This white paper takes an in-depth look at recent bankruptcy trends, highlights major new requirements and restrictions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “Act”), and offers projections for future bankruptcy activity. Finally, this paper discusses valuable tools that Equifax delivers to assist financial institutions in managing bankruptcy risk in this new environment.

Economists and researchers across the country are keeping a close eye on the impact of the Act, the most significant bankruptcy reform since the Bankruptcy Reform Act of 1978. The rise in consumer filings prior to the October 17th effective date attests to the changes wrought by this new law.

Recent Bankruptcy Trends

The growth rate of consumer credit debt outstandings provides insight into future bankruptcy activity. As the spending growth rate increases, consumers are more likely to outpace their earnings capacity and vice versa. Indeed, data shows that as consumer credit debt outstandings grew at a slower pace, bankruptcy filings declined steadily starting in mid-2003 (refer to Figure 1).

![Figure 1](image)


The new legislation was signed on April 20, 2005 and the bankruptcy figures in May and subsequent months reveal a dramatic consumer response. After a first calendar quarter of declining bankruptcies, the rest of the year to date has seen strong growth (refer to Figure 2). According to the Administrative Office of the U.S. District Courts, a surge in second quarter Chapter 7 filings — up 17.7 percent over the prior year period — has fueled an overall increase in filings.
Filings are expected to remain elevated until the Act becomes effective, followed by a correction, since most people who needed to file will have already done so. However, this correction is likely to be somewhat smaller than originally anticipated due to increased filings by Hurricane Katrina victims. Future projections are discussed in more detail below.

**New Legislation Requirements**

The Act imposes new requirements on consumers filing bankruptcy, tougher restrictions on the type of bankruptcy filed and the debt included in the filing, as well as increased attorney liability.

Consumers filing bankruptcy must attend a credit counseling session from an approved nonprofit credit counselor within six months prior to filing. According to the U.S. Trustee, the session is expected to last an average of 90 minutes and discuss topics including budgeting, alternatives to bankruptcy, and a financial analysis of the debtor’s situation. Consumers who file bankruptcy also will be required to complete a financial management training program prior to the discharge of their debts. These educational measures are designed to provide consumers the tools needed to avoid future bankruptcies.

The most significant change in the Act is the stipulation of a means test to determine the Chapter of bankruptcy for which the consumer is eligible. In Chapter 7, also referred to as a “straight bankruptcy,” the court liquidates the debtor’s assets into cash to cover costs and partially repay creditors. In Chapter 13, consumers are allowed to reorganize their finances and protect assets while a court-approved repayment plan is in effect. The new means test compares the combined gross income of the debtor’s family for the past six months to the median family income in that state. If family income exceeds the state median, the means test compares the income to spending allowed under local Internal Revenue Service collection standards.
If the resulting discretionary income is greater than $100 a month or the debtor can afford to pay 25 percent of unsecured debt, the debtor must file a Chapter 13 bankruptcy. If family income is less than the state’s median, the debtor is eligible to file a Chapter 7 bankruptcy. The means test is expected to shift more filings to Chapter 13, thereby significantly enhancing creditors’ ability to recoup receivables that would have been charged-off under the prior law.

Highlights of other notable changes to the bankruptcy code include:

- The courts will have less discretion in determining the repayment plan and must rely upon the local cost of living standards set by the Internal Revenue Service.

- Repeat filers will have to wait longer between bankruptcies. A consumer may only file for a Chapter 7 bankruptcy every eight years rather than the every six years allowed under the previous law. Chapter 13 filers must wait two years after a previous Chapter 13 filing or four years after another Chapter filing.

- The homestead exemption now is capped at $125,000 if the homeowner has been a resident of the state for less than three years and four months. Previously, some states — including Florida and Texas — allowed homeowners to protect the full value of their homes regardless of worth.

- Some “automatic stay” protections are being lifted; actions on evictions, driver’s and professional licenses, and certain lawsuits can continue while the consumer is filing bankruptcy.

- Child support and alimony payments are given first priority for debt payment (after trustee expenses, if any).

- The standard for non-dischargeable debts is more aggressive with a lower threshold for cash advances and a longer timeframe for luxury goods purchased.

- If an automobile was purchased within the two and a half years prior to filing bankruptcy, the debtor must repay the entire loan amount in order to retain the vehicle.

- Credit card charges made within three months of filing must be paid off.

- Creditors who have been shut out from receiving payments now can contest the case under both Chapter 7 and Chapter 13 filings; previously they could only contest Chapter 7 cases.

