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Consumer Bankruptcy Decision**

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THE SOCIAL DIMENSION TO THE HOUSEHOLD BANKRUPTCY DECISION

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Abstract

Personally knowing someone who has been bankrupt substantially increases the likelihood of an individual reporting they would consider filing for bankruptcy. This paper provides new evidence on the role of social effects in the personal bankruptcy decision using individual-level survey data from a representative sample of households in the United Kingdom. Respondents who reported they personally knew someone who had previously been bankrupt are more likely to consider bankruptcy as a viable option for discharging their debts. By contrast, respondents from an ethnic minority group are much less likely to consider bankruptcy. Both effects are substantial in magnitude, larger than the impact of demographic characteristics and point to a strong social element to the consumer bankruptcy decision

Keywords: consumer bankruptcy, social effects, personal insolvency

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Introduction

Between 1995 and 2005 the personal bankruptcy rate in the United States doubled. By 2005 there were over 2 million personal bankruptcy filings, or approximately 2% of households. In light of this remarkable increase and subsequent reform of the U.S. bankruptcy code in 2005, a growing number of studies seek to understand the bankruptcy decision at the individual level. Economists interested in understanding this phenomenon have only recently been able to utilise individual-level data. Fay, Hurst and White (2003) use data from a question on personal bankruptcy histories from the 1996 Panel Study of Income Dynamics to model the bankruptcy decision. They focus on whether the personal bankruptcy is better explained by the strategic benefit from going bankrupt or adverse events. They find strong econometric evidence for the strategic motive with only a weak role for adverse events such as divorce, health problems or a period of unemployment.

A finding from their and other studies of personal bankruptcies in the United States is that the likelihood of an individual filing for bankruptcy is positively related to the bankruptcy rate in the locality in which they live. This finding is not explained by variation in bankruptcy exemptions across districts. As further evidence of a 'social effect' of local bankrupties on the individual, Dick, Lehnert and Topa (2008) find that individuals who live in localities *neighbouring* states which undertake bankruptcy liberalisations are themselves more likely to file for bankruptcy even though the bankruptcy law in their locality is unchanged. Two explanations have been suggested for this 'social effect': an information effect whereby a higher local bankruptcy rate increases the local profile of bankruptcy opportunities, or a social stigma effect whereby higher local bankruptcy rates reduce the social stigma associated with filing for bankruptcy. Gross and Souleles (2002) suggest the social stigma hypothesis is of growing importance. They look to explain increases in the U.S. bankruptcy rate using detailed credit card data including lender's measures of credit riskiness but find that, controlling for these factors, the probability of default rose significantly between 1995 and 1997. They attribute this to a fall in bankruptcy stigma.

This is an important issue: as bankruptcy rates increase in both the U.S. and U.K., illustrated in Figure 1, a positive 'social effect' which encourages the spread of bankruptcy might reinforce the growth trend. One major drawback in existing studies is that given the

data available they are limited to defining the 'social effect' as the relationship between the local bankruptcy rate and the bankruptcy decision of the individual in that locality. As a consequence, the 'social effect' is defined solely by the locality in which the individual is resident. However, the strongest social effects on individual bankruptcies – either through the information effect of social stigma effect - are likely to arise from personal relationships between the individual and someone they know who has been bankrupt. Among a sample of bankruptcy filers surveyed by Visa (1997), half of filers reported they first heard about bankruptcy from friends or relatives (cited in Fay, Hurst and White, 2003). Using the local bankruptcy rate as a proxy for these relationships is most likely of limited value as such relationships are unlikely to be geographically limited. Also, a high local bankruptcy rate might also represent poor local economic conditions which make bankruptcy more likely.

