consumer action law centre

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By email: bankruptcy@ag.gov.au

Assistant Secretary, Business Law Branch
Civil Law Division
Attorney-General's Department
Robert Garran Offices
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Dear Assistant Secretary

Consultation Paper - Review of Debt Agreements Under the Bankruptcy Act 1966

The Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to comment on this consultation paper.

Briefly, this submission:

- argues for a minimum income threshold to access debt agreements in order to discourage debtors from entering into debt agreements when bankruptcy would be a better option;
- argues that statistics appear to show that termination rates have increased following the 2007 reforms, despite claims in the consultation paper to the contrary;
- advises against creating a statutory duty of good faith for debt agreement administrators, and instead recommends that administrators be required to complete a statement of suitability certifying that a debt agreement is, in their opinion, a suitable option for the client compared to bankruptcy or any other option;
- recommends that the Bankruptcy Act be amended to require that advertisements for debt agreements clearly set out that proposing a debt agreement is an act of bankruptcy, that applying for a debt agreement will be listed on the debtor's credit report and on the NPII, and that debtors should seek advice from a financial counsellor before entering into an agreement; and
- As discussed by the consultation paper, we recommend that that administrators be required to provide information to debtors comparing the administrator's fees to average fee levels charged in the industry.

Our comments are detailed more fully below.

About Consumer Action

Consumer Action is an independent, not-for-profit, campaign-focused casework and policy organisation. Consumer Action provides free legal advice and representation to vulnerable and disadvantaged consumers across Victoria, and is the largest specialist consumer legal practice

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in Australia. Consumer Action is also a nationally-recognised and influential policy and research body, pursuing a law reform agenda across a range of important consumer issues at a governmental level, in the media, and in the community directly.

Since September 2009 we have also operated a new service, MoneyHelp, a not-for-profit financial counselling service funded by the Victorian Government to provide free, confidential and independent financial advice to Victorians with changed financial circumstances due to job loss or reduction in working hours, or experiencing mortgage or rental stress as a result of the current economic climate.

General Remarks

Targeting and appropriateness of debt agreements

Many consumers are not choosing to enter into a Debt Agreement on the basis that it is the best option for their situation -- rather many are entering into an Agreement without fully understanding the options, and struggling to maintain payments, in circumstances where bankruptcy would be their best choice. This is due to the combination of:

- The incentive for debt administrators to place consumers into a debt agreement rather than bankruptcy,
- Marketing (and therefore higher awareness) of Debt Agreements and those providing Debt Agreements rather than other options such as bankruptcy;
- Inappropriate thresholds which see low income consumers struggling to pay Debt Agreements.

In our view, debt agreements are a generally suitable option for only a very narrow band of debtors, namely those who:

- own or have equity in their family home (because under bankruptcy the debtor would lose the home during the liquidation process) or have equity in other significant assets; and
- earn an income in excess of the actual income threshold amount as determined by the Bankruptcy Act (currently $46,018.70 for a debtor with no dependants and 62,585.43 for a debtor with more than four dependants[1]) - because under bankruptcy this income is protected from creditors, whereas some of this income will probably be used to pay off creditors under a debt agreement.

Apart from this group, there will also be a small group of debtors who will have their employment threatened by bankruptcy, which will make a debt agreement a better option.

This means that the current thresholds for proposing a debt agreement (particularly that the debtor has an after tax income of less than $69,028.05, with no lower threshold) combined with very effective advertising by debt agreement administrators leads many debtors to enter into debt agreements even though they would be better off petitioning for bankruptcy.

[1] ITSA *Indexed Amounts*, 27 July 2011. Accessed on 24 August from http://www.itsa.gov.au/dir228/itsaweb.nsf/docindex/About+Us-%3EPublications-%3ECurrent+Amounts+Document/$FILE/Current_Amounts.pdf

It is widely considered that debt agreements hold a number of advantages for debtors compared to bankruptcy. However, to our knowledge, many of the purported advantages of debt agreements are either not advantages at all, or provide only marginal benefits. For example:

