

Dear Senators,

I'm writing to highlight my concerns about the Bankruptcy Amendments (Enterprise Incentives) Bill 2017, currently being considered by the Legal and Constitutional Affairs Legislation Committee.

While I support the introduction of the Safe Harbour and Ipso Facto Clause part of the Enterprise Incentives Bill, the 12-month Bankruptcy is ill-conceived and will have dramatic unintended consequences.

### **It failed in the UK.**

An evaluation of similar laws in the UK by the UK Insolvency Service found that the laws had failed to accomplish their goals. The Enterprise Act 2002, came into effect on the 1<sup>st</sup> of April 2004. The Act aimed to reduce the stigma of bankruptcy and social consequences of failure and encourage business start-ups by reducing bankruptcy from 3 years to 12 months.

The evaluation found that:

- There had been no reductions in the stigma associated with bankruptcy.
- There had been no improved access to financial markets for discharged bankrupts
- The Enterprise Act had not affected the "fear of failure".
- The early discharge provisions may not have added **any benefit**.

### **The association between bankruptcy length and self-employment is tenuous at best.**

The most often cited study on bankruptcy length and entrepreneurship, "Bankruptcy Law and Entrepreneurship", identified a link between the length of bankruptcy and self-employment, but this was only after labelling Italy, Greece and Spain as "outliers" and removing them from the analysis. Those 3 countries have the highest levels of self-employment in Europe; Italy 24.9%, Greece 35.4% and Spain 17.7%, indeed Greece has the highest level of self-employment in the world. At the time of the study, the three countries had no avenue for insolvent debtors to be discharged from their debts, a common feature of most bankruptcy legislation.

### **Forgiving bankruptcy effects the supply of credit.**

The availability of credit is positively associated with entrepreneurship (Freear and Wetzel, 1990; Carpenter and Petersen, 2002; van Praag et al., 2005). Stiglitz and Weiss found that unforgiving bankruptcy laws encourage the provision of credit and that more forgiving bankruptcy laws shift the risk from consumers to lenders. Lenders react by:

- charging higher interest rates to offset the risk,
- requiring collateral, or stricter collateral to reduce risk,
- reducing the supply of credit.

Davydenk and Franks (2005) also found that where insolvency laws are more forgiving banks, require more collateral. Rodano (2011) found that Italy's introduction of bankruptcy laws in 2006 led to an increase in commercial interest rates of 20 basis points.

### **Bankruptcy is a blunt tool.**

Only 16.1% of Bankruptcies in Australia are business related. The majority of the benefit of a 12-month bankruptcy will flow to the 83.9% of consumer debt related bankrupts. The leading non-business related reason for insolvency is "excessive use of credit" (spending too much) according to

government figures. In the UK when they reduced their bankruptcy to 12 months, their level of business-related bankruptcies was 65%.

### **Reduced incentives for repayment of consumer debt**

Currently, there are about 21,500 non-business related bankruptcies in Australia every year. Equifax identifies that 17% of the population has a credit score below 502, indicating that defaults are present for 5 years on their credit history, during which time it will make it impossible to borrow from mainstream lenders. If one can file for bankruptcy and be released after 12 months, the incentive to repay debts, once defaulted, is dramatically reduced.

### **The scale of the problem**

The current level of personal private credit (credit cards and personal loans) is currently \$150 billion according to Westpac. Australia has some of the highest levels of personal debt in the world. I estimate that Australians include \$2 billion dollars' worth of debt in bankruptcies every year, of which only 3% is returned to creditors.

KPMG identified increasing levels of financial stress in Australia with 10-15% of the population, or 460,000 households regularly unable to pay bills when they fall due, i.e., they are insolvent. Only 5% of these households, while meeting the definition of insolvency, file for bankruptcy annually. If bankruptcy is made more attractive, a dramatic increase in the number of bankruptcies will no doubt follow. That is, in fact, the intention of the legislative change. The flow-on effects of a dramatic increase in the number of bankruptcies to the rest of the economy could be large and have not been considered. A doubling of the bankruptcy rate could increase rates by 1.5% on unsecured debts, which in turn will push more people into bankruptcy as they will be unable to service their existing debt. Should Australia encounter any economic difficulties, the problem could be much worse.