The innovation in our approach is to utilise an individual-level survey in which respondents were asked specifically about whether they personally knew an individual who had filed to bankruptcy and also asked about their attitude towards filing for bankruptcy. Hence we directly identify an individual's social link with another individual who has filed for bankruptcy. The survey sample comprised a representative sample of the U.K. population surveyed in 2005. The survey included a series of questions on household demographics, labour market activity and finances, allowing us to control for a number of factors which might influence individual attitudes towards bankruptcy. We find that a personal association with someone who has filed for bankruptcy increases the likelihood that the individual would consider filing for bankruptcy considerably, whereas being a from an ethnic minority group substantially decreases the likelihood that an individual would consider consumer bankruptcy as a means of discharging their debts.

Bankruptcy Law in the U.K.

'Bankruptcy' in a U.K. context refers to the discharge of an individual's unsecured debts under the 1986 Insolvency Act and is comparable to Chapter 7 bankruptcy procedures in the United States. It covers the full range of unsecured debt with exceptions for student loans, benefit overpayments and non-provable debts. A bankruptcy order can either be petitioned by the debtor or by a creditor who is owed unsecured debt of more than £750. Under U.K. bankruptcy provisions, following a bankruptcy order an individual's estate is put into charge of an official receiver or registered insolvency practitioner who disposes of the individual's assets and makes payments to creditors. Few assets are exempt, charges may be

made from an individual's earned income for the bankruptcy period (with exemptions for their basic living costs) and durable goods including housing may be liquidated to settle outstanding debts. Individuals declared bankrupt are prohibited from gaining credit of more than £500 or being the registered owner of a business. Following the Enterprise Act 2002, from 1 April 2004 the majority of bankrupt individuals are discharged from these measures within 1 year instead of 3 years as was previously typically the case. Bankruptcy typically costs the applicant approximately £600 in court fees and administration costs.

Compared with U.S. Chapter 7 procedures, bankruptcy procedures in the U.K. have arguably historically been more stringent than in the U.S., where (prior to the 2005 reform) household future income was exempt. Also, unlike the U.K., most U.S. states exempt some proportion of the individual's housing equity, known as the 'homestead exemption'. In 2005 the U.K. bankruptcy rate was 0.13%, or approximately 47,000 individual bankruptcies. Whereas the 2005 reform in the U.S. made the bankruptcy code more stringent, particularly through the claim on an individuals' income, the 2002 U.K. reform made the U.K. bankruptcy code more generous by substantially shortening the time period during which an individual is subject to bankruptcy measures.

The U.K. has no parallel to U.S. Chapter 13 bankruptcy procedures (under which a court approves a debt repayment plan which creditors are obliged to accept), but has two similar measures which do not involve court approval and are contingent upon creditors agreeing a revised repayment plan. The first, a statutory alternative to bankruptcy, is an 'Individual Voluntary Arrangement', under which an insolvency practitioner negotiates on behalf of households who may be able to partially repay their debts over a period of time (typically 5 years). An IVA can be approved should creditors owed at least 75% of the value of the debt agree on the revised repayment plan. Under the IVA scheme the individual is not required to serve a period subject to bankruptcy measures and receives legal protection from creditors pursuing other means of debt recovery, such as a bankruptcy order. In 2005 there were approximately 20,000 IVAs successfully negotiated in the U.K. Approximately 30% of IVAs are terminated due to the debtor not meeting their obligations. The second is a non-statutory 'Debt Management Plan' (DMP) typically provided by debt charities or fee-paying debt advisors under a government licence. Under a DMP, no protection from a bankruptcy order is provided. Instead, the intermediary negotiates a revised repayment plan for debtors based on their likely future income. There are no official statistics for the numbers of individuals on a DMP, though market research organisations suggest that each year the

number of individuals starting a DMP is at least as many as are issued with bankruptcy orders. More detailed information on Bankruptcy and IVA terms is available from the U.K. Insolvency Service.

