



**INSOL INTERNATIONAL**

**CONSUMER DEBT REPORT**

**REPORT OF FINDINGS  
AND RECOMMENDATIONS**



**INSOL INTERNATIONAL**

INTERNATIONAL FEDERATION OF INSOLVENCY PROFESSIONALS

# **CONSUMER DEBT REPORT**

**REPORT OF FINDINGS AND RECOMMENDATIONS**

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## INSOL INTERNATIONAL

INTERNATIONAL FEDERATION OF INSOLVENCY PROFESSIONALS

The global economic boom that has been witnessed over the last twenty years is due largely to the growth of credit that has been available in ways that could not be imagined before the last quarter of the last century. This boom comes at a price, whereby the world, other than the USA where problems peaked a few years ago, is suffering an all-time high level of financial failures amongst consumer debtors and small businesses.

At the 1997 INSOL World Congress in New Orleans, INSOL International included for the first time a meeting on consumer debt problems. This programme drew far more attention than we anticipated when planning the Congress – it was literally standing room only. The subject was again on the programmes of the INSOL Pacific Conference in Auckland, New Zealand and the INSOL Conference of the Americas in Bermuda, both in 1999, again with outstandingly high levels of interest.

INSOL's Consumer Debt Committee grew out of this enthusiasm to tackle a problem of growing worldwide importance. It was tasked with undertaking a survey of insolvency regimes for individuals throughout the world. In the process, the committee obtained input from professionals serving a wide variety of roles in the insolvency system including regulators, judges, practitioners and academics.

The object of the research was not just to gather information from countries with developed consumer insolvency laws, but also to learn more about the issues affecting consumer debtors and their creditors in jurisdictions where laws are not so well established. Our long-term goal is to provide a resource for countries developing or reforming laws and systems that attempt to deal with the problems that face consumer debtors.

As part of this project, we are pleased to publish our first report of the findings of the Consumer Debt Committee. It is not intended to describe the various systems used throughout the world, about which sufficient has already been published, but to deduce the underlying principles on which consumer debtor insolvency laws can be based.

We are also able to make a number of recommendations for those involved in establishing processes for the reduction if not avoidance of consumer debtor insolvencies and the amelioration of the social and psychological consequences thereof.

We would be pleased to receive comments on these Principles and Recommendations.

A handwritten signature in black ink, appearing to read 'Neil Cooper', with a stylized flourish at the end.

**Neil Cooper**  
**President**  
**INSOL International**

## ACKNOWLEDGEMENTS

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This report is the work of the INSOL Consumer Debt Committee and its Chairman in particular. The Committee consisted of its Chairman, Jan C van Apeldoorn (The Netherlands); R. Gordon Marantz, QC, Past President, INSOL International, Osler, Hoskin & Harcourt (Canada); Mary Jo Heston, JD Lane Powell Spears Lubersky LLP (USA); Prof. Karen Gross, New York Law School (USA); Sara Dayman, BDO Stoy Hayward (England); Stephen Briscoe, BDO McCabe Lo & Co (Hong Kong, China); Michael Kayman, The Grabscheid Group Ltd. (USA); Perry Krieger, Perry Krieger & Assoc. Inc (Canada); Lee Manning, Kroll Buchler Phillips (England); Peter Joyce, INSOL Regulators Group, Inspector General and Chief Executive, The Insolvency Service (England); Dr. A I Layonu President, Business Recovery & Insolvency Practitioners Association of Nigeria (Nigeria); and Ladislav Zelinka, Vice Minister of Finance (Czech Republic).

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## INTRODUCTION TO CONSUMER DEBT PROBLEMS

It seems almost paradoxical that in this era of strongly expanding economies and low unemployment figures in many countries, which increase the incomes of almost all working groups in most parts of the world, over-indebtedness keeps rising. As a result of the economic conditions, credit is not just more easily available, but consumers have access to proportionately larger amounts of credit.