- Consumers must provide additional documentation including copies of pay stubs, an itemized statement of monthly net income and tax records (the most recent period for Chapter 7 and the last four years for Chapter 13).
Overall, the changes to the bankruptcy law should diminish the financial impact of bankruptcy to creditors as fewer debts are protected and more cases will be put on a repayment plan. The credit card industry is expected to benefit the most from the new restrictions as several provisions specifically exclude credit card related purchases from bankruptcy protection.

A third dynamic that may discourage consumers from filing involves new liability placed on attorneys. Bankruptcy attorneys will be subject to fines and fees if information about a client’s case is found to be inaccurate. A signed petition indicates that the attorney has investigated the case and determined that the petition has legitimate grounds. Analysts estimate that the cost of filing a petition will increase from $150 to $500 in the case of Chapter 7 and from $2,000 to $3,000 in the case of Chapter 13. Many attorneys are expected to stop offering pro bono or low-cost assistance through volunteer organizations.

**Bankruptcy Projections**

Economists predict that, after a brief correction, overall filings will increase starting in early 2006 and return to the pre-legislation predicted rate quickly as lenders become more aggressive in extending credit and relax underwriting standards in response to the increased protections of the Act. The rise in bankruptcy filings is expected to continue into late 2009 and beyond (refer to Figure 3).
Another ramification of the new legislation is a shift in the type of bankruptcy consumers will file. Historically, the ratio of Chapter 7 to Chapter 13 filings has been around 65:35. Predictions of the shift toward Chapter 13 vary widely. Some experts project 10 percent of those filing Chapter 7 today would file under Chapter 13 in the future and other analysts posit that the ratio could invert to 35 percent Chapter 7 and 65 percent Chapter 13 filings. The actual outcome will have a material impact on the financial benefit to creditors. Lenders who expand into riskier populations based on an optimistic view of the shift to Chapter 13 may experience a shock to their portfolios if the shift fails to materialize. Furthermore, observers estimate that less than a third of Chapter 13 bankruptcy filings are successfully completed, which suggests the benefit of the shift may not be as great to creditors as anticipated.

**Managing Bankruptcy Risk**

While lenders are expected to benefit greatly from the new law in terms of increased recoveries on net losses, the law itself does not protect creditors from eventual bankruptcy losses if lending standards are not actively managed.

A creditor’s best defense against bankruptcy losses is the implementation of practices that manage lending to consumers who pose the greatest risk of filing for bankruptcy — a different behavior than delinquency — calling for a specific bankruptcy prediction tool.

Equifax has long been at the forefront of bankruptcy management solutions. Our industry-leading Bankruptcy Navigator Index (BNI) 3.0 is an advanced analytical tool that predicts the likelihood of a consumer filing for bankruptcy over the next 24 months. In anticipation of the bankruptcy reforms, Equifax successfully validated BNI 3.0 to predict both Chapter 7 and Chapter 13 filings.

BNI 3.0 was developed using advanced statistical techniques including proprietary score fusion and neural network technology, which enhances the model’s predictiveness.

Unique design features of BNI 3.0 include:

- A choice of standard score range of 1 to 300 or a normalized score range of 1 to 600 that allows comparison against national averages.
- Multiple development periods which eliminate seasonal bias and provide superior behavior identification and stability.
- Use of enhanced attributes created specifically for bankruptcy model development.
BNI 3.0 contains five scorecards based on length of credit history, depth of credit information and delinquency history (indicated in green in Figure 4).

![Figure 4]

BNI 3.0 is designed to help lenders maximize opportunities while minimizing risk by isolating the majority of bankrupt consumers in the worst scoring percentiles and by ordering the population such that bankruptcy rates are monotonically increasing from the top-scoring percentiles to the bottom scoring percentiles. Since the bankruptcy rate varies significantly in the lowest score ranges (increasing as scores decrease), BNI 3.0 provides lenders the opportunity for multiple decision points based on risk tolerance.

Using a bankruptcy-specific tool has proven more effective than traditional risk scores in predicting bankruptcies. In Equifax research, BNI 3.0 has identified 12 to 14 percent more bankruptcies in the bottom scoring five to 20 percent of the population than a general risk model. Combining BNI 3.0 with other scores such as the Equifax Risk Score 3.0, Smart Score 2.0 or Multi-Screen 2.0 provides even more complete portfolio management.

It also is important to track bankruptcy activity at the macro level as part of planning and analysis. Equifax, in partnership with Economy.com, offers a strategic tool, CreditForecast.com, which provides online access to historic and forecast credit, economic and demographic data, including bankruptcy filing and score trends. With CreditForecast.com, customers also have access to in-depth econometric analyses of credit trends and quarterly credit outlook conferences.

For more information about BNI 3.0 or CreditForecast.com, contact your Equifax sales representative.