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Committee Secretary
Senate Legal and Constitutional Affairs Legislation Committee
PO Box 6100
Parliament House
Canberra ACT 2600

By email: legcon.sen@aph.gov.au

Dear Secretary

Debt Agreement Reform – Exposure Draft Legislation

Consumer Action Law Centre, Financial Counselling Australia and Financial Rights Legal Centre welcome the opportunity to provide comment on the exposure draft of the Bankruptcy Amendment (Debt Agreement Reform) Bill 2018 (**Bill**).

About Consumer Action Law Centre

Consumer Action is an independent, not-for profit consumer organisation with deep expertise in consumer law and policy and direct knowledge of people's experience of modern markets. We work for a just marketplace, where people have power and business plays fair. We make life easier for people experiencing vulnerability and disadvantage in Australia, through financial counselling, legal advice and representation, and policy work and campaigns. Based in Melbourne, our direct services assist Victorians and our advocacy supports a just market place for all Australians.

About Financial Counselling Australia

FCA is the peak body for financial counsellors. Financial counsellors provide information, support and advocacy for people in financial difficulty. They work in not-for-profit community organisations and their services are free, independent and confidential. FCA is the national voice for the financial counselling profession, providing resources and support for financial counsellors and advocating for people who are financially vulnerable. Financial counsellors frequently see clients who have been given inappropriate debt agreements. Research conducted by the University of Melbourne in 2016 confirms widespread concerns from the sector about debt agreement practices.[1]

[1] P Ali, L O'Brien and I Ramsay, 'Bankruptcy, Social Security and Long Term Poverty: Results from a Survey of Financial Counsellors and Consumer Solicitors' (2016) 44 *Australian Business Law Review* 144, also available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2773960.

About Financial Rights Legal Centre

The Financial Rights Legal Centre (formerly known as the Consumer Credit Legal Centre (NSW)) is a community legal centre that specialises in helping consumers understand and enforce their financial rights, especially low income and otherwise marginalised or vulnerable consumers. We provide free and independent financial counselling, legal advice and representation to individuals about a broad range of financial issues. Financial Rights operates the Credit & Debt Hotline, which helps NSW consumers experiencing financial difficulties. We also operate the Insurance Law Service which provides advice nationally to consumers about insurance claims and debts to insurance companies. Financial Rights took close to 25,000 calls for advice or assistance during the 2016/2017 financial year.

Contents

1. Executive Summary

1.1 Consumer advocates welcome the comprehensive reform of the debt agreement regime under Part IX of the *Bankruptcy Act 1966* (Cth) (**the Act**). In particular, we strongly support the reforms in the Bill that:

- give the Inspector-General power to investigate *any* conduct by an administrator, including advertising and conduct prior to lodging the proposal;
- give the Minister power to set industry-wide standards as a condition of registration;
- limit debt agreements to 3 years;
- expand the grounds for debtors to void debt agreements; and
- introduce an affordability gauge in a new payment-to-income ratio and provide discretion for the Official Receiver to refuse a debt agreement proposal that would cause undue hardship (although we consider that amendments are needed to these reforms).

1.2 Although these are positive developments, further reforms are essential to improve the integrity of the debt agreement regime. These include:

- introducing minimum eligibility thresholds and a statement of suitability to ensure that debt agreements are affordable, suitable and well-targeted at people who can genuinely benefit from this insolvency option – these reforms would be far more effective at reducing inappropriate debt agreements than a payment-to-income ratio or undue hardship discretion;
- requiring administrators to provide internal and external dispute resolution to resolve complaints, an important mechanism to ensure access to justice, resolve systemic issues and encourage good industry practice;
- limits on excessive and upfront fees to ensure affordable repayments, a fair return to creditors and curb the rampant mis-selling of debt agreements;
- providing a statement of account and referral to a financial counsellor for debt agreements that terminate due to arrears; and
- comprehensive reform of debt agreement brokers and the debt management industry more broadly.

1.3 The number of debt agreements were the highest on record in 2016–17 for the sixth consecutive financial year.[2] As at 30 June 2017, the debt agreement regime affected over 43,000 Australians. Rather than a vote of confidence in the debt agreement regime, the growing popularity of debt agreements is testament to effective marketing and the high level of financial difficulty in our community.

1.4 The growing use of debt agreements is cause for serious concern given that our casework experience and new research by Vivien Chen, Lucinda O'Brien and Professor Ian Ramsay[3] reveal significant failings with the debt agreement regime. We strongly support the findings and recommendations from this important research. Common problems include:

- unsuitable debt agreements that prolong rather than resolve financial difficulty;
- inappropriate eligibility thresholds which see people on the disability support or age pension making repayments to creditors that they can't afford and would not have to make if properly advised of more appropriate solutions, such as hardship arrangements from creditors, debt waiver or bankruptcy. Creditors operating under the National Credit Code for example have a legal obligation to consider a request for a hardship variation;
- misleading advertising, which overstates the benefits and understates the significant consequences of debt agreements, or conflates debt agreements with debt consolidation, by positioning of advertising;
- poorly informed debtors, who did not understand the true cost and consequences of a debt agreement, their other options, or thought it was a debt consolidation loan;
- excessive and unwarranted fees—with administrators taking upwards of 28 percent of every repayment and set-up fees running into the thousands, it is unsurprising and concerning that a majority of debtors now pay *more* under a debt agreement than the initial debts they were struggling to repay;
- entirely unregulated and unscrupulous brokers providing conflicted advice to people in financial difficulty and shielding administrators from scrutiny;
- no access to justice—people have few practical remedies when their administrator breaches legal obligations under the Australian Consumer Law or Bankruptcy Act, with no requirement on administrators to provide internal or external dispute resolution to resolve customer complaints, and court action to recover fees generally futile if the person bankrupts after a failed debt agreement; and
- no regulatory safeguards to prevent administrators or brokers charging upfront fees to prepare debt agreement proposals that were never likely to succeed.

1.5 We agree with the Explanatory Memorandum that administrators now play a significant financial advisory role as the primary source of information for 92% of people who have entered a debt agreement. This is concerning given the fundamental conflict of interest at the heart of this regime, in that the administrator (or an aligned broker) advising on a person's debt options stands to gain thousands of dollars in set-up and administration fees from recommending a debt agreement.

1.6 In our view, there is only a very narrow band of people for whom a debt agreement is a suitable option, and even fewer for whom it is their **best** option. Generally, consumer lawyers and financial counsellors only recommend a debt agreement when the debtor is facing bankruptcy and has a substantial asset, such as the

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[2] AFSA, *Annual Statistics 2016-17*: https://www.afsa.gov.au/statistics/annual-statistics.
[3] Chen, O'Brien and Ramsay, 'An Evaluation of Debt Agreements in Australia' (2018) 44(1) *Monash University Law Review* (forthcoming).

family home, that would be seized in bankruptcy, or where bankruptcy would impact their job. Otherwise, debtors generally have better options to resolve a situation of unmanageable debt.

1.7 Despite this, we frequently see people who have entered debt agreements on the advice of an administrator (or an aligned broker) when a hardship variation from a creditor, debt waiver or bankruptcy clearly would have been a better option for the debtor. People frequently report that they misunderstood or were misled about the cost and consequences of a debt agreement, or were not advised of other options.

1.8 In the context of significant irresponsible lending in the consumer credit sector—currently the subject of a Royal Commission—it is important that underlying irresponsible lending breaches are not masked by the conflicted sales of an insolvency product to people in financial difficulty.

1.9 We provide comments on particular provisions of the Bill below. A list of recommendations is available at Appendix A.

2. The need for comprehensive reform

Unsuitable debt agreements

2.1 Comprehensive reform of the debt agreement regime is needed to curb the rampant mis-selling of patently inappropriate debt agreements to Australians in financial stress.

<u>When is a debt agreement suitable?</u>

2.2 Debt agreements are a form of personal insolvency, regulated by Part IX of the Bankruptcy Act, designed for people on lower incomes who are insolvent.[4] Compared with bankruptcy, a debt agreement involves significantly higher costs to the debtor generally over a longer period, often 5 years or more. Debt agreements are otherwise similar to bankruptcy.[5] If debtors cannot afford or sustain repayments under the agreement, termination or continuing hardship is inevitable.

2.3 Given the significant costs and serious consequences of a debt agreement, and availability of other options to resolve unmanageable debt, a debt agreement should only be chosen where there is a demonstrable benefit to the debtor. In our view, debt agreements are only suitable for a very narrow band of debtors, namely those who are:

a) otherwise **facing bankruptcy** and:

   i. own or have equity in their home (because under bankruptcy the debtor would lose the home during the liquidation process) or have equity in other significant assets;

[4] A debtor cannot propose a debt agreement if their annual after-tax income exceeds $78,815.10 or the amount of unsecured debt or the value of their divisible property exceeds $105,086.80. These amounts are indexed twice per year. Refer to <u>https://www.afsa.gov.au/resources/indexed-amounts/indexed-amounts</u>.