Growth in consumer borrowings is across all sectors of societies but is strongest among relatively low-income households and sources of credit are most likely to be used when their incomes are disrupted for any reason. Financial difficulties however, are not restricted to low-income households, but can be found amongst all groups of consumers in our societies. Nor must it be suggested that consumer debtor insolvency is always credit-related. There are many reasons an individual becomes insolvent. Frequently the causes are business related. In this report, we have not sought to examine the correlation between business failure and the insolvencies of individuals connected with those businesses.

The term *consumer debtor* in this publication refers to a debtor whose liabilities are incurred primarily for private, family or household purposes and not, in the first place, as a result of carrying on business, either on the debtor's own account or in partnership with others, or arising from guarantees given on behalf of limited liability entities. In short, a consumer debtor's liabilities relate primarily to bank overdrafts, loans from banks and other financial institutions, personal credit cards, mortgages and hire purchase or credit sales agreements relating to purchases of capital items such as automobiles.



Depending on the domicile of the debtor, failure to discharge debts may ultimately end in the debtor being declared bankrupt or subject to some other form of insolvency procedure in which the debtor's assets are divided amongst the creditors. The socio-psychological consequences on consumers facing financial difficulties have long been underestimated. Although some countries have legal systems in which the debts of consumers can be legally discharged, many countries have, mainly for historical reasons, regimes whereby, unless the bankruptcy is terminated by way of a scheme of arrangement or composition, creditors may seek recourse against the person's assets almost indefinitely.

Having said that, the consumer debtor's problems arise primarily from incurring domestic liabilities; the debtor may also have problems that arise from businesses with which they are connected. Consumer credit is used to finance small businesses either as start-up capital or for operating funds and many forms of business are legally identifiable with the natural person operating the business when, for example, the debtor acts as a sole trader.

Many countries have insolvency laws that seek to distinguish between the simple consumer debtors those whose liabilities arise from small business. They may differ considerably and this is not only due to the fundamental differences between the common law and civil law philosophy but for a variety of social and historical reasons. This report also recognizes that many countries currently do not have a fully developed consumer insolvency system.

It is not possible either to give a generally recognised definition of a consumer debtor. The words may have different meanings in different jurisdictions. Some countries exclude certain types of debtor from insolvency proceedings altogether and in other countries a natural person cannot be declared bankrupt, unless he

acted in the capacity of a “merchant”. However, these countries will have similar procedures for natural persons, which will hereafter collectively be referred to as *insolvency procedures* and which may contain *liquidation procedures* and *rehabilitation procedures*.

From the perspective of a consumer debtor, it makes no difference whether the debts the debtor is facing are commercial or private debts. To this extent, the term “consumer debtor” can be a misnomer. This report is about individuals, natural persons, men and women, whose debts for which they are personally liable, however caused, (private or commercial) exceed their capacity to repay within a reasonable period.

This report examines the principles on which consumer insolvency laws should be based. These principles should be equally applicable in all jurisdictions. The recommendations are intended to help all those groups involved in establishing due processes for the reduction and avoidance of consumer insolvencies and the social and psychological implications thereof.

## SOLVING CONSUMER DEBT PROBLEMS

During the last two decades, aggregate consumer debt has grown exponentially with the increasing availability of consumer credit, an increase in the number of credit cards in use and in opportunities for debtors to raise (second) mortgages on their domestic properties. Consumer debts however are no problem per se: they are one of the great dynamic factors in our economies. A high level of domestic consumption is required for both stability and growth. This is why consumers are encouraged by governments to consume. One of the ways to boost this consumption is to facilitate and expand credit facilities for consumers. Consumer debts become a problem when debtors are unable to find solutions for repayment without professional help and that is why society as a whole bears a collective responsibility.

Solving consumer debt problems can be very complex. Unfortunately, these problems are frequently caused by or in relation to socio-psychological factors, such as divorce, redundancy, job loss, addiction, disability etc. These situations interfere with the quality of life and in many respects may have serious consequences for the health of the debtor and his or her family and the way they live. They may become socially isolated or retreat from life altogether.

In this regard, various types of consumer debt problems can be distinguished.

