



**Testimony of  
The National Association of Federal Credit Unions**

**Committee on the Judiciary  
United States Senate**

***Bankruptcy Reform***

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## **National Association of Federal Credit Unions Bankruptcy Executive Summary Statement**

In the twelve-month period that ended on December 31, 2004, NAFCU estimates over 1.6 million consumers filed for bankruptcy; with approximately 267,000 of those consumers being credit union members (estimates based on trends through 3<sup>rd</sup> quarter 2004 for consumer filings and 2<sup>nd</sup> quarter 2004 numbers for credit union member filings). Congress has recognized this trend and has taken action in an attempt to alleviate this problem with the introduction of the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S.256*.

Credit unions are member-owned not-for-profit institutions that serve a broad and diverse membership base, including many members of low and moderate means. Because of their cooperative form of ownership credit unions, have no choice but to pass bankruptcy losses on to financially responsible members through increased interest rates on loans or decreased dividend rates on savings. As the number of bankruptcy filings continues to rise, bankruptcy losses have a disproportionately heavier impact upon fiscally responsible credit union members than they do on the customers of for profit financial institutions.

NAFCU supports meaningful reform of the bankruptcy code that brings about both responsible lending as well as responsible spending. NAFCU believes that the bankruptcy reform legislation Congress has been working on over the past 7 years represents a well balanced approach and goes a long way toward making appropriate and long-needed reforms to the bankruptcy system.

Three issues have risen to the top of NAFCU's agenda with regard to bankruptcy reform. First, require the courts to conduct a "means" test to determine whether debtors who file for total elimination of their debts under Chapter 7 of the Bankruptcy Code have the resources to repay some portion of their debt, in which case they should be required to file under Chapter 13 or be dismissed out of bankruptcy. Second, require mandatory financial education for all filers. Credit unions have a history of educating their members in financial matters, including the wise use of credit and the value of systematic savings. Finally, preserve the right of voluntary reaffirmations for credit union members. Credit unions traditionally have higher reaffirmation rates than many other lenders, partly because their members realize that credit unions are cooperatives, and offer them low interest rates on loans and high dividend rates on savings.

As you know, the legislation introduced in the 108<sup>th</sup> Congress included these three important provisions that NAFCU believes are necessary in any reform effort. We are pleased to see that these provisions are again included in the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* and urge its quick passage.

## ***Introduction***

The National Association of Federal Credit Unions (NAFCU) is the only national organization exclusively representing the interests of the nation's federally chartered credit unions. NAFCU is comprised of approximately 800 federal credit unions -- financial cooperatives from across the nation--that collectively hold approximately 66 percent of total federal credit union assets; NAFCU represents the interests of approximately 26 million individual credit union members. NAFCU, and the entire credit union community, appreciates the opportunity to participate in the discussion regarding the need for reform of the nation's bankruptcy system.

## ***Nature of Credit Unions***

Historically, credit unions have served a unique function since Congress first authorized the establishment of federal credit unions:

- First, credit unions remain totally committed to providing their members with efficient, low-cost personal service.
- Second, credit unions continue to emphasize traditional cooperative values, such as democracy and volunteerism.

As members of not-for-profit, cooperative financial institutions, all credit union members have an equal say in the operation of their credit union -- regardless of the amount they have on account at the credit union. These singular rights extend from basic operating decisions to electing the board of directors. Unlike banks and thrifts, federal credit union directors, motivated by an altruistic desire to be of service to others, serve without remuneration -- a fact that epitomizes the true "volunteer spirit" which permeates the credit union community.

Credit unions play an important role in the financial lives of more than 85 million Americans from all walks of life who have chosen the convenient and low-cost financial services that only credit unions can provide. As the package of services offered by various types of financial institutions becomes more and more homogenized, the emphasis shifts from the type of service offered to the quality and cost of service provided. Historically, credit unions have been

second to none in providing their members with quality personalized service at the lowest possible cost. According to an annual survey conducted by the *American Banker* newspaper, 2000 was the sixteenth consecutive year in which credit unions have rated higher than all other financial institutions in overall service quality and this trend shows no sign of change.

### ***Need For Bankruptcy Reform***

NAFCU recognizes that many individuals who file for bankruptcy do it because of legitimate reasons. Unfortunately, a small but growing number of consumers are not financially responsible and abuse the bankruptcy system at a high cost to other consumers and the national economy. The credit union community feels strongly that bankruptcy reform is needed to encourage financial responsibility for debtors and for those creditors who would mislead or take advantage of consumers. The bankruptcy reform issue is not one of balancing the pursuits of debtors with the interests of creditors. It is an issue of financial responsibility versus financial irresponsibility.

The credit union community does not oppose bankruptcy relief for persons who have encountered extraordinary circumstances in life and have a bona-fide need for relief. Instead, the concern is with those consumers who use bankruptcy as a financial planning tool and those who turn to bankruptcy as the “easy way out.”

### ***Costs of Bankruptcy***

Nationally, consumer bankruptcies have spiraled upward. In 2003, the number of consumer bankruptcy filings remained high with approximately 1.6 million filings. Credit union members have not been immune to the rising trend in personal bankruptcies. In 2003 approximately 257,000 credit union members filed for bankruptcy. On average forty percent of all loan losses at federally insured credit unions in 2003 were due to bankruptcy. As of December 2003, \$1.9 billion in loans was subject to bankruptcy, a 27 percent rise from the December 2002 level of \$1.5 billion in loans subject to bankruptcy in 2002.

