments, based on the 1995 national average (American Bankruptcy Institute, 1998, based on information from the Executive Office of the United States Trustee). Applying this percentage to all debt repayments over 60 months excluding mortgage debt repayments of filers with more than \$20,000 in real estate debt gives a high estimate of trustee fees of \$249 million. However, many consumers will likely choose not to file bankruptcy if they can repay all their debts under the needs-based test, since they would not get any debt relief under bankruptcy. These filers would have to continue repaying their debts, but by not filing bankruptcy they would not incur any trustee fees. Assuming that all likely impacted filers with the ability to repay all their debts choose not to file for bankruptcy reduces the trustee fee estimate to \$138 million. In addition, if all secured debts were kept outside the repayment plans, the estimate would drop further to \$93 million.

Table 4. Ability of Chapter 7 Filers to Repay Unsecured Non-Priority Debt Under H.R. 833's Needs-Based Provision

Share of unsecured non-priority debt repayable	Share of Filers:			Percentage of Debt Repayable in 60 Months by Actual Chapter 7 Filers Likely Impacted:		
	All Chapter 7 Filers	Chapter 7 filers with ability to repay > 25% or \$5K over 60 months	Likely Impacted Chapter 7 Filers	Total Debt	Secured & Priority Debt	Unsecured Non-priority Debt
Less than 25%	86%	2%	2%	7%	9%	4%
25-49.9%	5%	5%	3%	14%	16%	11%
50-74.9%	3%	3%	2%	8%	8%	9%
75-99.9%	1%	1%	1%	4%	4%	4%
100% or more	5%	5%	4%	22%	19%	25%
Total	100%	16%	10%	55%	56%	53%

See footnotes to Table 3.

Totals may not add up due to rounding.

Debt and Income Profiles of Filers Likely Impacted and Not Impacted Under H.R. 833

Filers likely impacted in 1997 under H.R. 833 had median incomes (\$51,974) considerably above the 1996 national median income (\$35,492) for all households¹⁷ (US Bureau of the Census, 1997b). Filers not impacted by the provision earned less than half at the median (\$21,204) of that earned by filers likely to be impacted. In addition, filers impacted had more unsecured non-priority debt (\$39,085 at the median) than filers not impacted (\$23,472 at the median). Chart 3 displays these results. Not surprisingly, likely impacted filers also had higher repayment capacity than the typical Chapter 7 filer: the median amount of unsecured non-priority debt that impacted filers could repay over five years was \$21,372; the comparable figure for all Chapter 7 filers was zero.