Data

The data source is the Bank of England's annual survey of household finances conducted by NMG. In each year beginning 2004 the Bank has commissioned NMG to survey a representative sample of between 1500 to 2000 U.K. households, focusing on household finances including detailed questions on the composition of the household balance sheet. Respondents to the survey were asked to answer household-level questions, such as balance sheet values, on behalf of the household. Results from the survey are published in the Bank's *Quarterly Bulletin* and the raw data is available for download from the Bank website. The survey has periodically included modules with questions on topics such as retirement saving, credit constraints and housing equity withdrawal. In 2005 the survey included these two questions on bankruptcy:

i) *"If you were unable to keep up with your debt, which of the statements on this card best describes your views on personal bankruptcy:*

> *I would seriously consider bankruptcy*
> *I would possibly consider bankruptcy*
> *I would only consider bankruptcy as a last resort*
> *I would never consider bankruptcy under any circumstances*
> *Don't know."*

ii) *"Do you personally know anyone who has become bankrupt?"*

> *Yes / No*

Respondents were asked both questions in the order shown above, irrespective of their answer to the first question. We drop from the sample respondents who answered 'don't know' or refused either question (345) and base our analysis on respondents who answered both questions (1,346). The first question asks about the respondents' attitude towards bankruptcy should they be unable to keep 'up to date' with their debt. The four possible responses have an ordinal ranking from 'never consider' to 'seriously consider' bankruptcy. By referring to 'keeping up to date' with debt the question is framed in the context of non-

strategic bankruptcy and relates to a scenario which is not necessarily currently relevant for the individual. Ideally, of course, we would use observations of actual bankruptcy rather than self-reported attitudes towards bankruptcy.

The question asked here may be wholly irrelevant for many households who do not have unsecured debts. Alternatively, it may be equally irrelevant for those households who do have debts but also have healthy asset positions such that bankruptcy would be unnecessary should they struggle to meet their relatively low debt repayments. Unfortunately, given the low bankruptcy rate in the U.K., as with the U.S., exploiting observations of actual bankruptcies in such a survey is infeasible. Fay, Hurst and White (2003) use a recall question inserted into the PSID which asked individuals whether they filed for bankruptcy between 1984 and 1995 and obtain only 254 records of bankruptcy from a sample of 54,000 households. Given the lower bankruptcy rate in the U.K., seeking to exploit actual bankruptcy occurrences is evidently not a plausible strategy.

So instead this question is used, albeit most likely irrelevant for many households. However, we are able to control for the household's balance sheet characteristics in our analysis – the level and composition of household debt plus whether the individual reported that debt payments were currently a burden. The second question identifies whether the respondent 'personally knows' anyone who has become bankrupt. It invites a yes/no response. We use the answer to this question to identify whether the individual has a social tie to someone who has become bankrupt.

Results

Of the 1,346 respondents, 45% said they would never consider bankruptcy if they couldn't afford to pay their debts, 42% responded that they would consider bankruptcy only as a last resort, 6% said they would possibly consider bankruptcy and 7% said they would seriously consider bankruptcy. Hence over 85% of respondents consider bankruptcy a very extreme or impossible option even in the context of being unable to meet debt payments. This is perhaps unsurprising given the way households may interpret the question. For most respondents their household had assets in excess of its debts such that bankruptcy would be unnecessary should the household be unable to meet its debt obligations – it could simply pay down is debts using its assets. Only relatively few households had large enough debts relative to their assets such that bankruptcy would be feasible should their income fall sufficiently to impair their ability to pay 'keep up with their debt' as the question asks.

Turning to the second question, 25% of respondents answered 'yes' to personally knowing someone who has been bankrupt with 75% answering no. The correlation between the respondent personally knowing someone who has become bankrupt and the respondent's attitude towards bankruptcy is summarised by Table 1. Among those who responded they would 'seriously consider' bankruptcy 41% personally know someone who has been bankrupt, whereas among those who would 'never consider' bankruptcy only 18.5% personally know someone who has been bankrupt. This indicates an unconditional correlation between personally knowing someone who has been bankrupt and the likelihood of considering bankruptcy in the future.