- **Survival debts** Survival debts occur as a matter of a survival strategy, when there is an accumulation of recurrent debts for the necessities of life, such as household debts (food, rent, electricity, education, clothing). They occur when families or single persons, often with growing children, have to live at a social minimum for any length of time.

- **Over-consumption debts** These debts are caused through over-consumption by a debtor who initially has a surplus in their budget, but who finances their extravagant life-style with borrowed money. Typically, the debtor has entered into more than one loan, (unconsciously) causing an increased extension of debt. The cause is often a lack of financial management skills, inadequate monitoring or insufficient knowledge of credit facilities and the conditions under which they are offered.
- **Compensation debts** These debts result from over-consumption by a debtor who typically suffers deprivation or social exclusion. It is triggered by advertising, and establishing social class, power, status or as compensation for other loss. This behaviour may result in illness-related debts, gambling debts, alcoholism and mental illness. They occur at all levels of society.
- **Relational debts** These debts are acquired through connection with others because of marriage, other relationship or death. In some states, they arise by operation of law as a result of liabilities being incurred by a spouse.
- **Accommodation debts** Accommodation debts are caused by the inability to adapt to misfortune, a sudden drop in income (redundancy or disability) or unforeseen expenses (increase of uninsured medical expenses or rise in housing costs). They also arise where the debtor anticipates prosperity that does not materialize. The debts are usually considered temporary, but they can become problematic if the debtor decides to try to preserve his way of life and is unwilling to dispose of any of his assets.
- **Fraudulent debts** These debts occur when a debtor wilfully over-commits himself financially. At the least, the debtor failed to act in good faith or deliberately attempted to defraud his creditors, either whilst incurring the

debt or in his representations of his ability to repay. Although these kinds of debts can be a problem, they are not part of this study. There is usually no special relief for these kinds of debts and/or these debtors are frequently excluded from a discharge altogether.

There are many ways for a consumer to get into financial difficulties. The reasons are not always directly connected to credit facilities offered by lenders. In many instances, they may occur due to factors beyond the control of the debtor or they may be caused deliberately. In all situations, however the debtor's legal position is weak. When the situation becomes so oppressive that there is no prospect of satisfaction of the debts and, as a result of judgment enforcements, executions, garnishment of wages, coercion and creditor harassment, eviction from homes or disconnection from basic facilities (water, gas and electricity), the effective social functioning of the debtor is disturbed or, in some jurisdictions, prevented. In these cases, there is clearly a task for the legislator. There is a general agreement that the consumer debtor should not be penalised, but offered some form of protection.

Insolvency laws providing for a discharge of the consumer debtor will generally be regarded as a solution for their financial difficulties. *Discharge* is the release from the payment of liabilities resulting from the filing of a bankruptcy or insolvency proceeding. A law offering a discharge should however not be seen as an easy way out. For the law to be respected, the legislators should seek to avoid a dichotomy between the debtor and society. The barriers to obtain a discharge should on the one hand not be so high that the debtor is discouraged from using the procedure. On the other hand, sufficient recognition of the system should be created so that society is willing to forgive and permit a fresh start.

A simple discharge may not be the solution to the problem in the end. After all, a consumer debtor is not helped when a discharge is obtained without the

underlying causes being solved or taken away. The debtor is likely to continue to incur further debts and there is a risk of recidivism. The debtor is not helped either when earnings and expenditure are balanced, but he still faces debts that cannot be paid within a reasonable period.

Therefore, for effective help to be made available to the consumer debtor, it should not be structured solely by way of a discharge through bankruptcy proceedings, which will be mainly court-driven procedures requiring the involvement of a trustee or administrator. A *trustee or administrator* in this respect is an individual or organisation appointed to administer the assets of the debtor and distribute the proceeds to creditors.

Help should also be directed at both finding a solution for the adverse financial situation and, as far as possible, preventing the debtor from getting into debt again. This may also require an out-of-court or extra-judicial approach and the involvement of a debt counsellor, a consumer advisory bureau or a social worker.

Within the extra-judicial approach (apart from various kinds of socio-psychological aid aimed at improving the debtor's living conditions, re-integration in the work process and immaterial factors), a distinction is made between aid to consumer debtors to solve debt problems (Debt-aid) and aid to prevention (Budgeting-aid).