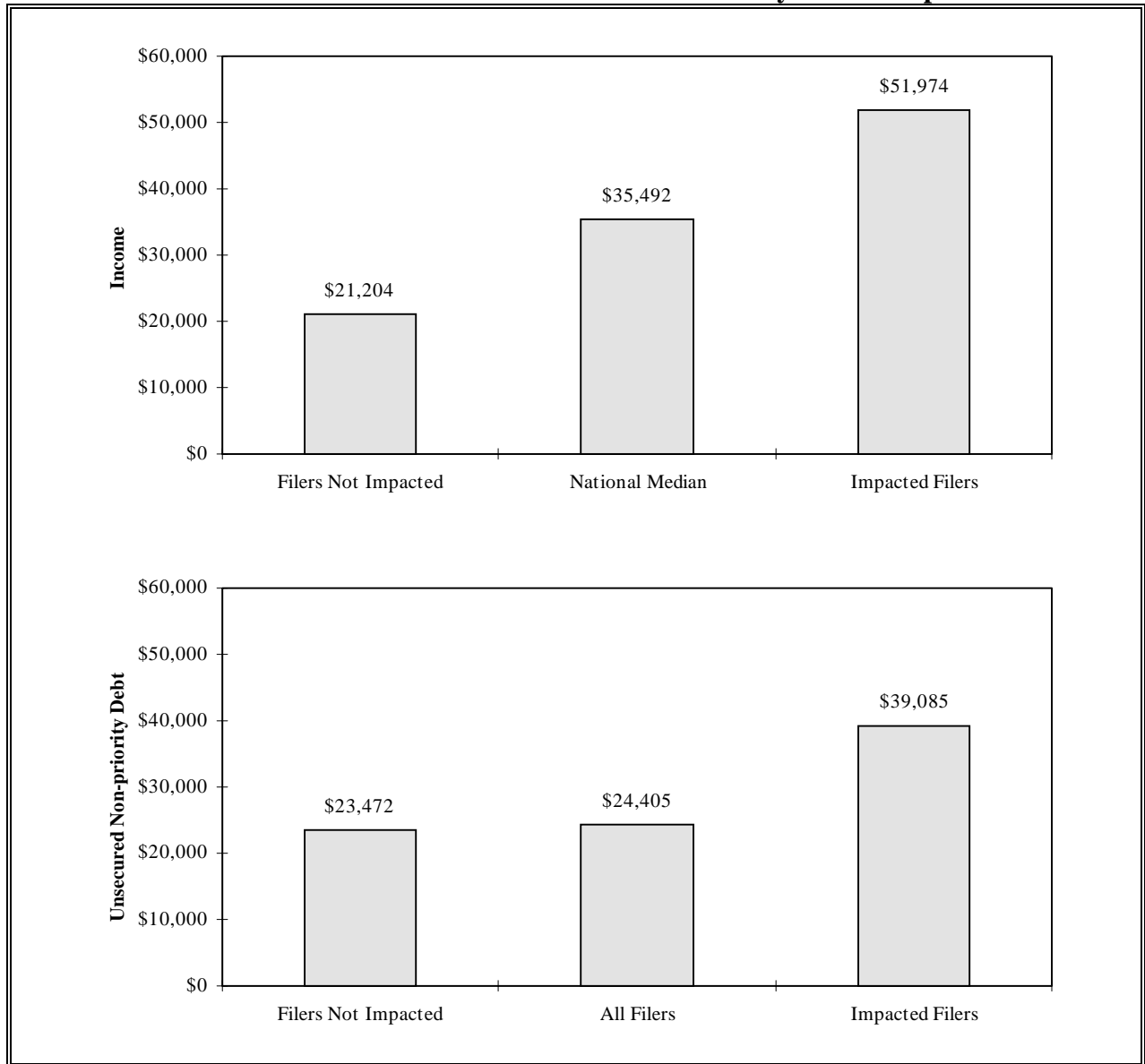
Expenses of Filers Likely Impacted Under H.R. 833

The ability of filers to repay unsecured non-priority debt under the needs-based test was assessed on the basis of their incomes and expenses. The expenses of filers can be broadly classified into two categories: (1) "actual expenses," which include expenses that were taken from Schedule J on the bankruptcy petitions and secured and priority debt repayment expenses based on the actual debt of debtors; and (2) "IRS standards," which include expenses used in the needs-based calculation that were taken from the IRS expense allowances. For likely impacted filers, the majority of expenses used in the needs-based calculation were obtained from the actual expenses of individual debtors, rather than from the IRS standards.¹⁸ Thus, the needs-based provision of H.R. 833 primarily reflects life style decisions which the debtors have made.

¹⁷ The needs-based provision uses family median incomes for families with more than two members, and uses the median income for households with one earner for single person households. For comparison purposes, household median income is preferable to family median income since family median income does not include single person households.

¹⁸ The composition of expenses was not calculated for filers not impacted by the needs-based provision, since many of these filers have expenses in excess of income, or do not have enough income available to service all of their secured and priority debts. In these cases, the actual expenses of debtors is understated for comparison purposes in this section. See Section 3 for more details on the repayment methodology.