This relationship may of course arise due to associated factors such as the level of respondent debt or socio-demographic characteristics. Table 2 provides summary statistics for a range of characteristics, comparing those respondents who report they would seriously or possibly consider bankruptcy (178) with those who would never consider bankruptcy or only consider it as a last resort (1168). Summary statistics show that across a range of demographic and educational background characteristics there are no statistically significant differences in the characteristics of the two groups. In terms of employment status, those seriously / possibly considering bankruptcy are more likely to be unemployed at the 5% level of significance (p-value for test of equivalence of means of 0.033). In terms of financial characteristics, there are no statistically significant differences between the two groups in terms of household incomes, values of unsecured debts or home values. However, households who would seriously / possibly consider bankruptcy have greater financial assets and smaller mortgages. In terms of personal association with someone who has been bankrupt, 34% of those seriously / possibly considering bankruptcy knew someone who had been bankrupt compared with 24% of those who would never consider bankruptcy or consider it only as a last resort.

The two groups of households described in Table 2 therefore exhibit statistically significant differences in their financial assets and mortgage debts as well as by knowing someone who has been bankrupt. It may be the case that, conditional on these two financial variables, there is no relationship between personally knowing someone who has been bankrupt and the likelihood of considering bankruptcy in the future. To control for these and other variables, a series of multivariate models are estimated including these financial variables and a collection of demographic, educational and labour market controls. Within the dataset it is possible to control for the level of household incomes, assets and debts and also

to approximate the strategic value of bankruptcy for each household. This will be relevant as the household's evaluation of the likelihood of going bankrupt is most likely related to the strategic value of bankruptcy to the household. If a household has a negative strategic value of bankruptcy it is sensible for the household to not consider bankruptcy even if it cannot pay its debts.

The immediate strategic value of a household entering bankruptcy can be calculated:

$$SVAL_i = \max\left[UD_i - A_i - X_i, 0\right]$$

Where $SVAL_i$ is the strategic value of bankruptcy, measured in U.K. pounds, for household i. UD_i is the value of unsecured debts eligible for discharge under bankruptcy, A_i is the value of financial assets eligible for liquidation under bankruptcy, X_i is the court and administrative fee for applying for a bankruptcy order, all for household i. A strategic value of zero implies that the household would make no immediate net financial gain from bankruptcy. The court and administrative fee is approximately £600. Under U.K. bankruptcy law, there are few assets not subject to liquidation under bankruptcy rules with no 'homestead' exemption as in many U.S. states, so the net value of the household's housing equity is included in the financial asset calculation. From 2004, occupational pensions are exempted (though no detail is provided about these in our data). The strategic value from bankruptcy does not take into account the potential future income of the household allocated by the trustee towards meeting outstanding debts over the 12 months following the bankruptcy order being issued.

The immediate strategic value of bankruptcy for households in the sample is summarised in Table 3. 11.1% of households would have an immediate financial benefit from filing and 9.1% would have an immediate financial benefit of over £1,000. However, far fewer households would make a sizeable gain from bankruptcy. Only 2.8% of households would make a financial benefit of over £10,000. These values, by not incorporating trustee-appropriated income in the period during bankruptcy, underestimate the financial cost of bankruptcy. Nevertheless, with the U.K. bankruptcy rate at less than 0.5% there appear to be a large proportion of households who would benefit from bankruptcy than actually file for bankruptcy in our data. These figures for the U.K. are comparable with those presented by Fay, Hurst and White (2003) for the U.S., for which 18.5% of households would make a positive financial benefit from filing and 3.1% of households would make a financial benefit

in excess of \$10,000. We incorporate the strategic value of bankruptcy into the multivariate model for the respondents' attitude towards bankruptcy.

Multivariate estimates are presented in Table 4. As the dependent variable takes one of four possible values which can be ranked from lowest (never consider bankruptcy) to highest (seriously consider bankruptcy) estimates from an ordered probit model and presented alongside OLS estimates. In each case the dependent variable takes four possible values (0,1,2,3). The multivariate model includes the respondent's age, gender, marital status, ethnic minority status, whether the respondent's household unit includes children, a series of dummy variables capturing the respondent's education and labour market status, household income, the strategic value of bankruptcy to the household and the dummy variable capturing whether the respondent knew someone who had been bankrupt.