A debt agreement is not bankruptcy and so carries less stigma	A debt agreement has many of the effects of bankruptcy - it is recorded on a debtor's credit file and the NPII register for the same length of time and is an act of bankruptcy. Promoting debt agreements on the basis that they are "not bankruptcy" (and so capitalising on the stigma associated with bankruptcy) is in our view misleading and is likely to lead many to use debt agreements despite being an inappropriate option (discussed further below).
Bankruptcy limits ability to travel overseas	To our knowledge, bankrupts will rarely be prevented from travelling overseas by a trustee so most bankrupts will be unaffected (except for the inconvenience of applying for the trustee's approval).
Bankruptcy can threaten debtor's employment	It appears to us that bankruptcy would be a threat to a debtor's employment in only a limited number of professions, and that using a debt agreement may create exactly the same problems[2]. This issue will likely be relevant only in a minority of cases, for example where the debtor operates a business or is a director of a corporation.

In particular, we are concerned that a large number of people who take out a debt agreement may be effectively "judgment proof". By judgment proof we mean a debtor who is effectively protected from recovery action by a creditor because any such action would likely be fruitless.

For example, under the Bankruptcy Act an income of less than around $46,000 per annum, basic household assets, and motor vehicles worth less than $7050 cannot currently be accessed by creditors under bankruptcy[3]. For this reason, a debtor with income and assets below those thresholds is unlikely to suffer any detriment whether he or she petitions for bankruptcy or is forced into bankruptcy by a creditor. Many debtors of low income are also protected from creditors who wish to secure payment through a judgment of the court, as income derived from Commonwealth benefits is protected by law[4].

Available statistics show that 79 per cent of those entering into debt agreements have less than $5,000 of realisable assets (69 per cent have none at all)[5], 80 per cent do not own or are not purchasing a home[6], and 20 per cent have a pre-tax income of less than $30,000[7]. This suggests that a large number of people with a debt agreement would be effectively judgment

[2] ITSA *Comparison of Features of Personal Insolvency Administrations* Accessed 24 August 2011 from http://www.itsa.gov.au
[3] ITSA *Indexed Amounts*, 27 July 2011.
[4] For example, Commonwealth social security payments are "absolutely inalienable" under s 60 of the Social Security (Administration) Act 1999. In Victoria, section 12 of the Judgment Debt Recovery Act 1984 provides an instalment order cannot be made against a judgment debtor whose income is derived solely from commonwealth payments, without the debtor's permission.
[5] ITSA *Profiles of Debtors 2009*, p 26. Accessed 30 August 2011 from http://www.itsa.gov.au
[6] ITSA, *Profiles of Debtors 2009*, p 27.
[7] Consultation paper, p 15.

proof, and (judging by the high number of people earning under $30,000) many are reliant on Commonwealth benefits.

It is clearly not in the interests of a debtor with an income of under $30,000 (probably of Commonwealth benefits) and no assets to enter a debt agreement. This kind of debtor is unlikely to be able to repay any debt without hardship. At the very least, the 79 per cent of debtors with assets worth less than $5000 would arguably be better off going bankrupt than proposing a debt agreement which required payments they could only pay with hardship. In addition, we would argue that directing Commonwealth benefits to repaying debt is a poor use of public funds that have been provided to give recipients a basic standard of living.

While eligibility thresholds could be increased, it is important to prevent inappropriate debt agreements being entered into by those who receive no benefit from doing so.

We strongly recommend that the Government introduces a minimum income eligibility threshold for debt agreements. We suggest that an individual should be presumed to be ineligible for a debt agreement if:

- their income is below the actual income threshold in the Bankruptcy Act; and
- their only assets could not be accessed by their creditors under Bankruptcy.

While it may be necessary to allow an exemption in special circumstances (for example where Bankruptcy would have an impact on the individual's source of income), we believe that this restriction would prevent many inappropriate debt agreements being entered.

<u>Interpretation of statistics presented in the consultation paper</u>

The consultation paper finds that amendments to the debt agreement system made in 2007 "appear to have had a positive impact on termination rates"[8]. We disagree. If anything can be drawn from post 2007 statistics, it is that there has been a clearly negative impact on termination rates.

The statistics in question[9] show that:

- 89 per cent of debt agreements created under the new system (that is, following the 2007 reforms) are still active, compared to 31 per cent under the old system;
- under the new system, 2.6 per cent of agreements have been completed, and 8.4 per cent terminated; and
- under the old system, 42.2 per cent of agreements have been completed, compared to 26.5 per cent terminated.