### ***Credit Union Response to Consumer Bankruptcy***

Most credit unions have lower operating margins than other types of lenders. Typically, credit unions pay higher rates on savings and charge lower rates on loans than other financial institutions. Because of these smaller margins, credit unions are more heavily impacted than other financial institutions by escalating bankruptcy costs. A natural reaction for some institutions is to increase interest rates, but that is not what has happened in the credit union community. Credit unions keep interest rates as low as possible for the benefit of their members.

Credit unions also do much to promote financial responsibility among their members. Because credit union members pool their resources for the mutual benefit of all members, they have traditionally relied heavily on member education and individual counseling to encourage and promote financial responsibility.

### ***Reform Efforts: Credit Union Perspective***

Because of the rising number of personal bankruptcy filings, the credit union community believes that legislative action is necessary to improve the current bankruptcy system. In a recent survey of credit union management NAFCU found that 89% percent of credit unions still consider the issue of bankruptcy reform to be an important legislative issue. Among the top legislative priorities listed by our members include:

- requiring Chapter 13 consideration before establishing eligibility for Chapter 7
- strengthening the right of reaffirmation for credit union members
- requiring mandatory financial education for all bankruptcy filers

The results of this survey closely resemble the results of a survey done by NAFCU's Ad Hoc Bankruptcy Committee in 1997.

In that survey NAFCU's Ad Hoc Bankruptcy Committee surveyed over 1,050 federally chartered credit unions. The survey revealed three issues that rose to the forefront of credit

union's agenda regarding bankruptcy reform.

First is *requiring Chapter 13 consideration before establishing eligibility for Chapter 7*. Bankruptcy courts do not require any showing of need or minimum level of debt. The bankruptcy court simply accepts the debtor's assertion that bankruptcy is necessary. As a result, Chapter 7 often gives more relief than is truly necessary. The full discharge of debts provided by Chapter 7 is a carryover from the last century, when most credit was secured by tangible assets. Today's consumer-based economy is built on unsecured revolving credit with the promise that debtors will pay from future income. Approximately 97 percent of the respondents support a bankruptcy system that is needs-based. This would help to increase debtor accountability, create a fairer bankruptcy system, and more fairly distribute payments among all creditors.

Second is *mandatory financial education for all bankruptcy filers*. Credit unions have a long history of educating their members in financial matters. The wise use of credit as well as the value of systematic savings are basic credit union principles. Most credit unions attempt to provide the best possible education for their members. Of those surveyed by NAFCU, 84 percent support a requirement that debtors participate in credit counseling before filing bankruptcy.

Third is *strengthening the right of reaffirmation for credit union members*. Credit unions traditionally have higher reaffirmation rates than many other lenders, partly because their members realize that credit unions offer them low interest rates on loans and high dividend rates on savings. The higher credit union reaffirmation rates reflect other characteristics of the credit union philosophy such as the knowledge that fellow credit union members will bear the costs of any debt discharged in bankruptcy. Credit unions believe that their members should be assured that they can retain their relationship with their financial institutions by reaffirming loans at reasonable rates, rather than being forced to pay higher prices elsewhere. Seventy-six percent of those surveyed believe that the bankruptcy code should not include any limitations on the right to reaffirm.

Over the last five years NAFCU has also recommended additional changes to the bankruptcy code. They include:

- Establishing uniform exemptions. At present, exemption levels vary greatly from state to state. The present range is from \$5,000 to essentially unlimited amount in a few states. This money should be used to pay the debtor's bills, rather than serving as a bonus to the debtor while creditors take a loss.
- Establishing a Bankruptcy Advisory Council that includes debtor and creditor representatives. The council should be charged with studying bankruptcy and bankruptcy reform. This council could be established under the auspices of the U.S. Department of Justice. Alternatively, the Federal Reserve Board's existing Consumer Advisory Council should be required to submit an annual report to Congress on bankruptcy and bankruptcy reform.
- Extending bilateral netting provisions to credit unions as well as other financial institutions. Bankruptcy reform legislation in the 108<sup>th</sup> Congress would have allowed for efficient and expedient settlement of bilateral netting agreements. The financial services industry considers bilateral netting essential to ensuring that the insolvency of one institution does not have a domino effect on other institutions that could lead to disruptions in the money supply.

### ***Reform Efforts: Congressional Action***

Despite all of the efforts to educate, to make sound loans, and to assist those in trouble, bankruptcy reform is needed to encourage financial responsibility. NAFCU believes that S. 256 is a well balanced approach and goes a long way toward making appropriate and long-needed reforms to the bankruptcy system. NAFCU is particularly pleased with the provisions that preserved the right of credit union members to voluntarily reaffirm their debts; required debtors

to obtain financial counseling upon filing; and, required debtors who have the means to do so to repay what they can before receiving a discharge in bankruptcy.

### *Conclusion*

Congress should consider a wide range of issues to foster responsibility and accountability among all persons involved in the personal financial services arena. These issues include strengthening the educational system, thoroughly evaluating lending practices, enacting a needs-based bankruptcy system that retains a credit union member's right to reaffirm his or her debts and streamlines uniform administrative procedures.

As bankruptcy filings increase, the burden on financial institutions also increases -- a burden that ultimately is shouldered by the American consumer. NAFCU recognizes the need for reform and is grateful that Congress is focused on the problem and is determined to implement reforms. NAFCU hopes that the Senate Judiciary Committee passes S. 256 and the full Senate send the bill to the House for consideration.

On behalf of NAFCU, thank you for considering the credit union perspective. NAFCU applauds the efforts of the Committee and hopes to continue to work with you to resolve this and other challenging issues.