Column 1 presents estimates from a model in which the demographic and financial variables and included. The coefficients on respondent age and characteristics are all statistically insignificant in this model, as are the coefficients on household income and the strategic value of bankruptcy to the household. The coefficient on the ethnic minority dummy is negative and statistically significant at the 1% level (t-statistic of 3.93). The coefficient on the ethnic minority dummy variable is -0.31. The baseline prediction is 0.75. Hence the respondent being from an ethnic minority background reduces the predicted probability for the dependent variable by 41%. Compared to the existing literature, Fay, Hurst and White (2003) find no role for ethnic minority status (as indicated by the household having an African-American head) affecting the likelihood of a household filing for bankruptcy, controlling for the financial benefit from bankruptcy. This may, of course, represent a sphere cultural difference between the U.K. and the U.S.

The model estimated in Column 2 includes the dummy variable for whether the respondent knew someone who had been bankrupt. The coefficient on this variable is positive and statistically significant at the 1% level (t-statistic of 4.03). The coefficient of 0.22 and baseline prediction of 0.75 implies that a respondent who knew someone who had been bankrupt has a predicted probability for the dependent variable 29% higher than a respondent who did not know someone who had been bankrupt. Estimates from the ordered probit model return stronger marginal effects. In Column 4 an ordered probit model is estimated including the strategic value of bankruptcy. The coefficient on the ethnic minority variable of -0.43 against a baseline of 0.45 implies a 95% decrease in the predicted probability. The coefficient

on the dummy variable for personally knowing someone who has been bankrupt of 0.29 implies a 64% increase in the predicted probability.

The results from the multivariate analysis make clear two relationships in the data. Firstly, being from an ethnic minority background substantially reduces the likelihood of a respondent reporting that they would consider bankruptcy should they become unable to pay their debts. Secondly, personally knowing someone who has previously been bankrupt substantially increases the likelihood of a respondent reporting that they would consider bankruptcy. Both of these social effects are large in magnitude. Furthermore, none of the other personal socio-demographic indicators are statistically significant in the analysis: age, marital status, gender, having children, educational status and employment status have no statistically significant impact on the likelihood of the respondent reporting they would consider bankruptcy.

Conclusion

Previous studies have found a positive relationship between the local bankruptcy rate and the likelihood of a household filing for bankruptcy. Authors suggest there is a 'social effect' of the bankruptcy rate on an individual household's decision to file, most likely a social stigma effect, and that this explains much of the increase in bankruptcy filings. However, the local bankruptcy rate is of limited value as a proxy for social relationships, which may not be geographically limited.

This study has shown that when individuals are asked whether they would consider filing for bankruptcy in the future, personally knowing someone who has been bankrupt substantially increases the likelihood that a respondent would consider filing for bankruptcy. Being from an ethnic minority substantially decreases the likelihood of an individual responding they would consider bankruptcy. Individual demographic characteristics – most notably age, gender and marital status – have no effect.

