The Bankruptcy & Diligence etc (Scotland) Bill

The Committee of Scottish Clearing Bankers (CSCB) is the representative body of the four Scottish clearing banks (Bank of Scotland, The Royal Bank of Scotland plc, Clydesdale Bank PLC and Lloyds TSB Scotland plc). The Committee represents Scottish clearing banking in the financial structure of Britain and seeks to promote the industry by providing an authoritative voice on Scottish matters to ensure that they are adequately recognised and safeguarded.

Introduction

The CSCB has been actively engaged in the Scottish Executive’s consultation process and is pleased to have been invited to make submissions to the Committee on the provisions of the Bill. The CSCB understands that the Committee has decided to take evidence separately on the four key sections of the Bill, given the length and complexity of the Bill. Therefore the following comments address only Part 1, the Bankruptcy provisions of the Bill. The CSCB anticipates it will provide a written submission on the other sections of the Bill, namely:

- Enforcement
- Diligence
- Floating Charges.

The CSCB is aware that its written submission at this stage is to assist the Committee in its understanding of the issues the CSCB will raise in its oral evidence. The CSCB may therefore provide a further, fuller submission in advance of the closing date of 24th February. The following comments and observations are given following consultation with our member banks.

Bankruptcy

The CSCB welcomes initiatives which encourage a more entrepreneurial culture, and supports the removal of unnecessary obstacles to business entrepreneurship in Scotland. The CSCB recognises that a consequence of this approach may be a requirement to help businesses restart more quickly following bankruptcy. The CSCB also supports a more tailored approach to restrictions imposed as a consequence of bankruptcy.

The CSCB’s main concerns are whether the proposals will:

- achieve the business entrepreneurship objective; and
- have unintended consequences.

There may be benefit in considering the bankruptcy elements of the Bill, and its implications, in two parts: (1) business debt and (2) consumer debt. By doing this, it may be easier to identify how the Bill can meet the objectives set out by the Scottish Executive, and minimise the impact of unintended consequences.

Business Debt

The CSCB understands that the proposed reduction of the bankruptcy period from three years to one year is designed to remove a perceived obstacle to business start up and business growth. The CSCB also understands that one of the reasons for shortening the bankruptcy period from three years to one year is to bring Scots law into line with the law in England and Wales. The CSCB has no objection in principle to the reduction of the
bankruptcy period for business debtors from three years to one year, if the consequence will be to strengthen the Scottish economy. However, the CSCB considers there are a number of different factors which affect the rate of business start ups and business growth. In particular, the CSCB considers access to appropriate business-focused education, including education in business and financial management, is key to developing an entrepreneurial culture. The CSCB submits that, in relation to the Bill’s theme of removing barriers to business, simply reducing the bankruptcy period for business debtors will have a negligible effect on the rates of business start up and growth, and will not, of itself, improve individuals’ confidence and competence in managing their business and financial affairs. The CSCB further submits that perhaps insufficient time has elapsed from the passing of equivalent legislation in England and Wales to assess to what extent similar legislation in Scotland can contribute to the Scottish Executive’s goal.

### Consumer Debt

The CSCB considers the question of consumer debt should be reviewed under two headings: (1) those who, through no fault of their own, have no income and no assets, and have no reasonable prospects of being able to repay their debts (these individuals are commonly called “NINAs”), and (2) those who either refuse to pay, despite having the means to do so, or who have exhibited recklessness in their financial behaviour.

(1) The CSCB supports the principle that those who cannot pay should be able to escape from the “debt in perpetuity” trap. This trap arises when a debtor has neither income nor assets with which to pay their debts, and has no realistic prospect of having income or assets with which to pay their debts. The “debt in perpetuity trap” is created because creditors generally choose not to take steps to sequestrate NINAs and, equally, NINAs do not qualify to declare themselves bankrupt. However, to strike the balance of ensuring responsible financial management, the CSCB submits that access to debt relief for NINAs, and the terms on which it should be granted, should include an assessment of their financial behaviour along the lines set out in Section 56B(2) of the Bill.

Key to providing relief to NINAs is defining when someone falls within that definition. There is evidence from England and Wales (‘Over-indebtedness in Britain’, Kempson 2002) which suggests that the main cause of over indebtedness is an unexpected life event such as divorce or separation, illness or death of a main breadwinner. Before that event, they have been financially stable. The evidence suggests that people in this category of NINA usually manage to resolve their financial issues, given time. The CSCB submits that, in these circumstances, there should be suitable support for these people to “get back on track” without automatically writing off their debts.

(2) The CSCB is concerned there may be wider consequences of the proposed legislative change. Evidence from other countries suggests that, on occasions when the law on bankruptcy is changed in favour of debtors, the number of bankruptcies increases exponentially. The CSCB suggests that this would have an adverse effect on Scotland’s economy.

The DTI’s paper “Over-Indebtedness Monitoring Paper Q2 2005” states:

“The figures show a gradual increase in write-offs over the past few years. Such an increase could be expected as a result of the recent rise in personal insolvencies. Total write-offs to individuals in Q2 2005 increased by 28.7% year on year”
Write-offs to individuals equate directly to write-offs for those businesses which extend credit to those individuals. If the proposed legislation has the (albeit unintended) effect of encouraging more people to seek sequestration, this may have the following unintended consequences:

(i) Increased finance costs for individuals, as lenders pass on the cost of rising bad debts (in the US, it is estimated that the average household pays $400\(^1\) a year to subsidise the cost of those who avoid repaying by going bankrupt).