### **Start-ups don't file for bankruptcy**

Bankruptcy in Australia refers to personal insolvency, not corporate insolvency. In general, business-related bankruptcy relates to sole-traders, not those using a company structure. The individuals filing for bankruptcy are not start-ups who utilise a company structure; they are in the main single employee micro businesses, whose major creditor is the ATO.

An inability to repay ATO debt is the major reason for business-related bankruptcy. Micro businesses with turnovers of under \$500,000 owe three-quarters of all business tax debts; approximately \$15 billion.

In my experience, micro-business bankruptcy relates to a lack of skill and knowledge in relation to the financial management of a business, specifically the failure to calculate and set aside GST, income tax, PAYG tax and superannuation. Specific educational measures such as mandatory financial literacy for those obtaining an ABN may be more effective at reducing the rate of business-related bankruptcies AND increase the amount of tax paid.

### **Increasing the risk of phoenixing**

Any attempt to make it easier for people to escape business-related debts will lead to an increase in phoenix activity. Phoenixing is estimated to cost Australia approximately \$3 billion a year. New federal laws have made it harder for those using a company structure to phoenix. However,

introducing a shortened bankruptcy period will make it easier for people using a sole-trader structure to phoenix. Even in the existing environment we already see people who, as a business practice, deliberately do not pay their income tax and GST, underquote their competitors, and then periodically file for bankruptcy.

### **Lack of balance**

Bankruptcy does not exist in isolation. There is a range of insolvency options within the insolvency ecosystem. Parts 9 and parts 10 of the Bankruptcy Act involve coming to a compromise with creditors (Similar to chapter 13 in the US but for individuals.). There are approximately 14,000 of these entered into every year; returning \$180 million annually to creditors, with an average return to creditors of 68% as opposed to 3% in bankruptcy. Increasing the incentive to file for bankruptcy while not doing anything to increase the incentives to enter a Part 9 or 10 will reduce the number of these agreements and reduce the amount of money flowing to creditors.

### **Summary**

The stated goal of the legislation is to encourage entrepreneurship. There seems little evidence that this legislation will accomplish that stated goal and much to suggest it will have negative unintended consequences. I encourage you to not proceed with the 12-month bankruptcy reforms, while still proceeding with the Safe harbour and IPSO Facto clause reforms.

Should the committee still choose to proceed with the 12-month reforms, it would be possible to legislate a shorter term for business-related bankruptcies only. The existing official forms have a section for identifying if the bankruptcy was business related, however, this would still lead to an increase in phoenixing in my opinion.

If you have any queries please do not hesitate to contact me on either my mobile or my email

