Australian Banking Association

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Dear Sir

Submission - The bankruptcy system and the impacts of coronavirus

The Australian Banking Association (ABA) welcomes the opportunity to comment on the discussion paper titled *The bankruptcy system and the impacts of coronavirus*. Our views on the issues raised therein are set out below.

Key points

- The current economic circumstances have not changed the views that we expressed in response to the proposal to shorten the default period for bankruptcy that was contained in the Bankruptcy Amendment (Enterprise Incentives) Bill 2017.
- Indiscriminate reduction of the default period from three years to one risks instilling a culture in which bankruptcy becomes normalised and the number of bankruptcies rises significantly. Risks include:
    - Increased use of bankruptcy could impact family law property settlements as the impact on obligations of bankrupt partners may prejudice the other parties.
    - A potential increase in risky borrowing behaviour, with resultant negative impacts to individuals and communities.
    - Potential negative effect on access to credit as risk of bankruptcy being resorted to is increased.
- If a period of one year is adopted it should be available on a limited basis to those who meet the criteria set out below.
- A review period should be built into the legislation to assess the impacts on borrower behaviour, business activity and lending.
- Informal repayment arrangements are more efficient and cheaper than formal debt agreements.
- Penalties for contravention of the regime should be robust, both for bankrupts as well as for any misconduct by trustees / advisors.
- The pre-insolvency / bankruptcy advice space needs to be more specifically regulated, to prevent misconduct by advisers.

Default period of bankruptcy

We note that the proposal to reduce the default period for bankruptcy from three years to one was contained in the Bankruptcy Amendment (Enterprise Incentives) Bill 2017. In a submission on that bill, we expressed reservations about this proposal. Among other things, we noted that the key motivation the Government expressed for the proposal - to encourage entrepreneurial business ventures - sits oddly with the fact that most (73.7% according to the latest figures from AFSA[1]) bankruptcies are not business related.

While we understand the Productivity Commission concluded, based on an academic paper (Armour & Cumming 2008, attached), that there was an observed link in some markets between more 'lenient' bankruptcy regimes and an increase in self-employment rates, that paper also recognised that this link differed based on cultural factors that vary from one country to another.2

In our view, the economic effects of the COVID-19 pandemic have not been such as to strengthen the case for a reduction in the default period since the time of the Bankruptcy Amendment bill. On the contrary, government and industry support for the economy during the pandemic seems to have had the effect of substantially reducing the incidence of bankruptcy and insolvency. We accept that this could change following the winding down of such support measures. However, in the current economic environment, the case for radical alteration of settings such as the default period for bankruptcy has not been made.

Increasing the incidence of bankruptcy

International experience has shown that reduction of the default period risks increasing the use of the bankruptcy process substantially. This has been the case in both Ireland when its bankruptcy period was reduced first from 12 years to 3 years, then from 3 years to 1 year; and in the UK when the bankruptcy period was reduced from 3 years to 1 year in 2004.

The result was broadly similar in the United Kingdom where bankruptcies increased by 31% in 2004; 44.9% in 2005; 58.7% in 2006, following the reduction from three years to one in 2004.3

For these reasons, we remain of the view that there is a high likelihood that bankruptcies will increase if the default period is reduced from three years to one. If this proposal is adopted, resources for monitoring and enforcement would need to be increased to account for the likely increase in bankruptcies.

Instilling a culture of bankruptcy

A reduction in the default period to one year risks normalising bankruptcy as an option for dealing with debt, with potential flow-on impacts that could be broad. Potential flow on impacts of a reduction include:

- Increased use of bankruptcy could impact family law property settlements as the impact on obligations of bankrupt partners may prejudice the other parties.
- A potential increase in risky borrowing behaviour, with resultant negative impacts to individuals and communities.
- Potential negative effect on access to credit as risk of bankruptcy being resorted to is increased.

Limiting resort to bankruptcy

If a reduction to one year is introduced, we recommend the development of firm eligibility criteria to limit access to the shorter period. This could include allowing access only where:

[1] https://www.afsa.gov.au/statistics/personal-insolvency-statistics-0

[2] Armour and Cumming 2008, paper attached - investigated entrepreneurship using data on self-employment for 15 countries from Europe and North America over 16 years

- index of the 'severity' of personal bankruptcy laws that turns on the number of years a bankrupt must wait until he may be discharged (if ever) from pre-bankruptcy indebtedness.
- analysis showed that the 'severity' of bankruptcy law has a statistically and economically significant effect on self employment rates when controlling for GDP growth, MSCI stock returns, and a variety of other legal and economic factors.
- carved out Greece, Italy and Spain on the basis which had higher self-employment rates, explained by the conclusion that there is a 'cultural / structural element to the determination of self-employment' in those countries.

[3] see https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/231653/1358.pdf

1. The bankruptcy was due to circumstances not within the bankrupt's control such as major events like pandemics or natural disasters.
2. The relevant amount of debt (and / or level of complexity) is below set levels, and
    a. there has been no misconduct by the debtor (The 'culpability' factor as a threshold for eligibility was recommended by the Productivity Commission report, stating: "The trustee, and the courts, should retain the power to extend the time until the bankrupt is discharged for a period of up to eight years if there are concerns regarding the bankrupt's conduct."); and
    b. the individual has not been bankrupted in the previous 10 years.

The Official Trustee could be the adjudicator if there was doubt about eligibility.

In addition, consideration should be given to whether creditors should vote on any proposed reduction in the period to one year.

Any reduction in the exclusion period could be supported by a national financial education program during the period of bankruptcy e.g. mandatory financial education for all bankrupts before clearance after 1 year.

Post implementation review

A review period should be built into the legislation to assess the impacts on borrower behaviour, business activity and lending.

This should include an assessment of the more far-reaching impacts such as the effect of pressure on trustees to investigate bankruptcies within the 12-month timeframe and the likelihood of customers adapting their payment behaviour to avoid further financial distress in such a short timeframe.

Debt agreements & Personal insolvency agreements

We agree that informal repayment arrangements are more efficient and cheaper than formal debt agreements.

Offence provisions

Penalties for contravention of the regime should be robust, both for bankrupts as well as for any misconduct by trustees / advisors.

We believe that the pre-insolvency advice space needs to be more specifically regulated. There have been concerns expressed that these advisors may encourage individuals and businesses in financial distress to engage in unlawful conduct, such as hiding or stripping assets and illegal phoenixing.[7] While some practitioners are accountants, lawyers and other professionals, there needs to be very targeted requirements for pre-insolvency advisors that ensures any misconduct by such advisors is discouraged.

Yours faithfully

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