Australian Government
Attorney-General's Department

Bankruptcy Amendment (Debt Agreement Reform) Bill 2018

Submission to the Senate Legal and Constitutional Affairs Legislation Committee

The Attorney-General's Department thanks the Senate Legal and Constitutional Affairs Legislation Committee for the opportunity to make a submission on the *Bankruptcy Amendment (Debt Agreement Reform) Bill 2018* (the Bill).

This submission provides background to the debt agreement system and reinforces the policy rationale for the proposed reforms contained in the Bill.

Background

Since the last comprehensive reform of the debt agreement framework (Part IX of the *Bankruptcy Act 1966*) in 2007, the number of new debt agreements per year has increased from 6,560 in 2007 to 14,639 in 2017. In the same period, new bankruptcies dropped from 25,754 to 16,378. If this trend continues, debt agreements will become the most common debt relief option under the *Bankruptcy Act 1966*.

The debt agreement system's popularity has corresponded with the development of an established debt agreement administrator industry. Administrators are frequently the first and only source of financial advice to debtors who undertake debt agreements. Given the important financial advice function performed by administrators, consumer groups are keen to ensure that administrators act in the debtor's best interests. Consumer groups contend that administrators commonly advise debtors to undertake debt agreements that cause significant financial stress.

Data collected by the Australian Financial Security Authority (AFSA) show that a higher proportion of debtors are falling into long term arrears. In the 2016-17 financial year, 11% of debt agreements were terminated due to six-month arrears, relative to just 5.7% in the 2011-12 financial year.

Consumer groups are also concerned that a debtor's ability to achieve a fresh start is undermined by debt agreements that are frequently running for five years or longer. AFSA's data shows that in the 2016-17 financial year, 88.6% of accepted debt agreements were proposed to run for five years or longer.

Policy Objectives

Improve debtor protection safeguards

Debt agreements play an important consumer finance function and provide a flexible means for debtors to repay debts without becoming bankrupt. However, the system must contain adequate safeguards to prevent administrator misconduct. Such misconduct can inflict considerable harm on debtors and their families by encouraging them to undertake debt agreements which they may not have chosen had they fully understood the consequences. Debtors in this position could suffer even greater financial and emotional stress than they already experience. For example, some debt agreements propose payment amounts which significantly exceed the debtor's income and ability to pay. This is a contributing factor to repeated variations and extensions to debt agreements, which the existing scheme allows. The frequency of debt agreements lasting five years or longer means that debtors who are in inappropriate debt agreements can experience financial stress for a prolonged period of time.

The Bill aims to improve safeguards for debtors through a combination of measures including stricter administrator duties, tougher penalties for administrator misconduct and stronger powers for the Inspector-General in Bankruptcy to investigate administrators. The Bill places restrictions on the adoption of debt agreement proposals that could cause the debtor significant financial stress and undermine their ability to achieve a fresh start.

For example, the Bill introduces a three year limit for the length of time a debt agreement can be proposed to operate. Importantly, this only limits the length that a debtor can propose. The debt agreement system still maintains its flexibility and allows debt agreements to continue running beyond the three year mark if the payment obligations have not yet been discharged. An undischarged agreement will continue to run until it terminates by six months arrears default, or earlier by another termination mechanism.

The Bill also gives debtors a more appropriate avenue for redress. If an administrator breaches a duty or standard in relation to a debtor, the debtor would be able to apply to Court to void the agreement. Voiding an agreement enables the Court to undo any harm which the debtor sustained by virtue of entering into the agreement.

Enhance transparency for creditors

Creditors are often expected to vote on debt agreement proposals with limited information about the administrator's fee structure and other arrangements. For example, some administrators use brokers for client referrals, and the administrator compensates the broker through the fee charged to the debtor. The creditor currently cannot ascertain this financial arrangement since the administrator is only required to declare their own remuneration. A creditor may also be interested in circumstances where a related entity of the administrator provided credit to, or is otherwise owed money by, the debtor. This information is also currently not circulated to the creditor.

When a creditor votes on a debt agreement, they decide whether they are willing to be repaid less money than they are owed. Creditors claim that the opaqueness of the administrator's fee structure does not allow them to make an informed vote. Creditors also have trouble understanding the factors determining an administrator's fees. The Bill aims to enhance transparency to creditors by requiring administrators to disclose additional information prior to the voting stage. This extra transparency will enable creditors to reject proposals where they consider that the administrator's fee arrangements are unreasonable.

