RESEARCH BRIEF

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Life After Bankruptcy: The Role of Credit Counseling and Financial Education in Helping Debtors Obtain a Fresh Start

In 2005, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). The Act includes two educational provisions. First, debtors are required to complete an approved credit counseling course prior to filing for bankruptcy. After filing, debtors are then required to complete a financial education course before they are allowed to discharge their debts.

It has been over five years since the legislation was enacted, and still very little research has been conducted to investigate the effectiveness of the counseling and education mandates. In 2009, Money Management International, Inc. (MMI), in conjunction with the University of Illinois, launched a multiphase research study to investigate the impact of BAPCPA's credit counseling and financial education requirements. The goal of the study was to track debtors through the entire bankruptcy process and follow up with them to assess the long-term impacts of the requirements on debtors' overall financial well-being.

The first phase of the study measured the "educational value" of the credit counseling and identified specific groups of debtors who were more likely than others to benefit from the experience. The results, which were released earlier this year, showed that debtors had significantly benefited from the counseling and were satisfied overall with the services they had received. Specifically, their financial knowledge, attitudes, and behavioral intentions had significantly improved as a result of their counseling experience. The effects of the counseling were primarily dependent on debtors' prior knowledge, behavior, and socioeconomic status, as well as the circumstances that led to their financial problems.

However, what happened to these debtors after they filed for bankruptcy? Were they able to actually put into practice what they learned from the credit counseling? Also, was there added value in having them participate in the financial education course prior to the discharge?

The second phase of MMI's study focused on investigating these key issues. At the end of 2009, follow-up data were collected from a national sample of debtors who had participated in MMI's bankruptcy counseling course and had completed the entire bankruptcy process. The goal was to determine if, and how, the counseling and education mandates were helping debtors to financially recover and obtain a "fresh start." The following were key findings. An official report is scheduled for release early next year.

Key Findings:

- **Significant improvements in debtors' financial behavior post-bankruptcy** – Prior to counseling and during the follow up, debtors were asked to report how often they were engaging in 12 financial practices. These behaviors were identified as necessary to successfully recover from bankruptcy. The results showed that debtors' financial behavior for all 12 practices significantly improved over time from pre-counseling to the follow up. Moreover, the magnitude of the improvement was significantly large. On average, overall behavior seemed to improve by almost 30%.

- **Financial behaviors are holding over time** – Not only did debtors' demonstrate significant improvement in their financial behaviors, but these improvements appear to be holding over time. Debtors' behaviors 12 months after counseling were at levels similar to debtors' behaviors less than 3 months after counseling. There was a slight drop off in behavior over time, but this should not be surprising since some clients are likely to revert back to past behavior. There may be a longer-term need, though, for ongoing support and education to help debtors implement and maintain positive financial management practices over time.

- **Steps being taken to improve financial situation** – Debtors appear to be proactively taking a number of steps to deal with their financial problems besides filing for bankruptcy. These actions include finding ways to reduce expenses, increase income, and make other lifestyle adjustments. Only 6% reported that they had incurred new debt post-bankruptcy, and it was either due to necessity (e.g., purchasing a vehicle to get to work, paying a reaffirmation agreement to save property, rebuilding credit, paying legal fees) or unfortunate circumstances outside of their control (e.g., health problems, loss of employment, child care expenses).

- **Longer-term financial goals are being set and achieved** – Debtors also indicated post-bankruptcy that they had achieved, or were working towards achieving, a number of longer-term financial goals. These included saving more money, starting an emergency fund, starting a retirement fund, re-establishing credit, finding employment, starting or completing school, buying a car or home, and becoming/staying debt free. Some debtors could potentially benefit from additional education to help them lay out a post-bankruptcy financial action plan, where they set personalized financial goals and are provided regular motivation and support to help them achieve those goals.

- **Some debtors are recovering better than others** – In particular, debtors who had a more solid foundation in personal financial management pre-counseling were more likely to engage in better financial management practices post-bankruptcy. This finding suggests that debtors with more severe financial knowledge and behavior deficiencies may require more intensive educational support and training to help them get back on track financially.

- **Bankruptcy filing status plays an important role** – Debtors who filed Chapter 7 were significantly more likely than those who filed Chapter 13 to report better financial management practices post-bankruptcy. This is perhaps not surprising since debtors discharge most (if not all) of their debt under Chapter 7, whereas they work to repay some portion of their debt under Chapter 13. Thus, under Chapter 7, they are likely to be in a better position to implement sound financial practices since they are less constrained by their previous debts.

- **Barriers to financial recovery though still exist** – Debtors reported post-bankruptcy that issues related to job loss, health problems, child care expenses, and unexpected house and auto expenses were still preventing them from achieving their financial goals. Other barriers included bad credit histories and legal fees. Those facing these types of challenges were significantly less likely to show improvements in behavior, as were those with lower socioeconomic status. Yet, even though these factors seem to be making it more difficult to recover financially, debtors' financial situations, on the whole, seem to be improving.

Overall, throughout the bankruptcy process, debtors' financial situations seem to be improving. From pre-counseling to post-bankruptcy, the evidence from this study points to marked improvement in debtors' financial behaviors and intentions - even after reported barriers are taken into consideration. The findings from this research have important implications for researchers, policymakers, legal professionals, financial educators, and consumers. The educational requirements were included in BAPCPA to ensure that debtors: (1) were able to make an informed choice about bankruptcy and (2) had the financial skills necessary to better manage their money and avoid future financial problems. From a policy perspective, the results suggest that the counseling and education requirements are serving their intended purpose and are likely viable mechanisms to help debtors deal with their financial situation and obtain the "fresh start" that they need. From an educational perspective, the findings provide valuable insight into the extent to which the current requirements are helping debtors recover financially. They also provide insight into how additional counseling and education efforts could help debtors stay on track and maintain good financial management practices moving forward.

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