Before making any assessment of whether the 2007 reforms have improved termination rates we must question whether any firm findings can be made when only 11 per cent of agreements under the new system have been completed.

However, if we are to make a finding on termination rates, the statistics actually show that a higher proportion of debt agreements are being terminated under the new system, not less. Under the new system, more than three times as many agreements have been terminated as have been completed (8.4 per cent terminated compared to 2.6 per cent completed). Under the old system, the statistics showed the opposite trend -- 1.6 times as many agreements were completed as were terminated (26.5 per cent terminated and 42.2 per cent completed.).

To make the same point another way, if we consider only agreements that are no longer active:

[8] At page 11.
[9] See page 13 of the consultation paper.

- under the new system, 77 percent have been terminated (1977 terminated out of 2580 no longer active)
- under the old system, 39 per cent have been terminated (4438 terminated out of 11503 no longer active).

To reiterate, we are wary of making any generalised findings based on the results of only 11 per cent of agreements. However, on current data we are not ready to accept that the 2007 reforms will improve termination rates.

Key issues raised by the consultation paper

Regulation of Administrators - A duty of good faith for administrators

While we agree that Debt Agreement Administrators should be required to act in the interests of debtors, we do not believe a statutory duty of faith will achieve this outcome.

As the consultation paper notes[10], there are incentives for administrators to encourage a debtor to enter into a debt agreement even if this is not the best option for the debtor. It is also in the interests of the administrator for the debtor to pay as much of the debt as possible, as the administrator's ongoing fees are calculated as a percentage of the total amount paid[11]. These incentives are offset to some degree by obligations on debt administrators to certify that the debt agreement is affordable for the debtor[12] and requirements that administrators provide information on alternatives to debt agreements and the consequences of debt agreements (disclosure is discussed further below)[13]. However, as discussed above, it appears that a large number of people enter debt agreements when they would be better off taking another option. This indicates that more needs to be done.

It is clear that administrators should act in best interests of debtor -- it is the debtor that selects an administrator and the debtor that pays them to provide a service. Further, there will usually be a significant imbalance of power favouring administrators. Most debtors will know little or nothing about the debt agreement process or their other options and statistics cited in the consultation paper show that almost all debtors -- 98 per cent -- receive most of their advice from their administrator[14]. Clients of debt agreement administrators are also likely to be at a special disadvantage because by the time they approach an administrator, many debtors will be in a great deal of financial and emotional distress.

Creditors may also have considerable bargaining power while the proposed agreement is being developed. Clients rely on the debt administrator to put forward an appropriate agreement, but if creditors are likely to require higher payments, the administrator is likely to try to get the agreement accepted - even where another option may be more suitable.

While we believe administrators should act in the best interests of debtors, we do not believe a statutory duty of good faith will work. Our experience of the duty of utmost good faith in the Insurance Contracts Act[15] (inserted to prevent insurers from relying on harsh or unfair terms

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[10] At p 22.
[11] section 185C(3A)(a).
[12] under section 185C(2D)(c)
[13] Bankruptcy Act section 185C(2D)and Bankruptcy Regulations r 9.01(1)
[14] At page 15.
[15] At sections 13 and 14.

when denying insurance claims) has failed to protect consumers from unfair terms and is difficult for consumers to enforce[16].

Rather than a duty of good faith, we recommend the Bankruptcy Act be amended to set out specific obligations of administrators. **In particular, we recommend that administrators be required to complete a statement of suitability, certifying that a debt agreement is, in their opinion, a suitable option for the client compared to bankruptcy or any other option.**

The consultation paper reports that some stakeholders may oppose further regulation on the basis that it will add additional costs, driving up administrators fees and reducing creditor acceptance rates. We are not convinced this will be the case. Responsible administrators should already be considering whether a debt agreement is suitable compared to other options, so completing the certification we recommend will require only minimal extra work. Those extra costs incurred are unlikely to significantly affect the dividends received by creditors once spread across the value of available income and realisable assets.