Chart 3. Median Income and Unsecured Non-Priority Debt Comparison



Source: Ernst & Young, “Chapter 7 Bankruptcy Petitioners’ Repayment Ability Under H.R. 833: the National Perspective.”

Comparison with Other Studies

The results of this study are consistent with several recently released studies. For example, earlier Ernst & Young analyses found that 12 percent of 1992/93 Chapter 7 filers in four court districts and 15 percent of Chapter 7 filers across the US would have been impacted by the needs-based provision of H.R. 3150 had it been in effect at the time.¹⁹ All of these studies corroborate the 1997 Georgetown study's conclusion that "a sizable minority of Chapter 7 debtors could make a significant contribution toward repayment of their non-housing debt over a five year period."²⁰ The cumulative weight of all four studies supports a consistent finding: that large numbers of Chapter 7 filers have the ability to repay a substantial portion of their debts.

The American Bankruptcy Institute study,²¹ by Marianne Culhane and Michaela White, reported somewhat less repayment capacity – the authors report that 3 percent of filers in their 1995 sample from seven districts would have been impacted. This study and the ABI study estimate the impact of different needs-based provisions. In addition, they differ on a critical interpretation of the legislative proposal with respect to the treatment of automobile debt. The ABI study assigned debtors with cars the greater of the IRS automobile ownership allowance or their monthly automobile debt payments. In fact, the debtors in the ABI study were provided the IRS ownership allowance even if they had no car loan. This approach is consistent with neither the needs-based test in H.R. 833 nor the needs-based test that they evaluated, both of which specifically allow only the debtor's actual secured debt payments and exclude IRS standards that are "payments for debts." Instead, the needs-based provisions require that debtors be allowed to deduct the average monthly payments on account of secured debts over the 60 month repayment period. In keeping with this, this study amortized automobile debt over 60 months. This approach more accurately reflects the legislative language in H.R. 833.

The different approaches of the two studies towards trustee fees is discussed in the "Issues of Interpretation" section below. As explained, changing this assumption has virtually no impact on the findings.

¹⁹ See Ernst & Young (1998a and 1998b) for details. It should be noted that the methodologies used for the February 1998 and March 1998 estimates are not directly comparable, because of factors such as differences in data availability, and the different cities and years covered by the samples. In addition, the two previous Ernst & Young studies are not directly comparable to this report since they estimate the impact of earlier legislation, with a different needs based provision. See the appendices in Ernst & Young (1998a and 1998b) and Section 4 in this report for methodological details.

²⁰ The Georgetown study, Barron and Staten (1998), calculated the ability to repay non-housing non-priority debt, and used reported petitioner expenses rather than IRS standards.

²¹ See American Bankruptcy Institute (1998) for further details.

Issues of Interpretation

The following points about the analysis of the impact of the needs-based provision contained in H.R. 833 should be noted:²²

- (1) As defined by H.R. 833, the repayment calculations assume all secured and priority debt²³ is paid first, whether reaffirmed or not. The remaining repayment ability of the debtor is stated as a share of total unsecured non-priority debt.
- (2) The calculations use petition data submitted by petitioners -- that is, all data were taken from the actual petitions, as filed by debtors. While submitted under oath, these data are unaudited, unless the petition is challenged by a creditor or trustee. Some have suggested that Chapter 7 filers may have an incentive to exaggerate their financial distress by overstating expenses and understating income.
- (3) H.R. 833 provides that Chapter 13 plans can be adjusted over the repayment period to reflect changes in circumstances. However, to "score" the proposed legislation, the repayment calculations assume that the petitioners' future income relative to expenses and liabilities during the five year period is the same as their current income relative to expenses and liabilities as reported on the bankruptcy petition. For petitioners whose income relative to expenses and liabilities increases over the five year period, this assumption would underestimate repayment ability. Conversely, the assumption would overestimate the repayment ability of petitioners whose income relative to expenses and liabilities declines during the five year period.²⁴
- (4) The needs-based test does not incorporate trustee fees incurred in Chapter 13 filings. In practice, trustee fees would be borne after the administration of the needs-based test. Hence, these fees would not be included as priority debt payments when the needs-based test is administered. While trustee fees would not be included when administering the needs-based test, their subsequent imposition would lower debt repayment by debtors. Consequently, the estimated amount of debt repayable includes estimates for these expenses. While this approach accurately reflects the needs-based test in H.R. 833, including trustee fees would not have any significant impact on the share of filers likely impacted. Testing the sensitivity of the results to the inclusion of trustee fees as part of the needs-based test revealed that the share of likely impacted filers is 10 percent, whether or not trustee fees are included.²⁵