Debt-aid consists of 'debt or financial -counselling' and debt restructuring based on the debtor's redemption capacity.

- **Redemption capacity** is the amount of the debtor's income above a certain amount, being the minimum allowed to cover necessary living expenses. The redemption capacity is established by establishing the debtor's

reasonable needs and is the amount available to creditors. To determine the redemption capacity the debtor may have to sell or to surrender non-exempted goods. Exempted goods are property that the consumer may keep to prevent the debtor from becoming destitute (a certain amount of equity, equipment and personal belongings).

- **Debt counselling** is a form of pre-bankruptcy mediation between the debtor and the creditors aimed at solving debt problems. The debtor in this situation may surrender his redemption capacity for a certain period, typically from three to seven years, to the creditors, in consideration for the balance of debts being waived.
- **Debt restructuring** is usually also pre-bankruptcy and is based on one or more payments to creditors for a discharge. These payments could be made from third parties or from newly obtained credit facilities, of which the size, term and repayment installments are based upon the redemption capacity. In this way, all outstanding debts are replaced by one debt that the debtor can service, with or without further professional assistance. Some countries have municipal credit banks or departments of social security services providing such credit facilities.

Both debt counselling and debt restructuring should lead to a discharge, composition or (voluntary) scheme of arrangement without the need to commence court proceedings. These arrangements usually require the approval of all creditors and are based in contract law. Some jurisdictions however, offer the consumer debtor the possibility of having an agreement with a required majority of creditors ratified by the court even where there are dissenting creditors. In these cases, dissenting creditors are bound to cooperate if their position in the out of court settlement is not materially worse than it would be in formal insolvency proceedings.

Insolvency laws providing for a discharge of the consumer debtor usually contain elements of both redemption capacity, debt-counselling and debt-restructuring, and are structured, either in the form of an asset liquidation procedure, a rehabilitation procedure or a combination of the two.

- **Asset Liquidation procedure** In this type of procedure, the debtor's non-exempted goods and everything in excess of the redemption capacity will be realized and distributed among the creditors, whereupon a discharge is obtained for any balances unpaid. The types of good that are exempted or the period of time during which the redemption capacity is available for the creditors differ from country to country. In some instances, the insolvency procedures are extended over a longer period (up to seven years) and discharge is only obtained thereafter.
- **Rehabilitation procedure** A rehabilitation procedure is designed to give the consumer debtor time to recover from temporary or more permanent liquidity difficulties and provide a way, through debt counselling or debt-restructuring, to reorganize his financial affairs. After a successful completion of a rehabilitation procedure, as well as an asset liquidation procedure, the debtor will obtain discharge or prepare a rehabilitation plan, composition or scheme of arrangement which is typically required to be approved by a majority of the creditors (possibly voting in classes) and/or by the court.

Insolvency proceedings may be voluntary or involuntary, although the difference is often artificial. This report neither distinguishes between the various procedures nor expresses any preference. General principles, which apply to all consumer debtor procedures, are set out in the next chapter.



Budgeting-aid consists of budgeting-advice, budgeting-support and budgeting-administration. These may be pre or post bankruptcy proceedings.

- **Budgeting-advice** is the providing of information to the debtor on all subjects involving the management of the debtor's financial affairs, including the procurement of social benefits, etc.
- **Budgeting-support** is aimed at acquiring budgeting skills and handling the exempted income.
- **Budgeting-administration** will take place when the debtor's income is paid to a trustee or administrator who manages the earnings and pays all (fixed) expenses. The debtor will only be allowed limited living expenses to ensure that recurrent debts (rent, gas, electricity and medical expenses) are met.

Often multiple forms of aid are required to assist a debtor with his debt problems. Countries apply different standards and other ways to handle such situations and the above analysis cannot be exhaustive.

There needs to be control as to who provides these service to unsophisticated purchasers, monitors them and ensures that they are of the highest quality to prevent financially unsophisticated debtors being taken advantage of.