[5] Proposing a Debt Agreement to the Official Receiver is an act of bankruptcy under section 40 of the Bankruptcy Act. Both impact a person's creditworthiness, with listings on credit reports and the publicly accessible National Personal Insolvency Index. Bankruptcies and debt agreements must both be disclosed to a potential credit provider if a consumer is seeking more than $5,681 in credit. Both may prevent a debtor from practicing in certain professions.

ii. earn income over the Base Income/Actual Income Thresholds in the Bankruptcy Act (from which they would have to make income contributions in bankruptcy);[6] or

iii. would have their employment threatened by bankruptcy; and

b) can **realistically afford** the proposed repayments under the debt agreement without ongoing hardship.

2.4 For people outside this narrow band of debtors, other options are generally far superior. Bankruptcy will often be a better choice than a debt agreement because it clears all unsecured debt without requiring any repayments from the debtor and, in most cases, will not affect a person's employment.[7] Choosing bankruptcy is often a painful situation for a person to be in—almost all people want to repay their debts and feel extremely ashamed when they cannot—but the reality is that requiring repayments from a person in financial distress will only create further hardship for the debtor and delay any possibility of achieving financially stability in the future. Unfortunately, unscrupulous operators can exploit this feeling of shame to sell debt options from which they earn fees but are not in their client's best interest.

2.5 In addition to bankruptcy, there are a number of non-insolvency options to manage debts that should be considered by a prudent advisor, depending on the debtor's particular circumstances. These include hardship variations from creditors, debt waivers, and informal negotiation with creditors.

Low-income, no asset debt agreements

2.6 New research by Vivien Chen (Monash University), and Lucinda O'Brien and Ian Ramsay (The University of Melbourne)[8] confirms our casework experience that many people find themselves in plainly unsuitable agreements. Their analysis of data from the Australian Financial Security Authority (**AFSA**) found that in 2016 (in which there was 12,150 new debt agreements):

- 13 percent of debtors stated likely after-tax incomes of $10,000 to $29,999; and
- 54 percent stated incomes of $30,000 to $49,999; and
- 1-2 percent stated incomes of $0 to $9,999, which raises serious doubts about their capacity to afford repayments under debt agreements without diverting money away from essentials like putting food on the table.[9]

The research also found that between 2011 and 2016, when their debt agreement commenced for this group:

- 58 to 67 percent of debtors owned realisable assets of less than $5,000; and
- only 5 to 7 percent owned realisable assets worth between $50,000 to $100,000. [10]

2.7 This is consistent with data from the 2011 Profile of Debtors, which revealed that 75 percent of people in a debt agreement did not own or were not buying real estate[11] and, therefore, were not using a debt agreement for its best purpose—saving the family home.

[6] The current threshold is between $55,837 (if the debtor has no dependents) and $75,939 (for more than four dependents): https://www.afsa.gov.au/insolvency/how-we-can-help/indexed-amounts-0.

[7] A bankrupt is not required to make contributions to the debt from their income unless they earn more than $52,543.40 per annum (or more if the bankrupt has any dependents). Vehicles with a value of $7350 or less, and tools of trade with a value of $3,600 or less are protected against bankruptcy.

[8] Chen, above n 3.

[9] Chen, above n 3, 23.

[10] Chen, above n 3, 24.

2.8 Together, these statistics confirm our casework experience that unsuitable debt agreements continue to be offered to people with no realisable assets and low incomes, wholly or partially from Commonwealth benefits. People in this situation are better off seeking other solutions, such as debt waivers, bankruptcy, which can be negotiated by free, independent, accredited financial counsellors. Generally, creditors recognise that, in such situations, it is unfair and futile to try to draw 'blood out of a stone'. In any event, people in this situation are 'judgment proof' because they have no assets that could be seized through court action or bankruptcy, and income from social security payments is protected under law.[12]

2.9 As the researchers found, 'debtors who rely primarily on Centrelink benefits are among the clearest examples of people unsuited to debt agreements.'[13] They are unlikely to be able to make even the smallest repayments without hardship, and directing Commonwealth benefits to repaying debt is a poor use of public funds that have been provided to give recipients a basic standard of living.

2.10 Among the most obvious examples of unsuitable debt agreements are those involving people with no realisable assets reliant on the age or disability pension. These incomes are highly unlikely to increase over time. Despite this, we continue to see people in this circumstance entering debt agreements on the advice of a registered administrator aligned broker.

Case study 1: Marco's story

In December 2015, Marco (name changed) called Beyond Debt for help after seeing an ad on TV. Marco was struggling with credit card debts, and with the loss of his wife a few years earlier. He subsequently entered an agreement with DCS Group (DCS), a registered debt agreement administrator. Marco's understanding was that DCS would help him enter a debt agreement that would consolidate his debt, freeze interest and that he'd pay $153 per fortnight over 5 years. DCS had a money back guarantee that he would get a full refund if they were unable to get his debt agreement approved.

We were told by Marco's financial counsellor that at the time, Marco was 75 years old, living at a friend's house and on the age pension. He had no assets that could be seized in bankruptcy.

Marco started paying $153 per fortnight to DCS on 11 January 2016. We are instructed that, in June 2016, DCS informed Marco that:

- he couldn't afford payments on a debt agreement and that he'd be better off going bankrupt;
- although they normally charge money to assist with bankruptcy, they would assist him for free given what he'd already paid.

Marco paid $1,837.44 to DCS over 6 months. Once Consumer Action became involved, DCS agreed to a full refund of fees. We are instructed that Marco's financial counsellor negotiated a waiver of debt on his credit cards. Marco did not need to bankrupt.

Source: Consumer Action Law Centre

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[11] Australian Government, Insolvency and Trustee Service Australia, *Profile of Debtors 2011* (2012), 47-8, available at: https://www.afsa.gov.au/sites/g/files/net1601/f/profiles-of-debtors-2011.pdf.
[12] For example, Commonwealth social security payments are "absolutely inalienable" under s 60 of the Social Security (Administration) Act 1999. In Victoria, section 12 of the Judgment Debt Recovery Act 1984 provides an instalment order cannot be made against a judgment debtor whose income is derived solely from commonwealth payments, without the debtor's permission.
[13] Chen, above n 3, 39.

Unaffordable repayments

2.11 A debt agreement will also be unsuitable when the repayment schedule is unaffordable. Section 185C(2D)(c) of the Act requires an administrator to certify that they have 'reasonable grounds to believe that the debtor is likely to be able to discharge the obligations created by the agreement as and when they fall due'. However, this requirement does not prevent unaffordable debt agreements.

2.12 We have seen many examples of debt agreements, certified by the administrator and accepted by the AFSA for processing, that involve repayment obligations that the debtor is unlikely to meet, or only meet with substantial hardship. This is may be caused by an unrealistic or inaccurate assessment by the administrator of the debtor's likely income and actual expenses over the life of the agreement. For example:

a) In Jade's proposal, the budget allowed only $12 per week for payments to creditors not included in the debt agreement, even though she owed over $5,000 to these creditors (see Case Study 3 below); and

b) Jen's proposal, the budget allowed a total of $2 per week ($104 per year) for clothing, shoes and haircuts (see Case Study 4 below).

2.13 Sometimes there is a suspicion that the budget in the proposal and explanatory statements have been overly 'crafted' to make the debtor's uncommitted income match the repayment amounts that will be palatable to creditors. In other cases, the administrator may have failed to verify the information provided by a highly-stressed debtor over the phone. In any event, section 185C(2D)(c) does not require the type of assessment of the suitability that is required, for example, in consumer lending.[14]

Case study 2: Monika's story

Monika was born in Germany and emigrated to Australia in 1980s. Her first language is German, and although she speaks English at home, her understanding is limited. She lives in a small regional town with her partner, who is 70 years old and has cancer. Monika suffers poor health as a result of injuries sustained to her ankles. Monika now receives the aged pension.

In April 2016, Monika's partner called Debt Fix after seeing their advertisement. He provided details of Monika's income and expenses. Monika subsequently received some documents in the mail and, on the advice of Debt Fix, entered into a debt agreement.

At the time Monika entered the debt agreement she was 64 years old, in poor health, and her sole income was NewStart Allowance. Monika was due to qualify for the age pension in 2 months' time, at which point she intended to retire. Her partner was receiving the aged pension and had a number of debts of his own that he was repaying. Monika's partner had not been employed for 6 years. They lived in a regional area with high unemployment. Although her partner hoped to find work, there was not any particular prospect of finding employment.

The debt agreement proposal and explanatory statement shows:

- that Monika's income, including income support from her partner, was $535.24 per week
- total household expenses were $495.24 per week
- Monika's total uncommitted income was $40.01 per week
- that the proposed payments to creditors over 5 years would be

[14] By comparison, Chapter 3 of the *National Consumer Credit Protection Act 2009* (Cth) requires that a lender must make an assessment that a proposed loan is 'not unsuitable' for the borrower. In undertaking this assessment, the lender must enquire about the borrower's objectives, income and expenses, and take steps to verify their financial circumstances.