²² Appendix 2 in Ernst & Young (1998b) contains a full discussion of the procedures used in processing the petitions, and an assessment of the importance of sampling error. Here, attention is confined to conceptual clarifications.

²³ The repayment calculations include interest on back taxes and secured debt. See Section 4 for details.

²⁴ Two measures of income were examined for the analyses: current 1997 gross monthly income and income for calendar year 1996. The smaller (and hence more conservative) of these, 1997 current monthly income, was used as the starting point in the projections. As noted earlier, 10 percent of the 1997 Chapter 7 filers would likely have been required to file Chapter 13 under the H.R. 833. Using 1996 income, the fraction of the Chapter 7 filers likely impacted by the needs-based provision would have been over 14 percent.

²⁵ The methodologies used for estimating trustee fees are described in the "Debt Repayment Capacity" section. Three different methods were used, and though these methods do have some impact on the share of filers impacted,

4. Methodology for Calculation of Repayment Ability

This section describes the methodology used to calculate repayment ability under the needs-based provision of H.R. 833, as implemented given the data available.

Basic Calculation

The needs-based repayment measure is based on the following formulas:

- | | |
|---------------------------------|--|
| 1. Repayable Amount | Projected Monthly Net Income *60 |
| 2. Projected Monthly Net Income | Current Monthly Total Income - Monthly Expenses |
| 3. Current Monthly Total Income | Current monthly income on Schedule I. For joint filers, income and deductions included spousal income and deductions. |
| 4. Monthly Expenses | Transportation Expenses + Housing and Utility Expenses (for non-homeowners) + Mortgage Debt Service, Utility and Home Maintenance Payments (for homeowners) + Other Living Expenses + Other Necessary Expenses + Secured Non-mortgage Debt Service Payments + Priority Debt Payments + Business Expenses |

“Current monthly total income” is defined by H.R. 833 as “the average monthly income from all sources derived which the debtor, or in a joint case, the debtor and the debtor’s spouse, receive without regard to whether it is taxable income, in the 180 days preceding the date of determination...” The current petition schedules do not capture average income over the 180 days prior to filing. Analysis of the data revealed that, on average, current monthly income on Schedule I was lower than the prior year’s (1996) income from employment, business and other sources from Form 7 divided by 12. Current monthly income from Schedule I was therefore used as a conservative approach which underestimates the amount of repayment ability under H.R. 833. Repayment calculations were also done using prior year’s income. Using 1996 income, the fraction of Chapter 7 filers likely impacted by the needs-based provision would have risen to over 14 percent. It is reasonable to expect that the average income over the six months prior to filing would lie within the range represented by current monthly income and prior year’s income.

The repayable amount as described above was calculated for households meeting the minimum income requirements specified by H.R. 833, i.e., only households whose income exceeded 1996 median national income for families of comparable size as reported by the Census Bureau. While family size data is not currently required on bankruptcy petitions, family size was estimated and included in the database. For individual petitions, family size was determined by adding one to the number of dependents listed on Schedule I. For joint petitions, two was added to the number of dependents listed.

when rounded to the nearest integer, the estimate is that 10 percent of Chapter 7 filers are impacted, regardless of whether or not trustee fees are included.

