



General Government Division

B-279743

April 10, 1998

The Honorable Charles E. Grassley
Chairman, Subcommittee on Administrative
Oversight and the Courts
Committee on the Judiciary
United States Senate

Subject: Personal Bankruptcy: Debtors' Ability to Pay Their Debts

Dear Senator Grassley:


On March 11, 1998, I testified before your Subcommittee on the Credit Research Center and Ernst & Young reports on the ability of those who file for personal bankruptcy to pay at least a portion of their debts (Personal Bankruptcy: The Credit Research Center and Ernst & Young Reports on Debtors' Ability to Pay, GAO/T-GGD-98-76). Following the hearing, you asked us to answer several questions from you and Senator Strom Thurmond regarding the statistical issues we identified in the Credit Research Center report, the need for a longitudinal study of bankruptcy filers; and whether, under the provisions of S. 1301, creditors would be likely to file a motion to transfer a case from chapter 7 to chapter 13.

Our responses to your questions are provided in the enclosure to this letter. We did not respond to the question posed by Senator Strom Thurmond (question 4), because we had no basis on which to estimate the impact of S. 1301 on creditor motions to transfer a case from chapter 7 to chapter 13. In developing our response, we relied on our February 9, 1998, report (Personal Bankruptcy: The Credit Research Center Report on Debtors' Ability to Pay, GGD-98-47); and the data and reports we have reviewed in our work on bankruptcy, such as the National Bankruptcy Review Commission's October 20, 1997, final report (Bankruptcy: The Next Twenty Years).

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We hope this information is helpful to you. We are sending a copy of this letter to Senator Richard Durbin, Ranking Minority Member of the Subcommittee, and will make it available to other interested parties on request. If you have any further questions or wish to discuss these responses, please contact William Jenkins of my staff on (202) 512-8757 or me on (202) 512-8777.

Sincerely yours,

A handwritten signature in cursive script that reads "Richard M. Stana".

Richard M. Stana
Associate Director
Administration of Justice Issues

Enclosure - 1

QUESTIONS FROM SENATOR CHARLES GRASSLEY AND SENATOR STROM
THURMOND AND GAO'S RESPONSES

1. **Mr. Stana, what were the most serious statistical shortcomings of the Staten report?**

Answer: The sample of bankruptcy petitions used in the study was not designed to be statistically representative of all bankruptcy filings in each of the 13 locations from which petitions were drawn. Therefore, there is no scientific basis on which to generalize from the sample to all bankruptcy petitions filed in 1996 in each of the 13 locations or to all bankruptcy filings nationally in 1996. Consequently, we disagree with the Credit Center report's statement that its "sampling procedures were adopted to generate a representative sample of all petitioners filing with those courts." In addition, the national estimates presented in the conclusion of the Center report are not supported by the report's study methods. Without a scientific, random probability sample, it is not possible to calculate statistical error rates that are important to describe the probability that the sample represents the characteristics of petitions in the universe of petitions from which the sample was drawn

It should be noted, however, that the most serious problems with the Credit Research Center (Staten) report were not strictly statistical. The report's conclusions rest on several fundamental assumptions that were unvalidated and for which no empirical support was cited in the report. The report assumed that the data on income, expenses, and debts that debtors reported in the schedules filed with their bankruptcy petitions were accurate and could be used to satisfactorily forecast debtors' income available for debt repayment for a 5-year period. The data in these schedules are of unknown, but questionable, reliability.

Two additional fundamental shortcomings were (1) the report assumed that 100 percent of a debtor's net income would be available for debt repayment each year for 5 years, and (2) the report's estimated total debt repayments were based on the assumption that 100 percent of debtors would successfully complete a 5 year repayment plan. The report provided no empirical basis for either of these assumptions, which had the effect of increasing the amount of debt the report estimated that debtors could potentially repay. In fact, administrative expenses consumed 16 percent of all chapter 13 debtor payments in fiscal year 1996. Moreover, historical experience suggests that only about one-third of chapter 13 repayment plans would be successfully completed, and about 14 percent would be converted to chapter 7 liquidation within about 2 years after they began. The report did not include an analysis of how much less debt could potentially be repaid if fewer than 100 percent of debtors successfully completed their repayment plans.

2. **Mr. Stana, could you elaborate on the sampling errors or inconsistencies you detected when reviewing the staten study?**

Answer: The principal issue with regard to the sample of petitions used in the Credit Research Center study was that the sample was not a scientific random sample whose results could be used to generalize to all 13 bankruptcy locations from which petitions were drawn or to all bankruptcy filings nationally in 1996. Because of the methods used to select the petitions used in the study, the sample petitions were potentially different from the universe of petitions from which the sample petitions were drawn, and there is little scientific basis for estimating how representative the sample may be of the universe of bankruptcy petitions filed in 1996.