- 52 weekly payments of $32, and then
- 208 weekly payments of $200.

Despite their age, health and low employment prospects, the proposal prepared by Debt Fix states:

Do you expect a substantial change to your income or household expenses in the next 12 months?	☒ Yes ☐ No
If yes, explain how and when – After a term of 52 weeks, both the Debtor and Partner intend to be working, affording additional payment to the DAP.	

We are instructed that Monika did not state that she thought that she'd be working in 12 months' time. Monika also disputes that the total household expenses contained in the proposal is accurate as it fails to take into account, for example, expenses incurred by her partner.

Monika was aware that the initial weekly payments for the first year would be $32 and recalls being told that those weekly payments would 'step-up' after one year. However, we are instructed that Debt Fix did not adequately inform Monika that the repayments would increase to $200 per week. Such an amount was patently unaffordable and Monika would not have entered into the agreement had she understood this.

Debt Fix certified that there were "*...reasonable grounds to believe that the debtor is likely to be able to discharge the obligations created by the agreement as and when they fall due*." AFSA accepted the agreement for processing.

The proposal states that Debt Fix was to receive set-up and administration fees totalling $8,450.

Consumer Action became involved and a negotiated outcome was reached with Monika's creditors and Debt Fix.

Source: Consumer Action Law Centre

2.14 The certification requirement has been a focus of AFSA' recent compliance work. In 2016-17, 44 percent of compliance errors resulted from failure to comply with certification duties.[15]

2.15 The unaffordability of debt agreements is also linked to the high rate of dividends paid to creditors (often around 70 cents in the dollar) and excessive fees to administrators. The research by Chen, O'Brien and Ramsay found that some administrators are charging 'excessive and unwarranted fees'.[16] Administrators' fees accounted for 22.9 percent of total monies received in 2016. These statistics do not include the set-up fees—often $2000 or more—that are generally added to the agreement as an unsecured debt owing to the administrator or broker. In some proposed debt agreements, the administrator's fees are more than the initial debts.[17]

2.16 The relatively low termination rates give little comfort that debt agreements are affordable. Early termination of a debt agreement has significant adverse consequences for the debtor as it allows creditors to recommence collection activity for the full amount of the debt (not the discounted amount previously negotiated) and to backdate interest. Given these consequences, people may choose to struggle along, prioritising payments under the debt agreement and cutting back on essential living expenses—as people do with unaffordable loans to avoid home or car repossession.

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[15] AFSA, Personal Insolvency Practitioners Compliance Report 2016-17, 15, available at: https://www.afsa.gov.au/sites/g/files/net1601/f/afsa_pipcr_201617.pdf.
[16] Chen, above n 3, 40.
[17] Chen, above n 3, 37.

Total repayments more than the original debt

2.17 Many debtors are now paying *more* under the debt agreement than their initial debts. A statistical analysis by Credit Corp Group, a party to more than half of debt agreements in force at June 2015, found that after fees and charges:

- 64 percent of agreements required debtors to pay more than 100 percent of their original debts;
- 13 percent of agreements required debtors to pay more than 120 percent of their original debts.[18]

2.18 These statistics raise two concerning questions: were these debtors able to meet their commitments without substantial hardship; and, if they could meet such repayments, were they even insolvent?

2.19 This is troubling in the context of the advertising by the industry that pitches debt agreements as a form of 'debt relief' that involves a *reduction* in the amount of debt. Our experience suggests that some debtors do not understand the true cost of the agreement, largely because they do not understand (or were misled about) the total administration fees and charges. While the amount of debt may be reduced to 70 cents in the dollar, fees and charges often erode these savings. This is a poor outcome for both the debtor and their creditors.

2.20 If a person was already struggling to make repayments on their original debts, it is hard to see how paying more will resolve their financial difficulty. Some debt agreements involved 'stepped up' payments in the later years, with more affordable repayments in year one. However, if there is no credible prospect of a person's income increasing, this is unlikely to be sustainable.

Poorly informed and misled debtors

2.21 Poorly informed debtors and misleading advertising were major findings of the research by Chen, O'Brien and Ramsay.[19] Many debtors in a debt agreement were misled or not adequately informed of the true nature of a debt agreement. Overwhelmingly, people that complain to Consumer Action about their debt agreement, or who call for a second opinion on advice from a for-profit company to enter one, report one or more of the following:

- they thought it was a debt consolidation loan, not a type of insolvency;
- the broker or administrator did not discuss their other options, such as hardship, informal negotiations, debt waiver or bankruptcy;
- the broker or administrator led them to believe that a debt agreement was their best or only option (when it is clear to the financial counsellor or lawyer that this is not the case);
- they didn't understand one or more of the consequences of the debt agreement; or
- they didn't understand the total cost of the agreement or the fees involved.

Case study 3: Jade's story

In 2014, Jade was under significant financial stress. We are instructed that a debt collector was pursuing her for an old Westpac loan debt of approximately $5,500. Jade was studying at TAFE and casually employed at a florist, earning approximately $320-$480 per week. Her only asset was a car, subject to a secured loan, and unlikely to have been seized if she had bankrupted.

[18] Ibid.
[19] Chen, above n 3, 40.

Wanting to get her debt under control, Jade searched online to find a way to consolidate her debts and make the harassment stop. She found Company A. After speaking with Company A, Jade's understanding was that they would help her consolidate her debts and that the fees would be minimal.

On their advice, Jade entered a debt agreement administered by Company B, a registered administrator linked to Company A. Jade wasn't aware that a debt agreement was a form of insolvency, or that the fees would be 28 percent of every repayment plus the $1,980 set-up fee—a total of $5,256.

Under the debt agreement proposal:

- Jade was obliged to make repayments of $11,700—more than the amount of her unsecured debt, which was only $9064 (excluding Company A's fees);
- The budget allowed only $12 per week for payments to creditors not included in the debt agreement, even though she owed over $5,000 to these creditors;
- The budget allowed only $2 per week ($104 per year) for clothes, shoes and haircuts.

When Jade's work circumstances changed, she could no longer afford repayments and fell into arrears. Jade instructs that this is when the harassment from her administrator began—they kept calling her, threatening termination, trying to get her to commit to repayments that she knew she couldn't, in good faith, commit to.

Jade only found out that a debt agreement was a form on insolvency when, struggling to make ends meet, she applied for a payday loan. The payday lender explained the true nature of a debt agreement.

Jade's debt agreement terminated in September 2017 due to a 6-months arrears default. Jade has paid over $5,000 for a debt agreement that failed.

Jade instructs that she has requested information about the payments made to her creditors so that she can establish her outstanding debts, and a refund of fees, but that information has not been provided. Jade instructs that she now feels that the debt agreement wasn't the best route to take—a better option would've been to speak to a financial counsellor and to consider other her options.

Source: Consumer Action Law Centre

2.22 It is essential to improve the accuracy of advertising and the quality of advice on debt options given by administrators, and the debt management industry more broadly, particularly given the evidence of the impact of financial stress on decision-making. ASIC found in Report 465 that 'the cognitive burden associated with financial stress may make the services of debt management firms more attractive to consumers in financial hardship.'[20] The UK Financial Conduct Authority found that consumers are very unlikely to shop around for help with debt, and more likely to engage with the first organisation that offers the prospect of 'making the problem go away'.[21] Once engaged with a company, consumers are 'susceptible to influence or may make choices that are not in their best interests.'[22]

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[20] Australian Securities and Investments Commission, *REP 465 Paying to get out of debt or clear your record: The promise of debt management firms*, January 2016, [38], available at: http://download.asic.gov.au/media/3515432/rep465-published-21-january-2016.pdf.
[21] Financial Conduct Authority, *Thematic Review TR15/8: Quality of Debt Management Advice*, June 2015, [2.5], available at: https://www.fca.org.uk/publication/thematic-reviews/tr15-08.pdf.
[22] Ibid [2.6].

2.23 This is reflected in AFSA's recent survey of debtors in debt agreements. The survey found that 63 percent of debtors were not aware that they could even access the services of a free financial counsellor. Concerningly, 36 percent said that they thought access to a counsellor may have made a difference to their decision.[23] As one debtor said:

> *I was vulnerable and at my wits end, perhaps I still made the right choice I don't know, but I should have spoken with an independent financial counsellor first, but when you are at wits end and ashamed, a person on the phone who tells you this will be much better and the banks will stop calling you, seems like a really easy end to the pain*.[24]

2.24 Although administrators are required to disclose information about the nature and consequences of entering a debt agreement, it is clear that disclosure alone doesn't work. It seems likely that many debtors form a view of the product from the advertising and their early conversations with the administrator or broker. As is commonly the case with financial services disclosure, disclosure statements are either not understood or not read at all. In our experience, the prescribed disclosure usually takes place late in the relationship with the debtor, after payments have been diverted from credit providers for some months to pay set-up fees, leading to increased debt collection activity. Under this pressure debtors either do not take in the real import of the information, or proceed despite severe misgivings because they believe they no longer have a choice.