Filers were considered likely to be impacted under the plan if their repayable amount exceeded either \$5,000 or 25 percent of their unsecured non-priority debt and if their income exceeded the national median adjusted for family size.

Unsecured non-priority debt includes finance company and personal loans, credit card loans, student loans, and other miscellaneous debts.

Expense Items

The monthly expense items are described in detail below. The 1997 IRS National Collection Standards were used for food, housekeeping supplies, apparel & services, personal care products and services and miscellaneous expenses. Local IRS standards were used for housing, utilities and transportation expenses.²⁶

(1) Housing and utility expenses.

IRS standard expenses for housing and utilities are determined according to the county and family size. Since H.R. 833's needs-based bankruptcy provision would allow the IRS standard expense in the absence of mortgage payments, non-homeowners²⁷ were allowed the IRS standard housing and utility expense for the relevant county and estimated family size. Conversely, homeowners were allowed to deduct their mortgage payments (discussed below), home maintenance expenses, and utility expenses for electricity and heating, water, sewer and telephone, as reported on Schedule J.

(2) Transportation expenses.

IRS standards for automobile operating costs and public transportation are determined by census region; there are also IRS standards for a number of large US cities. The reported county was used to assign petitioners' transportation expenses. If the county was in a metropolitan statistical area that contained one of the cities with separate IRS transportation expense, then the transportation expense for that city was used. Otherwise, the petitioner was assigned the transportation expense for the appropriate region. IRS transportation expenses also depend on the number of vehicles.²⁸ IRS standards generally make allowance for necessary or income producing expenses. There is no information on the bankruptcy petitions indicating whether a petitioner's vehicle meets this test. Therefore, transportation expenses were assigned to petitioners based on the number of vehicles reported on the petition, regardless of whether or not all of the vehicles were necessary. The only exception made was for debtors with a family size of one who had more than one vehicle. In this case, it seems reasonable to allow transportation expenses based on one vehicle.

²⁶ See Internal Revenue Service (1997) for more details.

²⁷ The calculations assumed a debtor is a homeowner if the petitioner had home or second mortgage debt on Schedule D, and had real property on Schedule A that was either a primary residence or multiple family housing unit.

²⁸ The number of vehicles was obtained by taking the larger of the number of personal property items identified on Schedule B as a vehicle, and the number of secured debts identified on Schedule D as vehicle debt.

The IRS standards also include allowances for automobile ownership costs. These allowances are intended to cover automobile debt payments. However, H.R. 833 specifically excludes IRS standards that are "payments for debts," and instead requires that debtors be allowed to deduct the average monthly payments on account of secured debts over the 60 month repayment period. Therefore, automobile debt was amortized over 60 months along with secured non-mortgage debt, as described below.

(3) *Other living expenses.*

The IRS national standards for living expenses include allowances for housekeeping supplies, apparel and services, personal care products and services, food, and miscellaneous items. These expenses are determined according to household gross monthly income and the number of individuals in the household. Accordingly, all petitioners were assigned these expenses based on their gross income and estimated family size.

(4) *Other necessary expenses.*

The H.R. 833 provision also allows filers to claim "other necessary expenses" based on IRS guidelines. Consistent with the needs-based bankruptcy provision, the following reported monthly expenses were deducted from monthly income: alimony, charity, child care, health insurance, medical expenses, taxes and payroll deductions (payroll taxes, social security, insurance, union dues, and other taxes not deducted from wages or included in home mortgage payments). All of these items were taken as reported *by the petitioner* on Schedules I and J. As a conservative approach, all charitable expenses were used, even though the IRS limits the type of charitable contributions which are allowed. Similarly, all taxes were used as listed on Schedule J. It is likely that some petitioners listed their monthly payments for back taxes on Schedule J. For such filers, the calculation would double count monthly back tax payments twice: once as shown on Schedule J, and once on the basis of calculated monthly back tax payments based on amortization of priority debt (see section on "Priority and Secured Non-Mortgage Debt Payments" below). All of these conservative approaches tend to underestimate the share of debtors impacted and the amount of debt repayable under the needs-based provision.

