Scared to File for Bankruptcy? The Alternative Could Be Worse

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In the world of personal finance, credit concerns and debt issues, there is no single issue that is more misunderstood than bankruptcy.

Recently the Federal Reserve Bank of New York came out with an exceptional report on the bankruptcy reform of 2005 — which made it tougher for people to file bankruptcy, and was the last time bankruptcy law was significantly altered.

Bankruptcy is a lot of things to different types of entities. For a business, it is seen as a healing process that allows a company to reorganize debt so the company can do better moving forward. When an airline files for bankruptcy protection, its stock goes up. Executives are praised for taking well-reasoned action.

For individuals, however, there is stigma that bankruptcy is a process for immoral people who want to game the system and get something for free. Some credit counseling and debt relief companies say bankruptcy should be avoided at all costs so they can promote their brand of debt help. Some personal finance gurus say bankruptcy is the worst thing an individual can ever do. Banks give the impression you'll never get credit again if you file bankruptcy.

The reality is bankruptcy myths are everywhere.

How Consumers Fared Post-Bankruptcy

As the FRBNY noted, people who filed bankruptcy had access to more new lines of credit than those who limped along in a poor financial state.

The focus of this study was to look at the financial lives of people who struggled with trying to repay problem debt rather than opt for bankruptcy. Those who didn't file bankruptcy were described as insolvent.

"For each quarter, we present the average number of new unsecured accounts four quarters later for individuals who become insolvent in that quarter but will not go bankrupt, compared to individuals who go bankrupt in that quarter. Clearly, individuals who do go bankrupt open a larger number of new unsecured accounts. Since the number of inquiries is very similar across the two groups, this outcome is not driven by difference in demand for new accounts, but rather by difference in access to credit," says the FRBNY.

So there is a misconception that filing bankruptcy closes the door to new credit, whereas it can actually give a consumer access to more credit, according to the study. People who have filed bankruptcy learn the reality that immediately following the discharge of their debt their mailboxes start to fill with new credit offers again. In helping many consumers with their debt problems, I've seen within a year that they can start to get exceptional market rates on car financing, and within two to three years they can qualify for good mortgage rates.

Those who filed bankruptcy saw an improvement in their credit scores over time, when compared to those who continued to struggle with their debts, according to the FRBNY.

"The individuals who go bankrupt experience a sharp boost in their credit score after bankruptcy, whereas the recovery in credit score is much lower for individuals who do not go bankrupt," says the Federal Reserve Bank.

Here is the bottom line in the words of the Federal Reserve Bank of New York, "Our analysis suggests that the 2005 bankruptcy reform negatively affected individuals who became delinquent by increasing the probability that they would become insolvent, a state associated with a high degree of financial distress."

They also concluded, "Moreover, we show that insolvent individuals who do not go bankrupt exhibit more financial stress than those who do, suggesting that these individuals would likely prefer to file for bankruptcy if they could afford it."

But maybe the most disturbing reality about shunning bankruptcy is the significant amount of retirement income that is lost by people who avoid filing. You can use this calculator to see for yourself.

To demonstrate how dramatic the impact is, let's look at a 25-year-old debtor who diverts $300 a month for five years into a retirement plan instead of entering into a credit counseling plan, debt settlement program or limps along making minimum payments. They would repay their debt but that plan would cost them $23,231.12 in retirement funds that could be worth $1,247,526.55 when they eventually retired at age 70. A 45-year-old would lose $170,239 in future retirement funds.

So is bankruptcy right for you? If you're struggling with debt, consider talking to a local bankruptcy attorney to see if it's the right option, rather than just assume everything you hear is true.

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