## SUMMARY OF PRINCIPLES AND RECOMMENDATIONS

The Principles that underlie the resolution of consumer debt problems are as follows:

- Principle 1:** Fair and equitable allocation of consumer credit risks
- Principle 2:** Provision of some form of discharge of indebtedness, rehabilitation or “fresh start” for the debtor
- Principle 3:** Extra-judicial rather than judicial proceedings where there are equally effective options available
- Principle 4:** Prevention to reduce the need for intervention

In order to achieve these Principles, it is necessary to take the following actions.

### **Legislators should:**

- Enact laws to provide for a fair and equitable, efficient and cost effective, accessible and transparent settlement and discharge of consumer and small business debts
- Provide for appropriate alternative proceedings depending on the circumstances of the consumer debtor
- Consider providing for more appropriate separate or alternative proceedings for consumer debtors

- Ensure that consumer debtor insolvency laws are mutually recognised in other jurisdictions and aim at standardization and uniformity
- Offer the consumer debtor a discharge from indebtedness as a method of concluding a bankruptcy or rehabilitation procedure
- Encourage the development of extra-judicial or out-of-court proceedings in order to resolve the problems of consumer debts.

**Governments, semi-governmental or private organisations should:**

- Ensure the availability of accessible, sufficient, competent and independent pre and post bankruptcy debt-counselling
- Set up voluntary educational programmes to improve information and advice on the risks attached to consumer credits.

**Lenders should:**

- Review the way credit is made available to consumers and small businesses, information is presented and the way these debts are collected.

**Organisations of lenders and consumers should:**

- Set up methodologies to monitor consumer loan delinquencies and to make recommendations on such matters including the need for safeguards on privacy
- Make reliably accurate credit reporting and scoring information available to individuals.

We expand on these Principles and Recommendations in the next Chapter.

## THE FIRST PRINCIPLE

### A fair and equitable allocation of consumer credit risks

Society should accept that consumer debtors who cannot repay debts, for reasons beyond their control, are not always solely to blame and that the creditors that consequently receive little or no payment are not necessarily the only victims. Society and legislators have to determine.

- *Levels of exemptions* - the property excluded from recourse by the creditors
- *Avoiding powers* - to nullify certain acts and to redress the damage which were detrimental to the interest of all the creditors
- *An automatic stay or moratorium* - which prohibits the creditors pursuing actions against the debtor whilst a solution is being sought
- *Anti-discrimination provisions* - safeguarding a humane approach to the debtor and his entitlement to maintain, both during and after proceedings, a decent way of living, even at the cost of his creditors.

These benefits may be limited to debtors who acted in *good faith*, both as to the way debts arose and as to the reasons the debts could not be repaid.

#### ***Recommendation 1***

***Legislators should enact laws to provide for a fair and equitable, efficient and cost-effective, accessible and transparent settlement and discharge of consumer and small business debts.***

The object of the law is to provide for a discharge or fresh start for the consumer debtor that cannot reasonably repay its creditors, provided that the debtor acted in good faith both as to the way the debts arose and as to the reason, the debts cannot be repaid. The components must be:

**Fair and equitable** There should be a fair allocation of risk between debtor and creditors in a predictable and equitable way. The system should not be abusive to debtors and not necessarily designed just to protect and maximise value for creditors. It should contain a balanced approach to give the debtor the possibility of a second chance. Apart from the excluded property that will remain with the debtor, the entire estate should be available for the creditors. The law should therefore provide the trustee or administrator with sufficient powers to nullify avoidable actions. This report recognises that there are differences between creditors and their rights, but does not make recommendations about priorities, securities or preferred creditors.

**Efficient** Although consumer debtors come from all income groups, they seldom have sizable estates. Complicated and time-consuming procedures should therefore be avoided. The administration of the estate must be undertaken by a skilled, efficient trustee or administrator.

**Cost effective** A decision may have to be made as to who pays for the process, the trustee and the other costs involved. Where a fair and equitable bankruptcy or rehabilitation process is for the benefit of society as a whole, costs may have to be shared by all the stakeholders.