These results show that the decision to file for bankruptcy has a strong social dimension and imply that rising household bankruptcy rates in part themselves perpetuate the growth of bankruptcy by a reinforcing social effect. These results also raise the profile of the sociological / economic question of what the social effect represents (an information effect or a stigma effect) and that addressing this question is a key element in understanding the household bankruptcy decision.
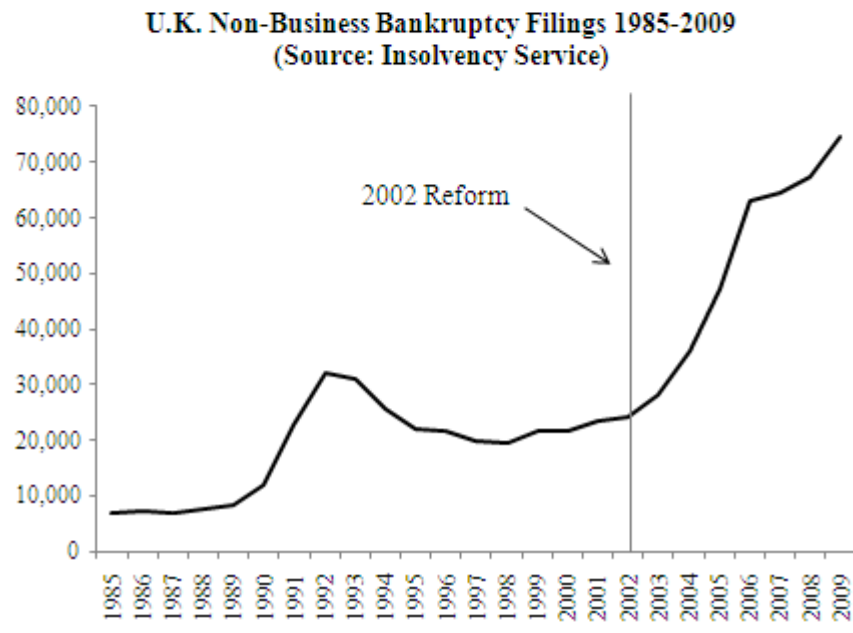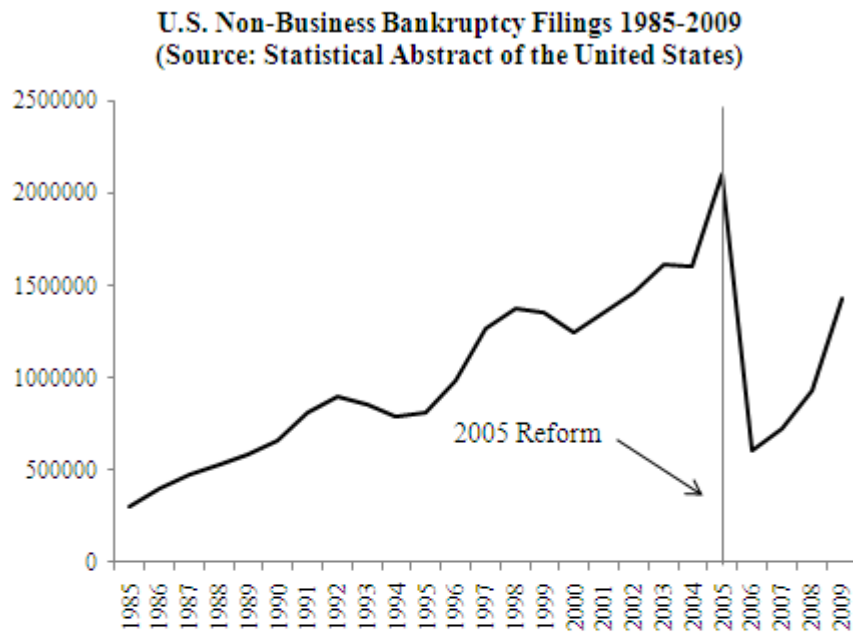
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Figure 1. Non-Business Bankruptcy Filings, U.S. and U.K. 1985-2009

U.S. Non-Business Bankruptcy Filings 1985-2009
(Source: Statistical Abstract of the United States)

U.K. Non-Business Bankruptcy Filings 1985-2009
(Source: Insolvency Service)

Table 1: Views on Bankruptcy By Personal Association With Someone Who Has Been Bankrupt			
	Respondent Personally Knows Someone Who Has Been Bankrupt		
View on Bankruptcy if Couldn't Pay Debt	No	Yes	
'Never Consider'	81.5% (493)	18.5% (112)	100% (605)
'Last Resort'	70.9% (399)	29.1% (164)	100% (563)
'Possibly Consider'	74.4% (64)	25.6% (22)	100% (86)
'Seriously Consider'	58.7% (54)	41.3% (38)	100% (92)

Notes: Total sample 1,346 households (336 answered 'yes', 1010 answered 'no').