Boost community confidence in administrators

It is vital to the continuing operation of the debt agreement system that creditors, debtors and financial counsellors have confidence in the professionalism of administrators. Instances of administrator misconduct appear to be limited to the fringe of the debt agreement administrator industry; however, they have a disproportionate impact on the industry's reputation.

A 2016 Australian Securities and Investments Commission (ASIC) report reveals inappropriate and deficient advice by debt agreement administrators. The report describes interactions between a 'mystery shopper', posing as a debtor, and debt agreement administrators. On one occasion the administrator told the shopper not to be candid with their credit card company.[1] In a separate assessment, 8% of surveyed debtors said they

[1] ASIC, *Paying to get out of debt or clear your record: The promise of debt management firms*, January 2016, p. 27.

were deliberately given incorrect advice by their administrator[2] and 20% said the administrator did not tell them they would need to declare their debt agreement status when applying for credit over a certain amount.[3] Misconduct also takes the form of misleading advertising. ASIC has previously ordered debt agreement administrators to remove advertising stating that debt agreements are 'government approved'.[4]

The Bill aims to boost public confidence in the debt agreement administrator industry through stricter administrator duties and higher registration standards. The Bill also enables the Attorney-General to create industry wide conditions for registered debt agreement administrators and registered trustees that administer debt agreements. A legislative instrument is a flexible mechanism which could be used to set appropriate advertising, advisory and disclosure standards to prevent misconduct.

Creditor confidence in the debt agreement administrator industry could also be undermined by proposed administrators or their related entities voting on debt agreements. This situation occurs when the debtor has not paid the administrator the full upfront fee at the proposal time. The administrator then becomes a creditor for the unpaid amount of the upfront fee. Alternatively, the administrator could be a creditor due to money they lent the debtor at an earlier time. In other circumstances, an organisation may separately operate credit and administrator functions, in which case the two businesses would be related entities.

A voting administrator, or related entity, has a conflict of interest when voting on debt agreements, because most of the administrator's remuneration is dependent on the agreement being approved. Conversely, other affected creditors would primarily base their vote on the merits of the agreement, such as the risk and return of entering into the debt agreement, relative to other recovery options. Enabling an administrator or their related entity to vote would thereby distort the voting process and increase the likelihood that substandard debt agreements are approved.

Preserve and expand access to the system for debtors

The substantial increase in new debt agreements may suggest that many insolvent debtors prefer to come to an arrangement to repay their creditors. The availability of a viable repayment option presents debtors with an alternative to bankruptcy. The debt agreement system also benefits creditors who, on average, receive 59.68 cents per dollar owed under debt agreements, compared to just 1.15 cents per dollar under bankruptcies.[5]

The Bill's three year limitation on proposed debt agreement timeframes could reduce returns to creditors, since debtors would no longer be able to maintain a high dividend rate by proposing a long payment period. The proposed amendment balances the interests of creditors in maximising returns with reducing the prevalence of unsustainable debt agreements which place debtors under additional financial stress. Given the variation between creditor returns under debt agreements and bankruptcies, debt agreements are likely to remain an appealing option to creditors even if returns are reduced in some circumstances due to the three year limitation. Moreover, during earlier consultation in development of the Bill, creditor groups expressed support for a three year timeframe, in part because a shorter timeframe entails a lower risk.

---

[2] AFSA, *Assessing the experiences of debtors and creditors with practitioners during the personal insolvency process — a market research report for the Australian Financial Security Authority*, May 2017, p. 13.
[3] Ibid. p. 10.
[4] ASIC, *17-130MR ASIC crackdown on misleading advertising by debt management firms*, media release, 3 May 2017.
[5] These figures pertain to debt agreements and bankruptcies finalised in 2016-17.

In recognition of the benefits to debtors and creditors of an improved debt agreement system, the Bill aims to preserve and, where possible, expand the system's accessibility. The Bill expands accessibility by doubling the assets threshold at which insolvent debtors are eligible to access the system. The Bill also ensures that new debtor safeguards preserve low-income debtors' agency to choose a debt agreement. For example, the payment to income ratio would only prevent certain types of agreements, rather than deeming lower income debtors ineligible. Therefore, the Bill preserves debtors' access to the system while protecting them from undertaking excessive payment schedules.