Conflicted advice

2.25 As the explanatory memorandum acknowledges, administrators and brokers now perform a significant financial advising function. Given that administrators were the primary source of information for 92 percent of people in a debt agreement in 2016,[25] it is essential that their advice is high-quality and free from conflicts of interest.

2.26 Much of the harm caused by debt agreements stems from this advice function, including early interactions with the person who advises on whether to enter a debt agreement, and on what terms. While some administrators observe high standards of ethical practice, unscrupulous administrators can exploit a person's financial stress or lack of knowledge to mis-sell inappropriate debt agreements.

2.27 At the heart of the debt agreement regime is a fundamental conflict of interest between the administrator's role in advising on debt options, and its role in administering an agreement. Administrators (or their aligned broker or referrer) stand to receive significant fees if a debtor chooses a debt agreement—fees they would not earn if they chose a hardship arrangement or bankruptcy. A further conflict arises from the link between rate of repayments and fees: the higher the dividend offered to creditors, the higher the administration fees.

2.28 We recommend that the regulator—either AFSA or ASIC—be empowered to undertake file reviews to examine the quality of advice provided by the administrator to the debtor. This should include an assessment of whether the outcome was beneficial for the debtor, compared to other realistic options available to the debtor at the time. Such an approach will improve the standards of advice given by administrators and enhance trust and confidence in the industry.

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[23] AFSA, Personal Insolvency Practitioners Compliance Report 2016-17, 20, available at: https://www.afsa.gov.au/sites/g/files/net1601/f/afsa_pipcr_201617.pdf.
[24] Ibid.
[25] Chen, above n 3, 27.

RECOMMENDATION 1: Empower AFSA or ASIC to undertake file reviews of the quality of advice provided by administrators to debtors.

Advertising

2.29 Consumer advocates have long-standing concerns about the clever, targeted and heavy advertising of debt agreements and other forms of "debt solutions."

2.30 Consumer Action's 2013 report *Fresh start or false hope*[26] examined the website advertising claims of debt agreement administrators and found significant variability amongst debt administrators in meeting AFSA's requirements in its guideline on advertising.[27] Many of the websites reviewed contained multiple, serious problems including representations that contained inaccurate information, were exaggerated, or were likely to leave consumers with an imbalanced view of the nature of the services. For example, the websites:

a) highlighted the negative effects of bankruptcy, whilst downplaying similar consequences of undertaking a Debt Agreement—particularly the effect on credit report listings;

b) indicated that Debt Agreement Administrators are balanced or independent advisers acting in the best interests of a consumer, while underplaying the fact that administrators charge for their services;

c) were extremely optimistic about what a Debt Agreement can achieve for someone in debt, such as the amount of debt that could be forgiven by creditors or the likelihood of saving assets;

d) did not give a balanced picture of the positives and negatives of applying for a Debt Agreement, usually simply not mentioning the negatives;

e) implied or claimed endorsement by the government or ITSA (now AFSA); and

f) claimed that bankruptcy is stressful when anecdotal reports and other research indicates that bankruptcy relieves stress. [28]

2.31 Problems persist. Misleading advertisements have been the subject of recent compliance action by ASIC[29] and AFSA, which found that 56 percent of advertising by registered administrators required remedial action.[30]

2.32 Given that most debtors (and most Australians in general) know very little about insolvency law, and that administrators are the primary source of information for 92 percent of debtors entering an agreement, these misrepresentations will be persuasive. Accurate and honest advertising of debt agreements is crucial to ensuring that people aren't misled and prompted to enter into a debt agreement without full understanding of all their options and their consequences.

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[26] Consumer Action Law Centre, *Fresh start or false hope? A look at the website advertising claims of Debt Agreement Administrators* (April 2013), available at: https://consumeraction.org.au/wp-content/uploads/2013/05/Fresh-start-or-false-hope-April-2013.pdf.

[27] The guidelines can be accessed from https://www.afsa.gov.au/about-us/policies-and-practices/inspector-general-practice-guidelines.

[28] See for example J Hartnett, *Voluntary Bankruptcy as a Pathway to Recovery for Gamblers: A Financial Counsellor's Perspective*, in Gambling Research: Journal of the National Association for Gambling Studies (Australia), v.21, no.2, Nov 2009, 53-59.

[29] See e.g. http://asic.gov.au/about-asic/media-centre/find-a-media-release/2017-releases/17-130mr-asic-crackdown-on-misleading-advertising-by-debt-management-firms/.

[30] AFSA, *Personal Insolvency Practitioners Compliance Report 2016-17*, 17, available at: https://www.afsa.gov.au/sites/g/files/net1601/f/afsa_pipcr_201617.pdf

Barriers to justice

2.33 A lack of redress for debtors was a major finding of the research by Chen, O'Brien and Ramsay.[31] Short of negotiation, people have very few practical remedies against their administrator (or proposed administrator, where the debt agreement doesn't eventuate) even for clear breaches of the Bankruptcy Act or the general consumer law. While a debtor can apply to Court for a termination (or let the agreement terminate when 6 months' in arrears), this can have negative consequences for the debtor. By this point:

a) the debtor has likely paid significant fees to the administrator—money that could have gone to reducing their debts;

b) debt options that may have been available to the debtor at the time of the entry may no longer be available, for example utilising available funds to offer full and final settlement of debts or genuine debt consolidation;

c) the debtor's creditworthiness has been adversely affected, with listings on the NPII and credit report;

d) an act of bankruptcy has been committed, allowing creditors to commence bankruptcy proceedings;

e) creditors can recommence collection activity on the full, undiscounted debt and backdate interest.

Case study 4: Jen's story

We are instructed as follows.

In late 2016, Jen (name changed) was struggling to make ends meet. Then aged 26, Jen was financially supporting her partner (who had become unable to work due to a change in visa conditions) and their child. She had a personal loan with a major bank totalling $23,000 and a secured car loan with another lender worth $35,000. Her combined income from part-time work and parenting payments was approximately $48,000 per year.

Jen spoke to the bank about one month's financial hardship. Experiencing financial stress, Jen contacted a registered debt agreement administrator. Jen instructs that the administrator told her:

- that she would only have to pay the administrator $94 per week instead of the $150 per week she was paying to the bank; and
- she didn't need to pay the bank, and that interest would be frozen until the proposal was accepted.

Under the debt agreement proposal prepared by the administrator:

- the personal loan was the only unsecured debt, apart from the administrator's own fees;
- due to fees and charges, the total to be repaid was more than the amount owed to the bank on the personal loan;
- Jen was obliged to make payments of $94 per week over 5 years plus a one-off payment of $129;
- administration fees totalled $4,895 in addition to the $2,500 set-up fee.

Jen agreed to the proposal in early March 2017. On the advice of the administrator, Jen stopped making repayments on her two loans and commenced making payments to the administrator instead. As a result, Jen instructs that the bank gave her 28 days' notice to pay her arrears in full, totalling $2,500 and made a

[31] Chen, above n 3, 41.

default listing on her credit report. Before acting on the administrator's advice, Jen says she was up-to-date with payments to the bank.

Although the bank initially indicated it would accept the proposal, ultimately the debt agreement proposal was not accepted for processing. This was consistent with the Official Receiver's Practice Statement 12, which stated:

> *It is not appropriate to ask a single participating creditor to vote on something that is essentially an agreement that should be reached directly with the debtor. Where a debt agreement proposal involving a single creditor is lodged, it will not be accepted for processing unless the debtor is able to establish that there are exceptional circumstances that would justify accepting it*. [32]

The bank was the only participating creditor under the proposal, apart from the administrator.

Jen says she paid $1,500 in fees to the administrator over 15 weeks – money that could have gone to servicing her loans. Jen alleges that the advice to start paying the administrator instead of the bank 'ruined my financial situation more than anything' because, she says, couldn't catch up the arrears.

The administrator told Jen that it would not provide a refund.

Jen has since surrendered the car and is trying to avoid bankruptcy.

Source: Consumer Action Law Centre

2.34 Further, termination does not assist people whose debt agreement was not accepted or who ultimately did not proceed with the proposal. Although there is nothing to 'terminate', the debtor may have suffered loss and damage flowing from the misconduct by an administrator. On this issue, please refer to Noelene's story below.

2.35 The fundamental problem with the current remedies is that a debtor cannot be put back in the position they would have been but for the administrator's misconduct. In this way, the Act perpetuates injustice and is inconsistent with remedies under the general consumer and financial services laws, as well as community expectations.

2.36 Practical difficulties arise if the debtor intends to bankrupt. Once bankrupt, private court action against the administrator for compensation is difficult or futile: consent from the Trustee in Bankruptcy is required to initiate legal proceedings, and any refund of fees from legal action may be distributed among creditors. In our experience, people in this situation simply abandon their dispute against the administrator, who retains the profits of their misconduct.