**Accessible** The debtor should have easy access to the procedure without costs being an obstacle to those who need the relief that such systems offer and without numerous or complicated formalities. They should be free to choose between a bankruptcy or rehabilitation procedure, provided both systems are available to a consumer debtor. Since debtors typically only initiate insolvency proceedings as a last resort, powers to initiate proceedings are sometimes given to creditors, governmental or other authorities, including social security agencies.

**Transparent** Debtors and creditors alike must be able to monitor the process, have the opportunity to be heard, to receive notices and to exercise their rights. Public confidence in the process depends on transparency. Regard must be had for requirements for privacy.

Further attention should be given to the following issues:

**Size of the estate** The law will determine which assets of the debtor will be available for distribution among the creditors and consequently which assets will be excluded. The debtor should be able to maintain a reasonable standard of living. Where the law provides for a redemption capacity, the excluded income of the debtor is set according to a standard that the necessary living expenses (food, housing, public facilities, medical care, etc) of the debtor and his dependants can be met. Since the high costs of housing (either rent or mortgage) are often contributory causes of the insolvency, special attention should be given to the problems connected with housing.

**Duration of proceedings** In some jurisdictions, the redemption capacity is saved over a period of years before the funds so accumulated are distributed among the creditors in exchange for a discharge. The amount of income available to the debtor in such situations is usually minimal and often below the minimum standards that apply to the debtor in question. The underlying philosophy is that the debtor should endure some financial hardship, whereupon the discharge is considered as the reward. This period can be as long as seven or eight years. This period however, should not be over-extended. Debtors have quite often experienced long periods of financial hardship before proceedings started. The risk that the debtor will not be able to cope on a limited budget available, especially in times of misfortune, unexpected costs, etc and will relapse into overspending, is realistic. The law should accommodate unusual circumstances.

**Avoiding powers** Creditors should not be able to retain transfers received from the debtor within a certain period before insolvency procedures and which interferes with the principle of equal treatment of creditors.

**Automatic stay of action** Creditors should be prohibited from pursuing the debtor during the insolvency process or creditors who chose not to be bound by the process would prevail over those utilizing the collective mechanism.

In addition, the law should take into account the issues that are generally provided for in any fair and predictable insolvency law. In this respect, reference is made to provisions regarding the handling of encumbered assets and the position of secured creditors, treatment of contracts (where special attention should be given to contracts related to the basic necessities of life) and the priority of distribution.



## ***Recommendation 2***

***Legislators may consider providing for separate proceedings, depending on the specific circumstances of the consumer debtor.***

The law may provide for different routes to a discharge depending on the specific situation of the debtor and the nature of the debtor's financial difficulties.

A debtor who has no redemption capacity, who suffers from survival debts and who has no prospects of improving his financial situation within a reasonable period (possibly due to prolonged dependence upon social security benefits, permanent unemployment or disability), will require a different approach to a debtor with only accommodation debts. Where the insolvency is only likely to be temporary provided the debtor is given breathing space, he should be allowed an opportunity to restructure his earnings and spending.

In the first situation, there is no benefit extending insolvency procedures for a longer period, thus extending the agony of a hopeless situation. A debtor with only accommodation debts, however, may be able to offer his creditors a pro-rata payment of their claims or even a composition or scheme of arrangement. In the first situation, bankruptcy type procedures seem more appropriate, and in some jurisdictions a consumer debtor may apply for a discharge after a very short period, whilst for the second situation, a rehabilitation procedure could be the answer. Many countries with well-developed consumer-debtor insolvency laws have chosen either system or a combination thereof. The choice usually depends on the way insolvency laws are structured in general and has often been determined historically.

A debtor should be free to choose and either procedure should lead to both a discharge and a solution for the underlying causes of the debt problems. A debtor is not necessarily helped when a discharge is easily obtained without the underlying causes being solved or taken away.

***Recommendation 3***

***Legislators should consider providing for separate or alternative proceedings for consumer debtors and small businesses.***

Consumer insolvency laws are about human beings with debt problems. These may arise from consumer debts or may be related to the debtor's participation in the economic process in a small business.

