Research in Brief

COMMUNITY DEVELOPMENT STUDIES & EDUCATION

Summary — Credit Access After Consumer Bankruptcy Filing: New Evidence*

An increase in bankruptcy filings has initiated in-depth research on the topic of credit availability after households file for bankruptcy. A working paper from the Federal Reserve Bank of Philadelphia adds to the research by studying the differences between households that file for bankruptcy under Chapter 7 and those that use Chapter 13.

BACKGROUND

U.S. bankruptcy law allows for two basic types of personal bankruptcy proceedings: Chapter 7 and Chapter 13. Filing for Chapter 7 bankruptcy provides for "liquidation." Debtors sell their nonexempt property and use the proceeds to pay off creditors.[1] Exemption levels are determined by states. Successful Chapter 7 filing allows for the removal of most unsecured debt, but filers have to wait eight years to refile for Chapter 7 or four years for Chapter 13.

Chapter 13, also referred to as a "wage earner's plan," differs from a Chapter 7 filing because it allows debtors to make low monthly payments toward the amount owed over a three- to five-year period while keeping all their property before the remaining debt is cleared. As a result, the time between filing for bankruptcy and discharging one's debt is longer for Chapter 13 than for Chapter 7 filers. Also, Chapter 13 filers have to wait up to six years before filing for Chapter 7 bankruptcy, but they only have to wait two years to file for Chapter 13 bankruptcy again. A Chapter 7 bankruptcy flag can stay on one's credit report for 10 years, while a Chapter 13 bankruptcy flag is visible for only seven.

The working paper summarized in this brief explores whether these variations in Chapter 7 and Chapter 13 bankruptcy filings make a discernible difference in postbankruptcy access to credit.

DATA AND METHODOLOGY

The authors used anonymous borrower-level data from Equifax, one of the largest credit bureaus in the U.S. The data set contains quarterly information on a 1-in-20 random sample of borrowers from 2005 to 2012. Information from the data set used in this study includes the timing and type (Chapter 7 versus Chapter 13) of bankruptcy filing, the opening and closing of credit accounts, and the credit limits associated with such accounts.

The study took into account two events that may have played a role in a household's decision to file for bankruptcy: the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Bankruptcy Reform Act) and the Great Recession. Of particular relevance to the findings discussed here, the Bankruptcy Reform Act disallows prospective filers with household income above the state median income, with unsecured and secured debt falling below a certain threshold, and with the ability to repay some of the debt to choose Chapter 7; these households are now required to file for bankruptcy under Chapter 13. The Bankruptcy Reform Act still allows households below the state median family income to choose between Chapter 7 and Chapter 13 bankruptcy.

* The views expressed here are those of the authors and do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

[1] United States Court, "Liquidation Under the Bankruptcy Code," www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter7.aspx (accessed 2/4/2015)

Research in Brief is a new publication from the Federal Reserve Bank of Philadelphia's Community Development Studies and Education Department. The snapshot, which is intended for community development practitioners and other interested stakeholders, summarizes technical research produced throughout the Federal Reserve System. The first edition provides a summary of "Credit Access After Consumer Bankruptcy Filing: New Evidence," a working paper written by Julapa Jagtiani and Wenli Li that was originally released by the Federal Reserve Bank of Philadelphia's Research Department in 2014.

RESULTS

The authors focused on unsecured debt, such as credit cards, as opposed to secured debt, such as mortgages, and found that:

- Credit scores start to recover dramatically before the date on which debt is discharged for both filer types, which might be caused by the waiting period before debtors are allowed to file for bankruptcy again. This waiting period may mitigate the risk of default for lenders.
- Despite the recovery in their credit scores, bankruptcy filers have limited access to unsecured credit. Even though debtors may be able to obtain some unsecured credit after bankruptcy, their credit limits are substantially lower than they were before bankruptcy filing.
- Chapter 7 filers have a greater opportunity to acquire unsecured credit from new lenders than Chapter 13 filers do. The rebound in new credit cards occurred more slowly for Chapter 13 filers, possibly because they were using a portion of their income to pay down old debts and because they can file for bankruptcy again more quickly than Chapter 7 filers can.
- Despite reduced access to new credit, Chapter 13 filers are better able to maintain old credit and, as a result, generally have higher overall credit limits than their Chapter 7 counterparts.

POLICY IMPLICATIONS

This research sheds light on the different outcomes in the unsecured credit market experienced by Chapter 7 and Chapter 13 bankruptcy filers. Although bankruptcy reform in 2005 has made Chapter 13 the more common path for borrowers carrying unsustainable debt challenges, knowing the implications of the different bankruptcy processes is important for credit counselors and borrowers who face this difficult decision.

BEYOND THE BRIEF

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