Australian Government

Insolvency and Trustee Service Australia
Office of the Chief Executive and
Inspector-General

ITSA 2007/70

10 July 2007

Consumer Policy Framework Inquiry
Productivity Commission
PO Box 80
BELCONNEN ACT 2616

Dear Sir/Madam

INQUIRY INTO AUSTRALIA'S CONSUMER POLICY FRAMEWORK

I am writing to provide you with some information about the operation of debt agreements under Part IX of the *Bankruptcy Act 1966*. This information may assist you with your inquiry in light of a submission you have received from the Consumer Credit Legal Centre (CCLC). In my view, that submission includes misleading information about the operation of debt agreements. In addition, amendments to improve the debt agreement system commenced on 1 July 2007 and I would like to take this opportunity to explain the rationale for those changes.

The Insolvency and Trustee Service Australia (ITSA) is the Australian Government agency responsible for administering the personal insolvency system. This includes:

- providing advice to Government on policy and legislation;
- operating the bankruptcy registry (accepting debtors' petitions, processing debt agreement proposals and maintaining the public record of bankruptcy activity);
- administering estates where a private trustee or administrator is not appointed;
- regulating private sector insolvency practitioners (principally registered trustees and debt agreement administrators); and
- investigating fraud and referring possible offences to relevant law enforcement agencies.

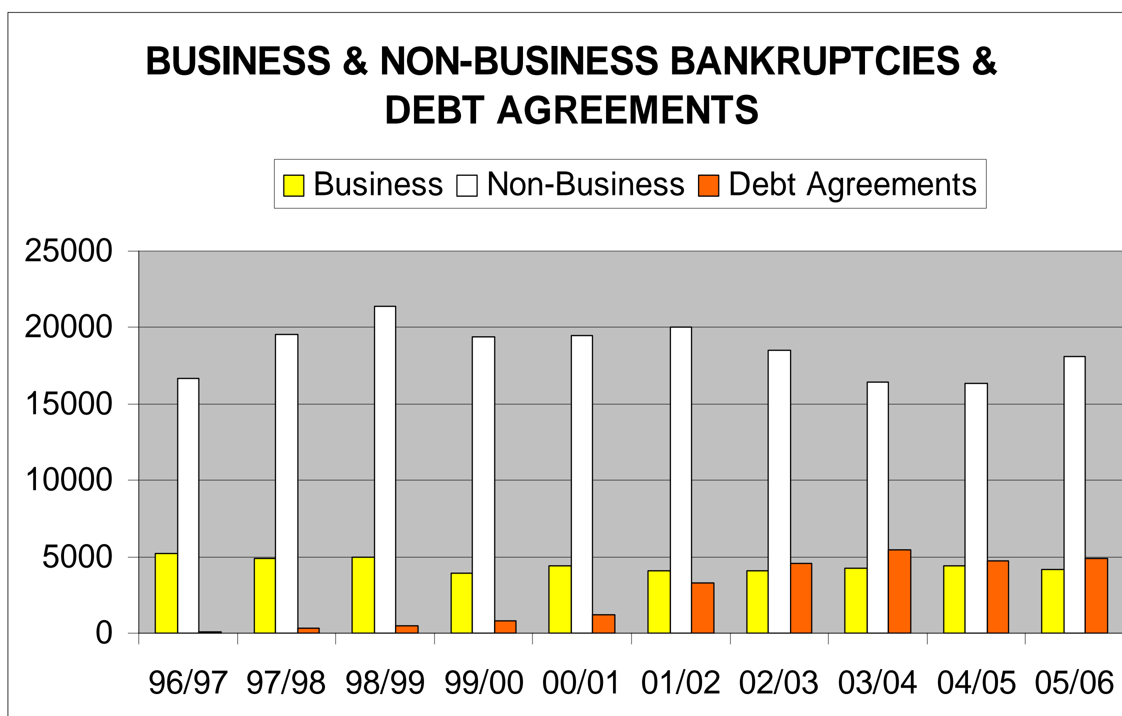
Background

Debt agreements were introduced in 1996 as a relatively low cost, informal and flexible option for debtors with lower levels of debt, income and assets. They provide debtors who can afford to make some repayments to creditors with the opportunity to do so. It was originally envisaged that a debt agreement could be administered by anyone (including the debtor personally or a friend or family member). However, in practice,