<u>Advertising</u>

As the consultation paper notes, the use of debt agreements has increased sharply relative to bankruptcies[17], due at least in part to very effective advertising by debt agreement administrators. However, we believe that many people who choose to approach a debt agreement administrator do so without having a sufficient understanding of the product on offer.

A scan of Consumer Action's casework records (from no earlier than 1 January 2010) shows that people who have entered into a debt agreement are frequently unaware that making the agreement is an act of bankruptcy or of the impact the on their credit reports. Some believe they have actually taken out a debt consolidation loan.

We note that administrators are required to disclose information about the nature and consequences of entering into a debt agreement[18], however this is clearly not working for many debtors. It seems likely to us that many debtors form a view of what a debt agreement administrator is offering based on advertising and (as is commonly the case with financial services disclosure) disclosure statements given to them later are either not understood or not read at all.

In our view tighter regulation of advertising by administrators will more effective in explaining the nature and consequences of a debt agreement, and will ensure that debtors who approach a debt agreement administrator will be better informed about the product on offer.

We recommend that the Bankruptcy Act be amended to require that advertisements for debt agreements:

- **clearly state that proposing a debt agreement is an act of bankruptcy, or at a minimum, prohibit advertisements from claiming that a debt agreement is not bankruptcy.** Our casework experience is that many people who have entered debt agreements are unaware that a debt agreement is an act of bankruptcy and anecdotally, it appears that this may be a significant driver for the popularity of debt agreements compared to ordinary bankruptcy. Most consumers have no knowledge of insolvency

[16] See submissions from Consumer Action and National Legal Aid to the Treasury on unfair terms in insurance contracts, available at http://www.consumeraction.org.au/downloads/SubmissiononUnfairInsuranceContractTermsOptionsPaperMay10.pdf and http://icareview.treasury.gov.au/content/_download/submissions_options_paper/NLA_Submission.pdf.
[17] See page 6.
[18] Bankruptcy Regulations r 9.01.

law and if told that a debt agreement is 'not bankruptcy' will have no reason to believe that the service advertised will still have many of the same consequences. A more accurate impression would be given by describing debt agreements as a different 'type' of bankruptcy**;**

- **clearly state that applying for a debt agreement will be recorded on the debtor's credit report for seven years, which may limit the ability to access credit in future;**

- **clearly state that the person's decision to enter a debt agreement, will be permanently listed on a public record (that is, the National Personal Insolvency Index); and**

- **that a debt agreement is not suitable for everyone, and people should consider taking advice from a Government funded free financial counsellor before making the decision.** Advertisements should include the nationwide financial counselling hotline.

We reject the suggestion that the impact of the Inspector General's advertising guidelines need to be assessed before regulating advertising in the Act. In the main, the guidelines simply restate existing law around misleading and deceptive conduct and, apart from warning administrators that they should not target advertising on internet search engines to the term "ITSA", create no new requirements for administrators. For this reason they cannot be expected to have had any impact whatsoever and no assessment is necessary.

<u>Remuneration of Administrators</u>

As discussed by Option 19 in the consultation paper, we recommend that that administrators be required to provide information to debtors comparing the administrator's fees to average fee levels charged in the industry. However, for this disclosure to be effective, it will need to be presented in a clear and simple format setting out the administrator's fee, the average industry fee, and the difference between the two.

As well as the options mentioned in the consultation paper, the Government may wish to consider allowing trustee fees to be reviewed by the Inspector-General upon application by either creditors or the debtor. A similar power is currently available with regards to the fees of bankruptcy trustees[19].

<u>Additional options for debtors</u>

We are aware of the work of the CCCS in the UK, and believe that Australia can learn from some of the CCCS's experience. Consumer Action currently has an interest in how telephone, and web-based financial counselling can help to reach more consumers. We have, been engaged in discussions with stakeholders (including Financial Counselling Australia) in relation to a range of issues including a national number for financial counselling, and the types of additional services which may be able to be provided.

We suggest that you seek further information from Financial Counselling Australia in relation to this issue.

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[19] under section 167 of the *Bankruptcy Act* and regulations 8.12D-8.12I of the *Bankruptcy Regulations*.

Thank you again for the opportunity to comment on this consultation paper. Please contact David Leermakers on 03 9670 5088 or at david@consumeraction.org.au if you have any questions about this submission.

Yours sincerely

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