Table 2: Characteristics of Respondents Who Would 'Seriously Consider' or 'Possibly Consider' Bankruptcy Vs Remainder of Sample			
	Seriously / Possibly Consider (n=178)	Never Consider / Consider as Last Resort (n=1168)	P-value
Demographics			
Age (Years)			
Male = 1	0.46	0.52	0.152
Married / Couple = 1	0.53	0.60	0.093
Ethnic Minority = 1	0.10	0.12	0.305
Have Children = 1	0.67	0.63	0.547
Education			
High School Educ. = 1	0.35	0.35	0.733
College Educ. = 1	0.19	0.18	0.718
University Educ. =1	0.16	0.18	0.495
Employment			
Employed = 1	0.55	0.52	0.508
Self-Employed = 1	0.04	0.04	0.959
Unemployed = 1	0.09	0.05	0.033
Retired = 1	0.16	0.22	0.056
Finances			
Net Income (£)	23,700	23,200	0.612
Financial Assets (£)	11,800	6,300	0.003
Unsecured Debt (£)	1,600	2,300	0.135
House Value (£)	71,000	86,400	0.093
Mortgage Value (£)	7,200	15,100	0.008
Knows Bankrupt = 1	0.34	0.24	0.004

Table 3: Percentage of Households With Positive Strategic Benefit From Bankruptcy	
Greater than £0	11.1%
Greater than £1,000	9.1%
Greater than £10,000	2.8%
Median	-£6,100
Mean	-£75,600

Table 4: Multivariate Analysis of Survey Responses				
Dependent Variable: Whether Individual Would Consider Bankruptcy (0,1,2,3)	OLS Regressions		Ordered Probit Models (Marginal Effects)	
	(1)	(2)	(3)	(4)
Age 25-34	0.12 (1.39)	0.09 (1.07)	0.17 (1.48)	0.13 (1.14)
Age 35-44	0.04 (0.46)	0.02 (0.26)	0.03 (0.29)	0.01 (0.05)
Age 45-54	-0.01 (-0.13)	-0.04 (-0.46)	-0.06 (-0.47)	-0.11 (-0.84)
Age 55-64	-0.09 (-0.86)	-0.11 (-1.07)	-0.15 (-1.11)	-0.18 (-1.33)
Age 65+	-0.14 (-1.03)	-0.13 (-0.98)	-0.30 (-1.57)	-0.29 (-1.53)
Male =1	-0.06 (-1.33)	-0.06 (-0.75)	-0.08 (-1.21)	-0.07 (-1.08)
Married / Couple =1	-0.05 (-0.85)	-0.04 (-0.75)	-0.04 (-0.58)	-0.03 (-0.47)
Ethnic Minority =1	-0.31* (-3.93)	-0.28* (-3.50)	-0.47* (-4.18)	-0.43* (-3.78)
Children = 1	0.02 (0.57)	0.01 (0.34)	0.00 (0.10)	-0.00 (-0.12)
Income / 100,000 (£)	-0.07 (-0.42)	-0.07 (-0.39)	-0.09 (-0.36)	-0.08 (-0.33)
SVAL / 100,000 (£)	-0.01 (-0.32)	0.01 (0.42)	0.03 (0.72)	0.03 (0.86)
Knows Someone Who Has Been Bankrupt = 1	-	0.22* (4.03)	-	0.29* (3.98)
Baseline Prediction	0.75	0.75	0.45	0.45
$F_{(24, 1321)}$	3.31	3.79		
Prob > F	0.0000	0.0000		
R^2 / Pseudo R^2	0.07	0.08	0.04	0.04
LR χ^2(27)	-	-	104.51	120.32
Prob > χ^2	-	-	0.0000	0.0000

*Notes: Sample of 1,346 households, additional variables are: educational dummy variables for high-school educated, college educated and university educated; employment dummy variables for employed, unemployed, self-employed and retired; regional dummies. T-statistics in parenthesis, * denotes statistical significance at the 1% level.*

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05/01	Simona Mateut, Spiros Bougheas and Paul Mizen	Trade Credit, Bank Lending and Monetary Policy Transmission