OFFICE ADDRESS: Level 2, AMA Building, 42 Macquarie Street, BARTON ACT 2600
POSTAL ADDRESS: GPO Box 821 CANBERRA CITY ACT 2601
TELEPHONE: 1300 364 785 **FACSIMILE:** (02) 6270 3413 **INTERNET:** www.itsa.gov.au
OFFICES IN ADELAIDE BRISBANE CANBERRA HOBART MELBOURNE PERTH SYDNEY TOWNSVILLE

most debt agreements are administered by fee-for-service debt agreement administrators who may or may not offer other services such as debt consolidation, refinancing, budgeting and general financial management. Many of these administrators actively promote their debt agreement services and this, along with concerns about fees charged by some administrators and the high failure rate of agreements, has led to calls for greater regulation of the industry.

Debt agreements have become an extremely popular option for debtors with unmanageable debt who have a reasonable income but few assets. They offer much higher returns to creditors than bankruptcy and also provide better opportunities for rehabilitating the debtor. The numbers of new debt agreements began to increase significantly in 2001-02. The following table shows the growth in debt agreements (compared with bankruptcies) since 1996:



In the 2006-07 year, there were about 6500 new debt agreements made.

Client research

ITSA has twice undertaken surveys of debtors who have been party to a debt agreement. On both occasions, debtors reported very high levels of satisfaction with their experience including with the services provided by their debt agreement administrator. In the 2005 survey, we included debtors whose proposals were not accepted by creditors or whose agreements had been terminated. A significant majority of those debtors reported a positive experience which revealed that many debtors in financial distress want to attempt an arrangement with creditors rather than declare bankruptcy. For many of these debtors, it was obviously important that they attempted to 'do the right thing' by their creditors.

Copies of these reports are available on ITSA's website (www.itsa.gov.au).

Recent amendments

In late 2005, ITSA and the Attorney-General's Department conducted a comprehensive review of the operation of debt agreements. This led to significant amendments to improve the system which commenced on 1 July 2007.

The most significant issues which led to the review were:

- high failure rate;
- lack of regulation of debt agreement administrators; and
- concerns about fees charged by some administrators.

These issues led to a lack of confidence on the part of creditors in debt agreement administrators and, in turn, in the system itself.

The Act has been amended to require that, from 1 July 2007, a debt agreement proposal will only be accepted if the nominated administrator is registered by the Inspector-General (unless the administrator is already registered as a trustee or is administering no more than five agreements at a time). Registration is on the basis of demonstrated ability to perform the duties set out in the Act (which cover both the pre-agreement phase involving providing information to the debtor about options and ensuring the debtor can afford the proposed agreement and the post-agreement phase involving handling and accounting for money and keeping creditors informed).

Although many debt agreements fail because the debtor's circumstances change after the agreement is made, a significant number fail because they were never sustainable given the debtor's circumstances. The system previously allowed the administrator's remuneration to be paid in priority to creditors. Where the agreement failed, a common result was that the only person to receive any money was the administrator leaving the debtor and creditors worse off than they were prior to agreement being made. This provided an incentive for administrators to develop proposals which were attractive to creditors regardless of whether they were sustainable over the promised term. The Act has been amended to provide that the administrator must be paid proportionately over the life of the agreement rather than in priority to creditors. This will provide an incentive to put forward proposals which are likely to lead to successful agreements.

The amendments also aim to ensure that debt agreements are used only by debtors for whom they are a suitable option. It is common for debtors proposing debt agreements to receive advice only from a debt agreement administrator. The amendments will require the administrator to certify that the debtor has been given prescribed information about other options and that, given the debtor's circumstances at the time of making the proposal, it is affordable. A breach of these obligations (including inappropriate certification of these matters) may lead to the administrator being deregistered.

Another factor leading to the high number of unsustainable debt agreement proposals has been the demands from some creditors for certain minimum levels of return. That is, it has become known that certain creditors will not support a debtor's proposal if it doesn't

offer a certain minimum rate of return. It is likely that these expectations arose because creditors were not confident that they were getting the debtor's 'best offer' or that they had all the information necessary to make an informed decision. These expectations led to administrators structuring proposals which attempted to meet creditors' requirements without necessarily basing them on what the debtor could afford to pay. This was possible because a debt agreement could provide for different rates of returns to individual creditors and the debtor's proposal needed to be approved by a majority in number and three-quarters in value of creditors. These features created an imbalance in the relative power of creditors with the more substantial creditors being able to make demands which were not always in the interests of the debtor or creditors generally. The Act has been amended to provide that all creditors must be paid on a pro rata basis according to the size of their debts and that a debt agreement proposal is accepted if a majority in value of creditors who vote, support the proposal. These amendments reinforce the nature of a debt agreement as a simple, one-off offer which represents the debtor's 'best offer' and leads to a collective agreement with all creditors (rather than a series of individual agreements contained in the one document).