First, the 13 locations were not chosen to be statistically representative of all bankruptcy filings in the nation. The locations were judgmentally selected from large urban areas with a Credit Counseling Center and large bankruptcy caseloads. The locations were also chosen to include variations in other characteristics, such as the growth in bankruptcy filings, the split between chapter 7 and chapter 13 filings, and state-specific asset exemption levels for chapter 7. Neither the court locations nor petitions were chosen with the objective of identifying the range of debts—lowest to highest—that bankruptcy debtors could repay.

Second, the petitions within each location were not selected to be statistically representative of all bankruptcy petitions filed in each location in 1996. The petitions for a court were generally gathered over several months in 1996 and generally included petitions filed in the first few days of May and June (eight locations), June only (three locations), or July (one location). In one location, the petitions were drawn throughout the months of April through June. Because the petitions selected were not drawn from the same time period in each of the 13 locations, estimates derived from the sample do not represent a well-defined time period.

Nor were the petitions selected at random from within the time periods used for selection. The petitions for a location were generally selected starting with the first day of the month(s) used for that court, and selection continued until the desired number of petitions was obtained. In some cases, all petitions selected in a month came from the first few days of the month. Because the sample procedure for selecting filings within bankruptcy court locations was not random, the characteristics of the petitions drawn may be systematically influenced by variation in the types of filings that can occur in (1) different months through the year and (2) days within the month.

The study evaluated the possibility that petitions from May to July might differ from those filed during other months of the year in one location, Indianapolis. However, the report provided no basis for judging whether the lack of monthly variation in Indianapolis could be expected for all 13 locations used in the report. Because the petitions selected were generally selected from the petitions filed in the first few days of the month, the characteristics of the petitions selected could differ from those filed later in the month. For example, in 3 of the 13 locations (Atlanta, Houston, and Dallas), mortgages are foreclosed on the first Tuesday of the month. About 95 percent of the petitions selected in Houston and Dallas were filed by the third day of the month. In both of these locations, the petitions drawn had been filed prior to the first Tuesday of the month. Thus, the petitions used from these two locations may have included a disproportionate number of debtors who sought to avoid mortgage foreclosures under chapter 13. The income and expenses of such filers may vary from those of debtors who filed petitions in these locations later in the month.

It is difficult to determine the effect that such potential errors may have on the Center report's analysis and results. That is one reason why we believe the report's results and conclusions should be interpreted with caution.

3. **Mr. Stana, in using bankruptcy petitions to predict the ability to repay, is it your view that any such prediction must be based on a longitudinal study?**

Answer: Generally, a longitudinal study would provide the best information on which to estimate debtors' ability to pay over a multiyear repayment period. The data reported on debtors' schedules of estimated income, estimated expenses, and debts that are filed with the debtors' bankruptcy petitions represent a snapshot in time. We do not know how accurate the data in those schedules are, nor do we know how useful the data in those schedules may be for forecasting debtors' ability to repay at least a portion of their debts. Even if the financial data reported on these schedules were known to be accurate, a debtor's financial circumstances could improve or deteriorate during the course of the 3 to 5 year repayment plan, thus increasing or decreasing the debtor's repayment capacity. At present, there is no reliable information on (1) the accuracy of the data debtors' report on their schedules of estimated income, estimated expenses, and debts; and (2) the reasons why historically only about one-third of chapter 13 repayment plans have been successfully completed.

A longitudinal study would be the most reliable way to identify the changes in a debtor's income and expenses over a 3 to 5 year repayment period and the impact these changes have on a debtor's repayment capacity. However, even data for a shorter period, such as 2 years, would be useful. These data could be used to identify changes in a debtor's repayment capacity that occur over time. The data from a longitudinal study could be very helpful in assessing how useful the debtor's initial schedules of estimated income, estimated expenses, and debts were in

predicting a debtor's ability to repay all or a portion of his or her debts over a 3 to 5 year repayment period.

4. **This question is for any panelists who care to respond. Under the Grassley-Durbin bill, creditors would have standing to file motions under section 707(b) to transfer a case from chapter 7 to chapter 13. However, the bill provides for penalties if the creditor's motion is denied and found not to be substantially justified. Under this approach, do you believe that creditors would often or seldom file motions to transfer a case to chapter 13?**

Answer: We have no information on which to base a response to this question.

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