(5) *Mortgage Debt Service, Utility and Home Maintenance Payments.*

As discussed in the section on housing and utility expenses above, mortgage debt payments were only allowed for homeowners. Two adjustments were made to the reported mortgage debt payment amount: (a) if income after non-debt-payment expenses was insufficient to make the entire mortgage payment reported, then the available income was used instead, and (b) if 85 percent of reported current monthly mortgage payments multiplied by 60 was greater than 110 percent of the outstanding mortgage debt, then the outstanding mortgage debt was repayable in less than 60 months, and the average monthly mortgage payment was calculated by dividing 110 percent of the outstanding balance by 60.²⁹ In addition, homeowners were allowed utility

²⁹ Mortgage payments were multiplied by 85 percent to remove taxes and mortgage insurance from the payment amount. The outstanding mortgage debt amount does not include interest, so the amount was grossed up by 10 percent. The 10 percent gross up for accrued interest is the ratio of the remaining cumulative interest to outstanding principal for an 8 percent 30 year amortized mortgage with 2 to 3 years to maturity.

expenses for electricity and heating, water, sewer and telephone, and home maintenance expenses for repairs and upkeep, as reported on Schedule J.

(6) Priority and Secured Non-Mortgage Debt Service Payments.

Secured and priority debt was amortized over 60 months by dividing the total secured and priority debt by 60 (ten percent was added to outstanding amounts of secured non-mortgage debt and back taxes to allow for interest).³⁰ H.R. 833 allows for amortization of priority debt by dividing the outstanding priority debt by 60. Allowing for interest on back taxes is a conservative approach which underestimates the ability to repay debt under H.R. 833. Estimated attorney fees payments were included as priority debt payments. Attorney fees were calculated for each individual debtor as the difference between the \$1,281 average total attorney fees for Chapter 13 plans³¹ and the amount paid up front by individual debtors, as reported on their petitions.

(7) Business Expenses.

Debtors were also allowed business expenses as reported on Schedule J. However, these expenses were only allowed for petitioners that reported business income on Schedule I.

³⁰ The 10 percent future accrued interest on secured non-mortgage debt is the ratio of remaining cumulative interest to outstanding principal for a nine percent four year automobile loan with 2 years to maturity. The nine percent market interest rate was obtained from the *Federal Reserve Board Bulletin*, Federal Reserve Board (1997).

³¹ The \$1,281 average of total Chapter 13 attorney fees is based on an estimate of attorney compensation by the National Association of Consumer Bankruptcy Attorneys, as reported in American Bankruptcy Institute (1998).

5. Conclusions

The results presented in this report indicate that large numbers of 1997 U.S. Chapter 7 filers had the ability to repay large portions of their debts. In particular, this study shows that:

- 10 percent of 1997 Chapter 7 filers would likely have been likely impacted by the needs-based provision of H.R. 833, had it been in effect in 1997.
- These filers could have repaid 55 percent of their total debts over five years. When broken down by type of debt for filers likely impacted, the corresponding repayment figures are 56 percent for secured and priority debt owed, and 53 percent for unsecured non-priority debt.
- An estimated \$7 billion of Chapter 7 debt could have been repaid within five years by the filers likely impacted.

Filers who likely would have been impacted by H.R. 833's needs-based provision had relatively higher incomes:

- Impacted filers had median gross annual income of \$51,974, compared to \$21,204 for those unaffected.
- Impacted filers also had more unsecured non-priority debt (\$39,085 at the median) than those not impacted (\$23,472 at the median).

The 1997 findings corroborate several earlier studies using different databases and different methodologies. Taken together with this earlier work, the 1997 Visa national bankruptcy database continues to be a sound basis for action on bankruptcy reform.

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