Issues raised by the Consumer Credit Legal Centre

Many of the CCLC's comments reflect a philosophical objection to a third party (in this case, a debt agreement administrator) charging fees for facilitating an arrangement with creditors. I am aware that some others in the financial counselling and community legal centre sector share this view. I note, for example, that CCLC representatives appearing at a public hearing as part of your inquiry suggested that it would be better if the fee paid to the administrator were paid to creditors. I do not believe this view is shared by creditors and nor is it practical. While creditors have expressed concerns about the level of fees charged by some administrators and that the level of fees varies widely among administrators, they do not object as long as it is clear that the fees reflect the service provided. In many cases, creditors have embraced debt agreements as a cost-effective means of recovering debts which complements their own recovery procedures. In addition, many debtors who use debt agreements have reached a point where it is not possible or it is too overwhelming for them to deal directly with all of their creditors (debt agreement debtors typically have up to six different creditors). In that situation, the services of a professional debt agreement administrator will provide the best option for striking a deal with all creditors based on what the debtor can afford to pay.

The amendments I have outlined above will place a significant onus on administrators to perform their duties in the interests of both debtors and creditors. Given the high standards to which they will be expected to operate, it is appropriate that they be remunerated appropriately. In addition to these amendments, a debt agreement proposal must clearly state the fees payable to the administrator for administering the agreement as well as other fees paid by the debtor for developing the proposal. This transparency is important to enable creditors to determine whether they are getting value for money.

Debt agreements continue to play an important role in assisting debtors with unmanageable debt to rehabilitate themselves and it is appropriate that there are professional administrators to support this regime. It would be unconscionable to suggest that they should not be entitled to payment for the professional services they provide.

The CCLC is concerned that some debtors who enter debt agreements are not insolvent. It is a legislative requirement that a debtor must be insolvent to give a debt agreement proposal to the Official Receiver. The Official Receiver scrutinises proposals to ensure they comply with the law and refuses to accept a proposal if it is apparent, based on the debtor's Statement of Affairs which must accompany a proposal, that the debtor is insolvent.

The CCLC asserts that the effect of a debt agreement on the debtor's credit rating is no different to bankruptcy. That is a matter for creditors to determine. However, the National Personal Insolvency Index, the public record of bankruptcy and personal insolvency administrations, records whether a person is bankrupt or has made a debt agreement to enable creditors to distinguish between the two. The information provided to commercial credit reference organisations similarly distinguishes between the various forms of administration.

The CCLC has stated that debt agreement promoters and administrators take their fees prior to paying creditors. This has not been the case with all administrators. And, as explained above, recent amendments will require the administrator to be paid on a pro rata basis over the life of the agreement rather than in priority to creditors. In addition, if a promoter or the administrator charges fees for developing the proposal and those fees have not been paid before the agreement is made, the promoter or administrator will participate in the agreement as an ordinary unsecured creditor. This means they will be required to receive a dividend on the same basis as all other creditors and cannot receive that dividend in priority to other creditors. Finally, the amendments will require a proposal to be given to the Official Receiver within 14 days of the debtor signing it. This will address a practice whereby the administrator got the debtor to sign up to the proposal and then submitted it to the Official Receiver only when all the set-up fees had been paid in full. This amendment will put pressure on administrators to charge a set-up fee which the debtor can afford to pay within that 14 day period.

The Government has acknowledged, by introducing the recent amendments, that there have been some problems with debt agreements. However, they have been successful in providing a good option for many debtors to pay off significant amounts of their debts and avoid bankruptcy. In my experience, the concerns raised by some in the financial counselling sector are based on their experience with a minority of debtors who have continued to find themselves in difficulty after attempting a debt agreement. They do not see the debtors who have been successful.

If you would like clarification of any of the matters I have raised or have further questions, please feel free to contact me or David Bergman (Adviser, Policy and Legislation) on (02) 6270 3434.

Yours sincerely

Terry Gallagher
Chief Executive and
Inspector-General in Bankruptcy
Telephone: (02) 6270 3401
Facsimile: (02) 6270 3413