(ii) Increased financial exclusion from mainstream credit. This is linked to the use of automatic credit scoring which takes into account the area where someone lives. If an area, by postcode, has a high instance of bankrupts, creditors may adjust their credit scores to the detriment of otherwise sound potential customers. Similarly, lenders may simply stop lending to high-risk groups, such as tenants (over 750,000 Scottish households) and students (270,000)\(^2\). The CSCB is particularly concerned that individuals may not fully understand the far-reaching implications of seeking sequestration, including the impact on their overall credit rating in the future.

The CSCB submits that an undue increase in the use of bankruptcy to obtain debt relief could therefore undermine the Scottish Executive’s drive for financial inclusion.

The CSCB is also concerned that, in the current climate of increasing personal debt, a perception that bankruptcy is somehow “easier” may detract from the need to encourage a culture where individuals have a proper sense of personal responsibility for their own financial management and commitments. An analysis of the impact of similar changes in bankruptcy laws in other jurisdictions suggests that a likely consequence of relaxing the laws on bankruptcy is to encourage a culture where individuals are less inclined to honour their personal responsibilities. This is evidenced by the increase in the numbers of those who seek their own insolvencies – known in other jurisdictions as “consumer bankruptcies”.

**USA:** US consumer bankruptcies increased dramatically from 718,107 in 1990 to an all time high of 1,625,208 in 2003 (an increase of 126%). This equates to around one in every 70 US households declaring bankruptcy every year\(^3\). By contrast, the number has started to fall since the US government introduced new measures to curb the abuses of the system in 2003. In 2004 there was a drop of 4%.

**Australia:** Consumer bankruptcies increased from 13,091 in 1990/1991 to 24,114 in 2001/20002 (an increase of 84%). In 2001, it was reported that the stigma of bankruptcy had lessened to such a degree that:

“There has been significant controversy in recent times over revelations that several Sydney barristers, including high-ranking Queen’s Counsel, were using bankruptcy as a means of avoiding paying substantial amounts of tax”\(^4\)

Like the US, the Australian government was prompted to change the law to curb the costly trend. The Bankruptcy Legislation Amendment Act 2001 was designed to:

---

\(^2\) Based on figures at www.scotland.gov.uk/stats
\(^3\) ‘European Counsel’ magazine November 1998
\(^4\) Source: the preamble to the Bankruptcy Legislation Amendment Bill, Parliament of Australia Library
“Make a number of significant changes ...which, it is hoped, will encourage debtors to seriously consider using alternatives to bankruptcy where possible, and make bankruptcy less of an easy option”  

The principal change was an increase in the discharge period to 3 years, effective from May 2003. Recent figures suggest that the Act is starting to have the desired impact: 2002/2003 saw a 6% drop in bankruptcies compared with the previous year. Since then, bankruptcy levels appear to have stabilised.

**England and Wales:** The attached Chart (at Annex 1) shows that the number of applications by debtors for their own bankruptcy in England and Wales has increased significantly. (By contrast, the chart also shows that, although there has been an increase in bankruptcies in Scotland, the increase has been creditor applications with a significant proportion by local authorities as a result of a recently introduced Local Government policy to crack down on individuals with persistent council tax arrears.) It is possible to conclude from this, therefore, that the population of England and Wales is reacting to relaxations in access to bankruptcy in the same way as those of the USA and Australia.

The CSCB acknowledges that the Bill proposes safeguards intended to balance the interests of creditors and debtors, in particular Bankruptcy Restriction Orders. However, these safeguards are generally based on a system only recently introduced in England & Wales. The limited evidence available from England & Wales suggests that few Bankruptcy Restriction Orders have been made which calls into question their effectiveness as a counter-balance to the reduced bankruptcy period. The CSCB queries whether the sanction of a Bankruptcy Restriction Order is effective in deterring individuals from taking on more debt than they can afford. The CSCB also questions whether the Accountant in Bankruptcy will have sufficient resources to ensure the effective operation of Bankruptcy Restriction Orders and Bankruptcy Restriction Undertakings. If there is a dramatic increase in bankruptcies, and the Accountant in Bankruptcy does not have sufficient resource to assess in which cases a Bankruptcy Order or Undertaking would be appropriate, the use of those Orders and Undertakings as safeguards will be negated.

**Summary**

In relation to the Bill’s theme of striking a balance and of removing barriers to business, simply reducing the bankruptcy period for business debtors will have a negligible effect on the rates of business start up and growth, and will not, of itself, improve individuals’ confidence and competence in managing their business and financial affairs.

There is insufficient evidence to support the proposition that reducing the bankruptcy period for consumer debtors, who are not NINAs, from three years to one year, will provide the appropriate balance for ensuring a culture of responsible financial management, which is key to a successful economy. Additionally, the Bill may have (unintended) consequences that may, in the long run, lead to increased costs of borrowing and be detrimental to the Executive’s financial inclusion objectives.

---

5 Source: the preamble to the Bankruptcy Legislation Amendment Bill, Parliament of Australia library
6 Sources: Citizen’s Advice Scotland briefing paper 18 on Council Tax Debt; DTI “Over-indebtedness Monitoring Paper Q2 2005”
7 Just 211 in the period 1 April 2004 to 31 October 2005, according to the Insolvency Service presentation to the Money Advice Liaison Group conference November 2005. This is just 0.3% of the total 62577 bankruptcies between 1 April 2004 and 30 September (source: 2005http://www.dtistats.net/sd/insolv200508/table2.htm.)
Debtor and Creditor Bankruptcy Applications

England and Wales/Scotland

![Graph showing Debtor Petitions and Creditor Petitions for England and Scotland from 2003 to 2005]