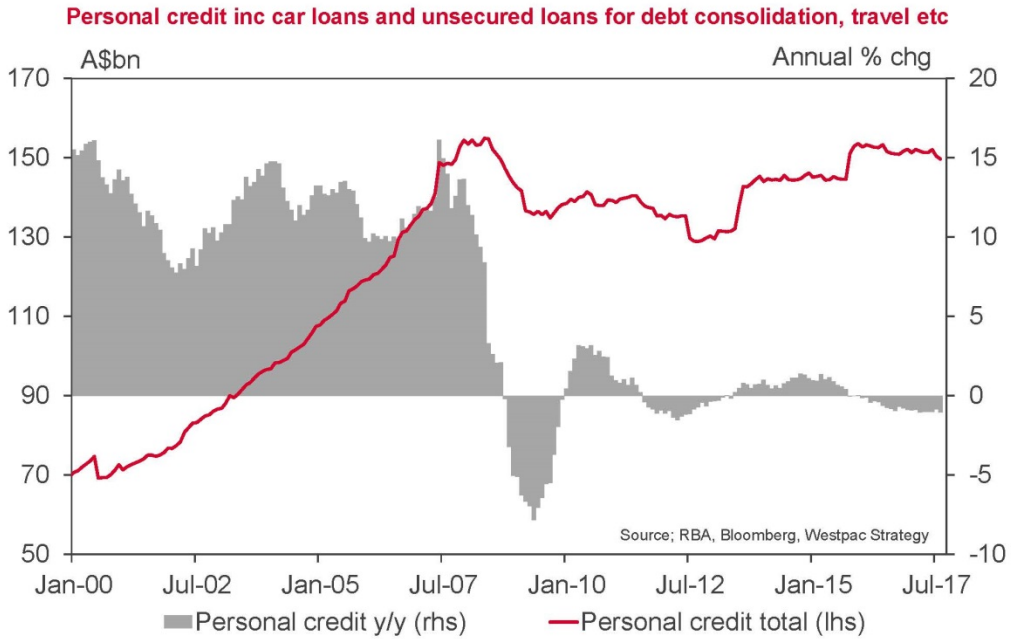
Kind Regards

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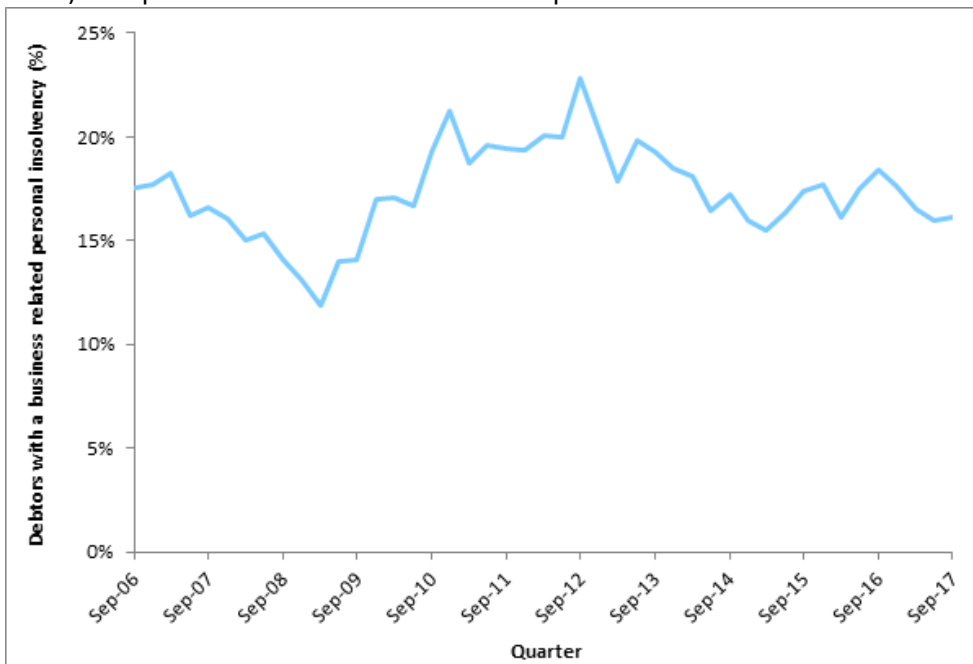
Appendix

1) Total Personal Credit

**Australian private credit – very weak since GFC**



2) Proportion of business related bankruptcies



Source <https://www.afsa.gov.au/statistics/business-and-non-business-statistics>

- 3) Enterprise Act 2002 - the Personal Insolvency Provisions: Final Evaluation Report November 2007

<http://webarchive.nationalarchives.gov.uk/+http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/legislation/evaluation/finalreport/report.pdf>

- 4) Bankruptcy Law and Entrepreneurship

[http://www.researchgate.net/profile/Douglas\\_Cumming/publication/46511449\\_Bankruptcy\\_Law\\_and\\_Entrepreneurship/links/02e7e51edbc286643b000000/Bankruptcy-Law-and-Entrepreneurship.pdf](http://www.researchgate.net/profile/Douglas_Cumming/publication/46511449_Bankruptcy_Law_and_Entrepreneurship/links/02e7e51edbc286643b000000/Bankruptcy-Law-and-Entrepreneurship.pdf)

- 5) 62 Sergei A. Davydenko and Julian R. Franks, Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the UK, ECGI - Finance Working Paper No. 89/2005. Available at: <http://ssrn.com/abstract=647861>.
- 6) Jochen Mankart and Giacomo Rodano, Personal Bankruptcy Law, Debt Portfolios and Entrepreneurship, London School of Economics, University of St.Gallen, Bank of Italy, 24 July 2009. Available at: <ftp://ftp.zew.de/pub/zewdocs/veranstaltungen/macroeconomics2009/Paper/Mankart.pdf>
- 7) <https://home.kpmg.com/au/en/home/insights/2017/04/financial-stress-australian-households.html>
- 8) <http://www.abc.net.au/news/2017-09-12/new-laws-to-target-dodgy-company-directors-and-phoenixing/8895444>