2.37 For many people, court action against an administrator is complex, risky, expensive and largely inaccessible without legal representation. External dispute resolution (**EDR**) is generally unavailable because, unlike lenders and financial advisors, administrators and brokers are not required to maintain membership of an EDR scheme.

2.38 The lack of effective remedies for debtors against administrators facilitates serious injustice and creates the perfect conditions for misconduct to flourish. An unscrupulous administrator can recommend a debt agreement to a person who clearly should bankrupt, safe in the knowledge that the debtor is unlikely to

[32] AFSA, *Official Receiver Practice Statement 12: When a debt agreement proposal is acceptable for sending to creditors for their vote* (updated 9 February 2017), [2.9], available at: https://www.afsa.gov.au/sites/g/files/net1601/f/official_receiver_practice_statement_12.pdf.

successfully pursue a refund of set-up or administration fees (except through negotiation). As Chen, O'Brien and Ramsay observed, '[t]here appear to be no regulatory safeguards to deter administrators from charging fees to draft agreement that have little chance of succeeding.'[33]

3. Further reform needed: Minimum eligibility thresholds

3.1 To reduce the number of inappropriate debt agreements and improve the integrity of the regime, we strongly recommend that the Bankruptcy Act be amended to introduce minimum eligibility thresholds for debt agreements.

3.2 We recommend that an individual should be presumed to be ineligible for a debt agreement if:

a) their income is below the Base Income/Actual Income Threshold Amount in the Act and Regulations; and

b) they do not have any assets that would be seized in bankruptcy.

The presumption of ineligibility could be rebutted where there are clear reasons why a debt agreement would confer demonstrable benefits on the debtor, for example where bankruptcy would put the debtor's job at risk.

3.3 While it should be up to the debtor to decide which option is best for them, there is a need to reduce the incentives for administrators to recommend debt agreements over better options. The introduction of a minimum income and asset threshold would significantly reduce the number of inappropriate debt agreements sold to people on very low incomes who cannot afford to pay. At the same time, people on low incomes who would benefit from a debt agreement—such as those on the age pension with a family home to protect—could still access the debt agreement regime.

3.4 Chen, O'Brien and Ramsay agreed that there are 'strong grounds for establishing a minimum income threshold of some kind, in order to protect low income debtors from financial harm.' The researchers recommended stricter eligibility requirements to 'better target the debt agreement system towards those who can afford to repay their debts, while reducing the potential harm that debt agreements pose to low-income and vulnerable debtors'.[34]

RECOMMENDATION 2: Amend the Bankruptcy Act to introduce minimum eligibility thresholds for debt agreements under Part IX.

4. Further reform needed: Statement of Suitability

4.1 To reduce the number of inappropriate debt agreements and improve the integrity of the regime, we strongly recommend that the Bankruptcy Act be amended to introduce a statement of suitability for debt agreements.

4.2 Affordability is an individual assessment based on income *and expenses*. Even more importantly, the assessment should be conducted in the context of the individual debtor's other options. As a safeguard for debtors, administrators should be required to submit a statement certifying that the proposed agreement is

[33] Chen, above n 3, 41.
[34] Chen, above n 3, 42.

suitable for the debtor in light of their circumstances, including their income, expenses and other viable options, with a corresponding duty not to certify if the agreement is not suitable. The statement should require the administrator to confirm that all other options have been discussed with the debtor, and why those options are not appropriate. If this duty is breached, the debtor should be empowered to void the agreement and receive compensation for any loss.

Case study 5: Holly's story

Holly was 21 and struggling to meet her repayments on loans and phone debt. She'd recently had to move out of home after an argument with her parents, and had also been injured in a car accident with flow on effects for her ability to work as many hours as previously. She contacted a debt agreement administrator in response to a television advertisement offering help for people in debt.

The total amount to be paid under the agreement was $42,669, plus $2,128 in set up fees (total $44,797). Her total outstanding debts at the time amounted to $29,470. Under the Debt Agreement the creditors were to be paid $28,290 representing 96% of their debts (but no interest). The Debt Agreement Administrator was to be paid $11,392 (in addition to the set-up fees) and there was a realisation charge payable to the government of $2,967. We have estimated using online calculators that our client would have paid between $40,641 and $42,190 had she paid back all her debt with interest at the applicable market rates over the same 5-year period, some $2,607 to $4,156 less than she was due to pay under the Debt Agreement!

While we accept that she had significant arrears at the time, our experience assisting clients in similar circumstances strongly suggests that Holly would have had a far better outcome dealing directly with her creditors. She also had no assets, and her income was below the threshold for making contributions in bankruptcy, although we are confident she could also have avoided bankruptcy while still making repayments under a negotiated hardship arrangement had she sought assistance of an independent, not-for-profit, accredited financial counsellor.

This would have been a very poor deal even if our client could afford it. In reality, her income was significantly less than the amount declared in the debt agreement proposal which was based on her standard pre-accident earnings and she defaulted repeatedly. This is unsurprising given that her repayments under the debt agreement were very similar to the contracted credit repayments she had already been failing to make.

Source: Financial Rights Legal Centre

4.3 A statement of suitability was considered in the 2012 Proposals Paper, which preceded the Bill. As that paper noted, the Act does not make explicit whose interest administrators should treat as paramount when advising a debtor on their options. The Paper acknowledged the potential conflicts of interest that arise given that the administrator stands to earn fees if the debtor enters a debt agreement, and where administrator offer services such as debt consolidation loans and mortgages.

4.4 Completing a statement of suitability will require minimal extra work for responsible administrators, who should already be considering whether a debt agreement is suitable compared to other options.

RECOMMENDATION 3: Amend the Bankruptcy Act to introduce a statement of suitability, with corresponding duties on administrators and remedies for debtors in the event of breach.

5. Payment-to-income ratio

5.1 We strongly support the introduction of a sustainability gauge to ensure that repayments under a proposed debt agreement are affordable and sustainable over the length of the agreement. To best achieve this, however, our primary recommendation is the introduction of a statement of suitability and minimum eligibility thresholds, as discussed above.

5.2 Nevertheless, we support the introduction of a payment-to-income ratio in Schedule 1, Part 4 of the Bill. This reform will be an improvement on the current framework, which has no effective mechanism to gauge sustainability.

5.3 As drafted, the ratio does not account for the debtor's living expenses or repayments to secured creditors, such as mortgage or car loan repayments, and other unsecured creditors not included the agreement, such as outstanding fines and child support payments. It may, therefore, operate harshly on a debtor with high mortgage or rental costs. In this regard, the payment-to-income ratio is far less useful in gauging affordability than a statement of suitability.

5.4 We recommend an alternative formula to include, at the very least, a person's housing costs. The ratio would be: (total payments that the debtor would be required to make under the proposed agreement) divided by (debtor's after-tax income *minus housing expenses* in the year beginning at the proposal time). This would ensure that the mortgage repayments are factored in, which is important given that saving the family home is a key benefit of debt agreements.

5.5 We recommend that the payment-to-income ratio be stated on the debt agreement proposal for ease of processing by AFSA.

Ratio must not exceed 100%

5.6 We are strongly opposed to the proposal that the payment-to-income ratio exceed 100 percent, as permitted by Schedule 1, Item 21 of the Bill.

5.7 A ratio in excess of 100 percent would mean that repayments on debt agreements could account for more than one third of anticipated net income, even before living expenses and payments on secured loans are considered. Such a ratio would certainly be unaffordable for most debtors, and may result in people struggling to make repayments on their mortgage or car loan—thereby undermining the main benefit of entering an appropriate debt agreement. This would be a perverse outcome, undermining the intention of the reform to ensure sustainable repayments.

5.8 We recommend that an appropriate payment-to-income ratio would be set at 5 percent. This would reflect that 5 percent (or 15 percent over three years) of a person's income is a significant amount to repay to unsecured creditors. Setting the ratio at 5 percent will promote financial rehabilitation of debtors and successful completion of debt agreements without ongoing hardship.

RECOMMENDATION 4: Amend the payment-to-income ratio to account for housing costs.

RECOMMENDATON 5: Amend the Bill to prohibit the payment-to-income ratio from exceeding 100%.

6. Undue hardship

6.1 We support the proposed discretion for the Official Receiver to refuse to accept a debt agreement proposal for processing where the proposed agreement would cause undue hardship in Schedule 2, Part 5 of the Bill. It is fantastic to finally see recognition in the Bill and the Explanatory Memorandum that debt agreements can involve unaffordable repayment schedules that prolong, rather than resolve, a period of financial difficulty.

