Liz Pulliam Weston

The Basics

Lenders create a bankruptcy monster

The bankruptcy reform law isn't working as advertised -- and lenders, whose loose lending standards contributed to the problem, appear to be abusing the system.

By Liz Pulliam Weston

Consumer bankruptcy filings are on track to exceed 1 million this year, laying waste to the idea that bankruptcy reform changed anything fundamental about how Americans go broke.

Furthermore, lenders, not consumers, are the ones that seem to be abusing the system these days. According to U.S. Senate testimony, bankruptcy trustees are seeing "systemic problems" with mortgage servicers that:

Tack on exorbitant fees.

Miscalculate how much is owed.

Refuse to communicate with borrowers or the court.

Force homeowners into foreclosure without authority to do so, usually because the servicers can't figure out or prove who actually owns a mortgage, which has typically been chopped up and sold to investors.

In some cases, servicers have tried to push through foreclosures when the borrower wasn't even behind on payments, Indiana bankruptcy trustee Debra Miller told a Senate subcommittee last month. The servicers used the borrowers' bankruptcy filings, which were intended to erase other debt, as an excuse to try to take away their homes.

Bankruptcy Abuse Prevention Act, my foot

The upshot, according to some bankruptcy experts, is that the fairness of the system is being eroded.

"Each of these practices has been exposed in litigation in bankruptcy courts but continues to occur despite court rulings that such activity is unlawful," bankruptcy expert Katherine Porter (.pdf file), a University of Iowa College of Law associate professor, told the subcommittee. "The upsetting reality is that the current bankruptcy system routinely forces borrowers to pay bloated amounts and permits mortgage servicers to misbehave without serious consequence."

If you missed the irony, I'll spell it out. Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 because lenders had alleged that consumers were abusing the bankruptcy system.

Back then, those in a position to know rejected the idea that consumer abuse was widespread. Bankruptcy judges, trustees and attorneys generally agreed that most people, far from rushing to file, waited too long while struggling to pay impossible debts.

But the reform act itself touched off a land rush. More than 2 million cases, a record, were filed in 2005 as consumers tried to beat the October implementation deadline for the new law.

Then filings dropped like a rock, and lenders declared victory.

Which was entirely premature. Consider:

Consumers filed 236,982 bankruptcy cases in the first three months of 2008, more than double the number filed in the same period two years ago.

Filings have continued to rise. They were up 48% in April and 31% in May from the same months a year ago.

"We're on track to go over the 1 million milestone, definitely," said Sam Gerdano, the president of the American Bankruptcy Institute, a nonpartisan organization that tracks bankruptcy trends.

What's more, the percentage of Chapter 13 filings has returned to pre-reform levels. The bankruptcy reform law was designed to force more consumers into Chapter 13, which requires borrowers to repay at least some of what they owe, instead of Chapter 7, which allows borrowers to erase most unsecured debt, such as credit card and medical bills.

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When good credit goes bad

There's been some action lately when it comes to helping people over their heads in debt. But maybe if lessons were learned earlier, there would be less need for intervention today.

The law seemed to be successful, at first: Chapter 13 filings rose from their traditional level of about 30% of filings to about 40%. But Chapter 13 filings in May were back down to about 32% of the total.

Lenders created their own problem

What's driving the upsurge in bankruptcies isn't a mystery. Loose lending practices allowed many consumers to overdose on debt. For a while, many were able to postpone their days of reckoning by tapping into home equity to pay off their more burdensome bills.

Continued: Current situation

But now we have:

A troubled economy with rising unemployment.

Soaring rates of foreclosure.

Falling home prices.

Tightening lending standards.

So we have more people turning to the relief that bankruptcy court offers.

Should people be smarter about debt? Of course. Anyone who carries credit card debt or agrees to an unaffordable mortgage is asking for trouble.

But most of those who file had willing accomplices in their lenders.

I've railed for years about what a terrible law the bankruptcy reform act is. It did nothing to curb lenders' worst practices while raising the costs and complications of filing for those least able to pay. And now we're seeing lenders abuse the bankruptcy system so they can inflict unfair fees and charges on borrowers.

It remains to be seen whether Congress or regulators will act to rein in mortgage servicers in bankruptcy court. But there are some interesting developments elsewhere. For instance:

Federal regulators are finally cracking down on credit card companies. Among other changes, regulators want to ban "retroactive pricing," the practice of jacking up interest rates on debt that's already been accrued. Any curbs on credit card issuers' practices may make credit less available, but it's also likely to reduce the need for bankruptcy relief.

A bankruptcy judge has opened a window for borrowers. In a little-noticed decision, U.S. Bankruptcy Judge Leslie J. Tchaikovsky let a California couple off the hook for debt they owed their home-equity lender because the incomes they had listed on their applications were obvious "red flags" that the lender had ignored.

The couple had jobs as a delivery driver and for an auto-parts distributor but claimed on one loan application that they earned a combined $146,000 a year and, on another, filed six months later, that they made $191,000.

Tchaikovsky rejected the couple's contention that their mortgage broker and the bank had inserted the phony numbers into the application. But the judge nevertheless said the bank's reliance on those figures "wasn't reasonable" and held the bank responsible for failing to investigate the couple's finances.

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Although Tchaikovsky's decision applies only to the bankruptcy court's Northern District of California, the American Bankruptcy Institute's Gerdano thinks other bankruptcy judges, weary of various lender abuses, may follow suit.

"Their patience wears out, and you get outcomes like this," said Gerdano, who noted that Tchaikovsky was a well-respected judge and "not just some nut job." "I think it will get the attention of other bankruptcy judges who might be willing to adapt the same reasoning."

And the impact could extend far beyond the so-called stated-income loans, also known as liars' loans, that have led to many foreclosures, Gerdano said. Credit card lenders, for example, rarely verify an applicant's income when they approve an account or increase a credit limit. Auto and home-equity lenders often don't check either.

If borrowers can lie on applications and walk away from the debt because the lender failed to investigate, the days of easy credit may be numbered.

"If stated income is no longer reasonable and the result is a claim disallowance" or the inability of a lender to collect on a debt, Gerdano said, "that's a San Andreas fault situation for the whole commercial credit industry."

That might initially be bad news for consumers. But over time, saner lending practices may accomplish what bankruptcy reform did not: fewer filings.

Liz Pulliam Weston's latest book, "Easy Money: How to Simplify Your Finances and Get What You Want Out of Life," is now available. Columns by Weston, the Web's most-read personal-finance writer and winner of the 2007 Clarion Award for online journalism, appear every Monday and Thursday, exclusively on MSN Money. She also answers reader questions on the Your Money message board.

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