6.2 However, this reform alone is unlikely to curb the rise in patently unsuitable and unaffordable debt agreements discussed above. Between 2010 and 2015, the Official Receiver rejected between 1.9 to 3 percent of debt agreement proposals.[35] This suggests that AFSA rarely uses its existing power to refuse to accept for processing a debt agreement that is not in the creditors' interest. This raises a concern about how frequently this new discretion will be used, particularly in light of the volume of new agreements each year (13,597 in 2016-17).[36] If implemented, the regulator must be appropriately funded to actively perform this role and include it in its priority regulatory responsibilities. This discretion is a key way in which AFSA can take steps to protect the interests of vulnerable debtors.

6.3 It also places the onus on the regulator, rather than placing a duty on administrators not to arrange debt agreements that would cause undue hardship.

RECOMMENDATION 6: Amend the Bill to include a corresponding duty on debt agreement administrators not to prepare a debt agreement proposal that would cause undue hardship to the debtor.

7. Maximum length of 3 years

New debt agreements

7.1 We strongly support the proposed reform in Schedule 2, Part 1 of the Bill to limit the maximum length of debt agreements to 3 years. This is an essential reform to ensure debt agreements are fair, sustainable and realistic. This will also align the period for repayment with the period of income contributions in bankruptcy of three years.

7.2 When the debt agreement regime was first introduced, debt agreements were expected to last no longer than three years, with a possible extension of six months for payment delays.[37] The length of debt agreements has increased over time. In 2010, 54 percent of debt agreements were expected to run for 5 years. By 2016, this had increased to nearly 85 percent.[38]

7.3 It can be very difficult for a person in financial stress to make a realistic assessment of their capacity to meet a repayment schedule for 5 or more years into the future. Making such calculations—generally during a time of high financial stress—poses an unfair risk to the debtor of termination, should their circumstances unexpectedly worsen later in the debt agreement. If the agreement falls over in the later years, the debtor may have incurred significant costs and consequences for little benefit.

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[35] AFSA, *Life cycle of debt agreements,* accessed 21 February 2018 at: https://www.afsa.gov.au/statistics/life-cycle-debt-agreements.
[36] AFSA, *Annual Statistics 2016-17*, available at: https://www.afsa.gov.au/statistics/annual-statistics.
[37] Chen, above n 3, 4.
[38] Chen, above n 3, 20.

Proposals to vary a debt agreement

7.4 Schedule 2, Part 2 of the Bill will prevent proposals to vary extending the debt agreement beyond 3 years.

7.5 We have some concern that this may have a harsh operation if the debtor's financial circumstances unexpectedly worsen late in the agreement. It would be unfair if people terminate in the final year of their agreement if, for example, they lost their job or became sick. We understand that a maximum duration of three years for debt agreements, even when varied, is important to stop regulatory gaming. However, we believe there should be a limited contingency for debt agreements that are not completed at the end of 3 years.

7.6 Unfortunately, the policy development process for this reform has hampered our ability to form a firm view on the best approach. We have been presented with an exposure draft Bill (since introduced into Parliament) without the opportunity to properly consult with consumer groups and other stakeholders, consider implications of some of the changes, and propose alternatives before the drafting of legislation. While we strongly support a three-year time limit on all debt agreements, we consider that further analysis be undertaken on the impact of preventing variations exceeding three years. There may be a better approach to this issue that has not been fleshed out.

7.7 At the heart of the problem is a lack of faith in administrators to act appropriately, and not 'game' the system by setting up debt agreements for 3 years on the understanding that they can be varied later to provide a higher return to creditors (and the administrator). Without this fundamental and long-standing problem, we would have more confidence in allowing variations if the debtor's financial circumstances unexpectedly worsen late in the agreement.

7.8 With the time available, our best recommendation is to allow a discretion to allow a proposal to extend a debt agreement to four years where there is a *genuine* and *significant* change in circumstance. If enacted, this should be a priority area for AFSA to monitor to ensure that vulnerable debtors are not being taken advantage of.

RECOMMENDATION 7: Permit a limited discretion for proposals to vary a debt agreement to extend a debt agreement to four years where there is a genuine and significant adverse change in the debtor's circumstances. The impact of this reform should be actively monitored by AFSA and be reviewed within 5 years of commencement to ensure that there is no unintended consequences or regulatory gaming.

8. Doubling the asset threshold

8.1 As discussed above, consumer advocates have long been concerned that debt agreements are a very poorly targeted product. Given that the main category of debtors who genuinely benefit from a debt agreement are those trying to save the family home, we provide qualified support for this reform in the context of the other beneficial reforms in the Bill. Rising house prices, particularly in Sydney and Melbourne, may mean that there are people in the category whose equity exceeds the current threshold.

8.2 We strongly recommend that the doubling of the asset threshold is introduced at the same time as minimum eligibility thresholds to ensure that debt agreements are appropriately targeted. In our experience, the biggest problem with the current thresholds is not exclusion of debtors due to the asset threshold—it's the inclusion of debtors on low incomes with no assets on patently unsuitable agreements. It is clear that most debtors in a debt agreement have few substantial assets.

RECOMMENDATION 8: The impact of the increase in the asset threshold be reviewed 12 months after commencement to ensure that there are no unintended consequences.

9. Voiding debt agreements

9.1 We strongly support the new grounds for voiding debt agreements in Schedule 2, Part 5 of the Bill. This will improve access to justice for debtors and incentivise greater compliance with administrators' duties under the Bankruptcy Act. Please refer to our comments on barriers to justice for debtors at 2.32-2.37 above.

9.2 In addition to the many debtors we see who should have bankrupted, we see many people in inappropriate debt agreements who were not insolvent at the time of entry. These new grounds to void will assist people in the situation to void the agreement and undo the harm.

10. Further reform needed: External Dispute Resolution

10.1 In addition to the expanded grounds for voiding debt agreements, we strongly recommend that all registered debt agreements be required, as a condition of registration, to join an EDR scheme, as recommended by Chen et al.[39] The most appropriate scheme would be the new Australian Financial Complaints Authority (**AFCA**), due to commence operations by 1 November 2018.

10.2 While the expanded voiding provisions are a vast improvement on the current voiding provisions in the Act, they will not provide a remedy for breaches of the general consumer law prohibitions against misleading and deceptive conduct and unconscionable conduct—claims that may be available based on the pre-agreement conduct of the administrator. While a debtor could pursue these remedies through the courts, the reality is that such litigation is complex, inaccessible, expensive and risky for most people, and entirely inaccessible without legal representation.

10.3 The Government has acknowledged the benefits of external dispute resolution over courts and tribunals with the establishment of AFCA. By comparison to courts and tribunals, EDR schemes have a number of useful features that contribute to strong justice outcomes:

a) membership of an EDR scheme is a condition of holding a relevant licence, so all businesses in an industry must participate in the scheme;

b) EDR schemes are funded by industry, so industry has a financial incentive to minimise consumer disputes;

c) EDR schemes have independent boards with 50 percent representation from consumers and from industry with an independent chair, so the dispute resolution processes are fair and balanced;

d) the schemes provide flexible solutions to disputes but also have 'teeth' because the ombudsman can make decisions binding upon the trader; and

e) the schemes are required to report and investigate systemic problems, meaning that they not only provide solutions for individual disputes but also help solve bigger problems at their source.

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[39] Chen, above n 3, 46: 'Remedies administered by the EDR scheme should facilitate debtors being restored to their position prior to entering the debt agreement. These include rescission of debt agreements, the refunding of fees, the removal of debt agreements from the NPII, annulment of bankruptcies and, where appropriate, financial compensation.'

10.4 In our view, a requirement for all debt agreement administrators (and brokers) to offer external dispute resolution would be transformative for the debt agreement industry. It would provide free, fair and fast dispute resolution to debtors, play a role in addressing systemic issues, and will improve industry practice over time.

10.5 Brokers should also be required to maintain membership of AFCA. We note that the Government has accepted but not yet implemented the Ramsay Review recommendation that debt management firms be required to join an EDR scheme, with consideration of further reforms to their regulation due to commence in 2018.[40] Administrators' advice function has considerable overlap with services offered by debt management firms.

RECOMMENDATION 9: Amend the Bankruptcy Act to require all debt agreement administrators to establish clear and consistent internal dispute resolution processes as an ongoing condition of registration. RECOMMENDATION 10: Amend the Bankruptcy Act to require all debt agreement administrators Act to maintain membership of the Australian Financial Complaints Authority as an ongoing condition of registration.

11. Conditions of registration

11.1 We strongly support the reforms in the Schedule 3, Part 2 of the Bill to enable the Minister to set industry conditions. There are many problematic practices in the debt agreement industry in need of urgent reform, discussed throughout this submission. This important reform will enable the Minister to set conditions of registration to protect debtors from administrator misconduct or unprofessional practice. This will also give weight to the expanded voiding provisions, providing remedies for debtors in the event of breach.

11.2 We recommend that the Bill permit the Minister to delegate this power to AFSA.

12. Functions of the Inspector General

12.1 We strongly support the reforms in Part 6 of Schedule 3 of the Bill to extend the Inspector-General's investigation and inquiry powers to *any* conduct of an administrator, including their advertising and any conduct from when the debtor and DAA first engage.

12.2 This is an essential reform that will empower the regulator to effectively regulate the industry and improve the quality of the advice function performed by administrator in the lead up to entering a debt agreement, and allow the regulator to address widespread problems with the advertising by administrators. At present, misconduct by administrators can go unaddressed if the debtor does not ultimately lodge the proposal.

[40] The Treasury, *Final Report: Review of the financial system external dispute resolution and complaints framework,* 3 April 2017, Recommendation 10, p 198-202; See also, Consumer Action Law Centre, *Communique on Debt Management Firms*, 2016, available at: http://consumeraction.org.au/debt-management-firms-comm/.

Case study 6: Noelene's story[41]

Approaching retirement and worried about nearly $31,000 of debt, Noelene called a debt management firm for help after seeing its advertisement on TV promising to stop all interest and make it easier to pay. Noelene was supporting her adult children and earning about $700 per week working in aged care.

Hours later, a salesperson was knocking on the door of her caravan in Moolap, her home for the past 20 years. He said that for $1,800, the company would negotiate with her two creditors to stop the interest and the debt collectors' calls. The company started deducting $300 per fortnight towards its fees, putting her budget into deficit before she even made any repayments on the debt. But even after she'd paid $900, "they had done absolutely nothing." The calls didn't stop and the interest kept accruing.

When the debt agreement proposal finally arrived, she saw nearly $8,000 extra in administration fees. "Shocked" and "angry," Noelene refused to sign. If Noelene had proceeded, she would have paid more under the proposed debt agreement than her total debt. Instead, she saw her local financial counsellor, who helped Noelene to arrange an affordable repayment plan.

Source: Consumer Action Law Centre

13. Further reform needed: Brokers and referrers

13.1 Comprehensive reform is needed to curb the harm caused by largely unregulated brokers and paid referrers operating in the debt advice industry. Many of these unregulated brokers attempt to shield administrators from scrutiny of inappropriate debt agreements and mis-selling. We are concerned that many administrators are not effectively supervising their brokers. While we would support the removal of all intermediaries from the debt agreement regime, at the very least the Bankruptcy Act should be amended to hold registered administrator responsible for the conduct of brokers.

Case study 7: Val's story

Val is a sole parent with 2 children. She had no assets and rented her home. She had one secured car loan and one credit card debt. She was not in default under any of her payments but she was interested in consolidating her debts. She found a debt management firm online and had several telephone conversations with them about her situations. They advised her to stop making payments to her creditors and start paying them instead. This went on for many months before a Debt Agreement Proposal was finally lodged. By the time Val was given the prescribed information about Debt Agreements (shortly before lodgement) she was desperate because of pressure from creditors and felt she had no choice but to proceed.

In the event the Debt Agreement was rejected because the main debt was a secured loan. By this time she had paid over $1000 in fees and had defaulted on her payments. When Financial Rights complained to AFSA about the debt management firm, they replied that because the debt management firm was a broker/intermediary, and not the registered Debt Agreement Administrator who would ultimately administer the agreement, they had no jurisdiction to investigate their conduct and directed us to complain to ASIC. Financial Rights responded that where the Debt Agreement Administrator has

[41] Noelene's experience was also featured on ABC's *7.30 Report*: http://www.abc.net.au/news/2017-04-05/debt-management-agencies-accused-of-preying-on-the/8419798. This case study previously appeared in Consumer Action Law Centre's Submission (Part 1) to the Financial Services Royal Commission, available at: https://policy.consumeraction.org.au/2018/01/22/royal-commission-into-misconduct-in-the-banking-superannuation-and-finance-sector-consumer-action-submission-part-1/.

effectively outsourced their role to the intermediary, they should not be able to avoid liability for the conduct of that intermediary. Our client never had any contact with the registered Debt Agreement Administrator throughout the entire process.

Source: Financial Rights Legal Centre

RECOMMENDATION 11: Introduce a seamless regulatory framework for all debt management firms.

RECOMMENDATION 12: Amend the Bankruptcy Act to hold administrators responsible for the conduct of aligned brokers in arranging the debt agreement.

Lead generation

13.2 A related problem is the use of lead generation in the debt agreement industry. According to AFSA, some registered administrators:

> are continuing to be approached by, and engage with, lead generating firms who "cold call" debtors to establish whether they are interested in entering a debt agreement or other form of insolvency. The lead generating firm then offer to sell leads for those debtors to the practitioner for payment of a commission or fee.[42]

AFSA has requested that such engagements cease and will focus on this issue as part of it 2017-18 inspection program.[43]

13.3 In our view, lead generation in the debt agreement industry should be banned. A debt agreement is a form of insolvency with serious consequences that requires a careful consideration of a person's situation and available options. It is not a product to be "sold" using high pressure sales tactics to anyone with debt. People who are *genuinely insolvent* will seek advice on their insolvency options when they need it, not when the phone happens to ring from an outbound call centre.

RECOMMENDATION 13: Amend the Bankruptcy Act to ban lead generation by debt agreement administrators, brokers and paid referrers.

Disclosing relationship on proposal

13.4 We support the reforms in Schedule 1, Part 6, Item 33 of the Bill to require administrators to disclose the relationship with, and payments to, brokers, referrers and related entities that are creditors in the proposed agreement.

13.5 However, disclosure of these details is unlikely to affect a debtor's decision whether or not to enter a debt agreement and on what terms, and therefore unlikely to reduce harm to debtors from inappropriate debt agreements. First, brokers are dealing with people at in a situation of high stress, and are highly reliant on advice from the broker. As discussed at paragraph 2.22 above, financial stress can impact decision-making and allow unscrupulous providers to effectively mis-sell unsuitable 'debt solutions'.

[42] AFSA, *Personal Insolvency Regulator* (December 2017, Volume 15, Issue 4), p4.
[43] Ibid.

13.6 Second, research suggests that disclosing commissions can actually increase trust rather than engender wariness. The existing requirement to disclose broker arrangements cannot resolve the systemic conflict created by fee structures. Disclosure does not necessarily alert a customer that they need to proactively assess the advice they receive. For example, US research has shown that requirements to disclose mortgage broker commissions actually increased trust in brokers, when it should have led customers to be more critical about the advice they received.[44]

13.7 The main beneficiary of this reform is affected creditors. The likely effect of this reform is to improve creditor's bargaining position to extract a higher return under the agreement, or creditors voting no if the broker's fees are excessive. Either way, the debtor—who by this point has already committed an act of bankruptcy and likely paid set-up fees—is not protected from harm.

13.8 Nevertheless, we support the increased transparency that this amendment will bring to the relationship between administrator and brokers.

14. Further reform needed: Excessive and unwarranted fees

14.1 We strongly support the recommendations by Chen, O'Brien and Ramsay on administrators' fees.[45] Considering the problems caused by excessive and unwarranted fees for debt agreements, we agree that the Bankruptcy Act should be amended to provide that: fees cannot exceed a certain percentage of the debtor's original debt; and that set-up fees only become payable after the debt agreement proposal is accepted.

14.2 This would reduce incentives for administrators to charge high upfront fees, whether or not the proposal they prepare is accepted. It would also prevent debt agreements where the fees are greater than the amount of the original debt. This reform would improve the integrity of the regime and encourage administrators to undertake a realistic and accurate assessment of the debtor's capacity to make the proposed repayments.

14.3 We also support greater transparency on fees by funding AFSA to gather and publish data on fees.

RECOMMENDATION 14: Amend the Bankruptcy Act to provide that administrators' fees cannot exceed a certain percentage of the debtor's original debt; and that set-up fees only become payable after the debt agreement proposal is accepted for processing.

15. Further reform needed: Orderly exit from a failed debt agreement

15.1 Many debtors exiting a failed debt agreement are confused about their financial position and their options going forward. There is no requirement on the administrator to provide a clear, easy to understand statement that sets out what has been paid to whom and what remains outstanding. This makes it very complicated for the debtor to unravel what the administrator has done and assess their options going forward. It is fundamentally unfair that creditors can immediately recommence debt collection and enforcement action on

[44] Lacko and Pappalardo, *The effect of mortgage broker compensation disclosures on consumers and competition: A controlled experiment*, Federal Trade Commission Bureau of Economics Staff Report, February 2004, https://www.ftc.gov/reports/effect-mortgage-broker-compensation-disclosures-consumers-competition-controlled-experiment (also cited in Financial Services Authority, *Consumer Research 69: Financial Capability: A Behavioural Economics Perspective*, July 2008).
[45] Chen, above n 3, 45.

the original debt (with backdated interest) without the debtor understanding what payments have been made on their behalf to reduce that debt. We refer to Case Study 3 (Jade's story) above.

15.2 People in a debt agreement that has terminated for arrears need advice and support, and are likely to be in a very vulnerable situation. Among them are those who were already insolvent and then experienced further hardship. These debtors need the support of a financial counsellor, who can work through any remaining options, which may include negotiations with creditors, or bankruptcy. It's clear from AFSA's recent survey of debtors that many were unaware of the services offered by financial counsellors.[46]

15.3 There is an easy fix to this problem: require administrators to provide a simple statement of account upon termination for arrears or upon request by the debtor. The statement should set out the original debts, payments received and disbursed under the debt agreement, amounts owing, and a referral to an accredited financial counsellor.

15.4 This simple recommendation is in the interests of both debtors and their creditors. It would ensure an orderly end to a failed debt agreement. Working with a financial counsellor can assist both the debtor and creditors to put in place a plan for the outstanding debts going forward. In extreme circumstances, this could involve arranging the sale of the family home without the need for creditors to pursue costly enforcement action or bankrupt the debtor, where trustees' fees would only further erode any equity in the home. Financial counsellors are very skilled in supporting a people through these difficult situations. This recommendation would involve no or minimal additional costs to administrators, who are already required to hold such information and account to AFSA.

RECOMMENDATION 15: Amend the Bankruptcy Act to place a duty on administrators to provide, upon termination for arrears or request by the debtor, a clear and simple statement setting out the original debts, payments received and disbursed under the debt agreement, amounts owing to creditors, and a referral to an accredited financial counsellor.

16. Further reforms needed

16.1 In addition to the reforms identified above, we also strongly support the remaining recommendations by Chen, O'Brien and Ramsay that:

a) A Key Fact Sheet be introduced to improve debtors understanding of the legal and financial consequences of a debt agreement; and

b) Further enhancement of financial hardship schemes.[47]

17. Other provisions in the Bill

Unregistered administrators

17.1 We do not oppose the reforms in Schedule 1, Part 1 of the Bill that effectively remove the ability for a debtor, or their friend or family member, to self-administer a debt agreement.

[46] AFSA, above n 23, 20.
[47] Chen, above n 3, 44, 46.

17.2 We rarely receive complaints about unregistered administrators but we do, however, receive frequent complaints about the conduct of many of the large, well-established *registered* administrators. The registration process alone is clearly insufficient to ensure ethical conduct and good industry practice. In this regard, we commend the Bill for its many improvements to the regulation of registered administrators, as discussed throughout this submission.

17.3 Removing the ability for a debtor or their family member to administer their debt agreement will further entrench for-profit administrators—a significant departure from the original intention that people would self-administer debt agreements. When the debt agreement regime was first established, it was not expected that for-profit administrators would play a major role in the regime. The explanatory memorandum to the 1996 amendments stated that it was 'not proposed that there be any fees or administrative charges associated with debt agreements,'[48] and that:

> *If fees were charged, debt agreements would in many cases not be viable either for the debtor, or for his or her creditors, which would of course defeat the purpose of creating a further alternative to existing regimes.*[49]

17.4 Today, upwards of 22.9 percent of every repayment—often made from social security payments—is going to the middleman, even before set-up fees or AFSA's charges are factored in. All too often, the main person benefitting from the debt agreement is the administrator.

17.5 We refer to our comments on the need to reign in excessive and unwarranted fees at paragraph 14.

Professional indemnity insurance

17.6 We support the new requirements in the Bill for administrators to hold appropriate professional indemnity and fidelity insurance in Parts 1, 3 and 4 of Schedule 3. These requirements are appropriate given the significant financial advising function performed by administrators.

Fit and proper person test

17.7 We strongly support the new requirements in Schedule 3 of the Bill for a company and its directors to each pass a 'fit and proper' test in order to practice as a registered debt agreement administrator. There are many companies currently practicing as registered debt agreements.[50] This reform is essential to the integrity of the debt agreement regime, and ensure trust and confidence in administrators. However, this alone will not ensure ethical practice by administrators.

17.8 To be useful to a regulator and to protect the public, a 'fit and proper' test must enable AFSA to consider a broad range of factors. For example, the legislation should expressly require AFSA to assess whether the controllers of the registered administrator are fit and proper persons to control the administrators—we understand some administrators are controlled by company groups and AFSA should not be limited in its assessment of them. AFSA should also be informed if controllers of an administrator are to change, and assess whether the new controllers are 'fit and proper'.

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[48] Explanatory Memorandum, Bankruptcy Legislation Amendment Bill 1996 (Cth), 16.
[49] Ibid 16-7.
[50] A list is available at: https://www.afsa.gov.au/practitioners/practicing-registered-debt-agreement-administrators.

Trust accounts

17.9 We strongly support the new power for the Inspector-General to more readily obtain necessary information from banks about administrators' trust accounts in Schedule 3, Part 5 of the Bill. This is appropriate given the increasing funds that administrators receive and disburse. In 2016, a total of $242,121,406 was received by administrators under debt agreements.[51] It is important that the Inspector-General has sufficient powers to ensure these funds are not being misused.

Reimbursement of expenses

17.10 We support the reforms in Schedule 1, Part 2 of the Bill to clarify that the only overhead expenses that an administrator can recoup are those listed on the debt agreement proposal. However, this reform should not be used as an opportunity for administrators to further increase their fees, which are already excessive.

Voting rights

17.11 We support the removal of voting rights on proposals (and proposals to vary) debt agreements for administrators and their related entities. Most debt agreement proposals that we see include the balance of set-up fees owing to the administrator or a related firm as an unsecured debt in the agreement. This reform will remove the inherent conflict of interest in the current Act, which allows administrators to vote on a proposal (or proposal to vary or terminate) under which the administrator or its related entity is an affected creditor.

Certification requirement on proposals to vary a debt agreement

17.12 We support new certification requirements in Schedule 2, Part 2 of the Bill, which is consistent with the certification requirements for new debt agreements. However, we repeat our comments at paragraph 2.11 above that certification alone has been ineffective at preventing unsustainable and unsuitable debt agreements.

17.13 We recommend that the Inspector-General, in considering whether to accepting a proposal for processing and it its compliance work, take a far more active role in scrutinising the accuracy of certifications made by administrators.

Alignment of offences

17.14 We support amendments to the Act to align offences under the bankruptcy and debt agreement regimes (Schedule 2, Part 8 of the Bill). There is no reason in principle for differences between these regimes.

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[51] Chen, above n3, 16.

Please contact Cat Newton, Policy Officer at Consumer Action, on 03 9670 5088 or at cat@consumeraction.org.au if you have any questions about this submission.

Yours sincerely,

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Appendix A: List of Recommendations

RECOMMENDATION 1: Empower AFSA or ASIC to undertake file reviews of the quality of advice provided by administrators to debtors.

RECOMMENDATION 2: Amend the Bankruptcy Act to introduce minimum eligibility thresholds for debt agreements under Part IX.

RECOMMENDATION 3: Amend the Bankruptcy Act to introduce a statement of suitability, with corresponding duties on administrators and remedies for debtors in the event of breach.

RECOMMENDATION 4: Amend the payment-to-income ratio to account for housing costs.

RECOMMENDATON 5: Amend the Bill to prohibit the payment-to-income ratio from exceeding 100%.

RECOMMENDATION 6: Amend the Bill to include a corresponding duty on debt agreement administrators not to prepare a debt agreement proposal that would cause undue hardship to the debtor.

RECOMMENDATION 7: Permit a limited discretion for proposals to vary a debt agreement to extend a debt agreement to four years where there is a genuine and significant adverse change in the debtor's circumstances. The impact of this reform should be actively monitored by AFSA and be reviewed within 5 years of commencement to ensure that there is no unintended consequences or regulatory gaming.

RECOMMENDATION 8: The impact of the increase in the asset threshold be reviewed 12 months after commencement to ensure that there are no unintended consequences.

RECOMMENDATION 9: Amend the Bankruptcy Act to require all debt agreement administrators to establish clear and consistent internal dispute resolution processes as an ongoing condition of registration.

RECOMMENDATION 10: Amend the Bankruptcy Act to require all debt agreement administrators Act to maintain membership of the Australian Financial Complaints Authority as an ongoing condition of registration.

RECOMMENDATION 11: Introduce a seamless regulatory framework for all debt management firms.

RECOMMENDATION 12: Amend the Bankruptcy Act to hold administrators responsible for the conduct of aligned brokers in arranging the debt agreement.

RECOMMENDATION 13: Amend the Bankruptcy Act to ban lead generation by debt agreement administrators, brokers and paid referrers.

RECOMMENDATION 14: Amend the Bankruptcy Act to provide that administrators' fees cannot exceed a certain percentage of the debtor's original debt; and that set-up fees only become payable after the debt agreement proposal is accepted for processing.

RECOMMENDATION 15: Amend the Bankruptcy Act to place a duty on administrators to provide, upon termination for arrears or request by the debtor, a clear and simple statement setting out the original debts, payments received and disbursed under the debt agreement, amounts owing to creditors, and a referral to an accredited financial counsellor.