The extent to which a natural person will be held liable for debts which arise from his participation in the economic process will largely depend upon the national system adopted, both with regard to the distinction between natural and legal persons, and to the legal and organizational forms in which a business may be conducted. A legal entity conducting a business, whether large or small, may cease to exist after the termination of insolvency proceedings, together with the remainder of any unpaid debt. However, where the business is in any way identifiable with a natural person who remains responsible for the debts of the business after insolvency, the person's situation may not be different from any other consumer with debt problems.

Nevertheless, the specific circumstances of a small business and the type of debt may be quite different. The business may have personnel and a different

type of creditors, may be engaged in all kinds of commercial transactions, etc. Solving these specific situations could require different approaches, as to the way the business should be dealt with, attempts at rehabilitation (within the national system) and as to the specific skills of the trustee or administrator.

#### ***Recommendation 4***

***Legislators should ensure that consumer insolvency laws are mutually recognised in other jurisdictions and should aim at standardization and uniformity.***

The majority of consumer debtors will only have assets and creditors within their own jurisdictions, but some will have assets and/or creditors in other jurisdictions. This may occur when people do not live and work in the same country or in areas with intensive cross-border transactions between connecting states or jurisdictions. In areas where trade barriers have disappeared and there is free movement of people, goods and services, (and credit) from abroad will be easily available. In addition, the Internet brings the world to everyone's doorstep.

Various treaties regarding the recognition of insolvency procedures between countries include the recognition of consumer-debtor insolvency laws. The UNCITRAL Model Law on Cross-Border Insolvency ensures judicial cooperation, access and recognition, but the Guide to Enactment allows enacting States to exclude insolvencies that relate to natural persons residing in the enacting State and whose debts were incurred predominantly for personal or household purposes, rather than for commercial or business purposes, from the scope of any domestic law. Nevertheless, the Model Law could be beneficial

for both consumer debtors and creditors where the debtor has assets and/or creditors in other jurisdictions.

Under the EU-Insolvency Regulation natural persons/consumer debtors are not excluded as such, but it is left to the laws of the contracting States as to whether they fall within the scope of the application.

Recognition of foreign proceedings alone, however, may not be sufficient. The conditions under which a discharge can be obtained considerably differ from jurisdiction to jurisdiction. Some jurisdictions require minimum dividends to creditors: in others, even a zero rate dividend qualifies as a dividend for discharge purposes. If these differences are too great, a foreign discharge may be considered contrary to public policy and therefore not binding on a creditor who retains the ability to pursue the debtor in another jurisdiction.

Overall uniformity or harmonization of consumer insolvency laws may not be a realistic objective, but it would assist if a greater level of standardization could be achieved.

## THE SECOND PRINCIPLE

### **Discharge of indebtedness, rehabilitation, the “fresh start”**

Providing a fresh start to a debtor who cannot reasonably repay all of his pre-existing debts is the recognition by society that over indebtedness is, in many cases, excusable. It is a key-element of any consumer debtor insolvency law or rehabilitation procedure, based on the principle that it is in society's interest - that the debtor should be able to begin afresh, free from past financial obligations and not suffer indefinitely. It is the distinction between punishment of yesteryear and the economic reality of the twenty-first century.

#### ***Recommendation 5***

***Legislators should offer consumer debtors a discharge of indebtedness as a tailpiece of a liquidation or rehabilitation procedure.***

In whatever form a discharge ultimately takes, debtors should have an opportunity to obtain relief from pre-existing indebtedness and to have a fresh start, free from their past financial obligations. In this respect, attention should be given to the following issues.

**Contributions to the estate** A debtor may have to contribute part of his income to the estate or his creditors either during the insolvency proceedings, which in some jurisdiction may take a considerable time, or after these proceeding have been terminated, by way of an imposed

condition on the debtor. Ideally, the debtor's ability to obtain a discharge should not be linked to a debtor's income after the termination of the proceedings.

**Extent of discharge** Either the discharge should cover as many debts as possible that exist at the beginning of the proceedings or at the time that the discharge is obtained. In many jurisdictions, however certain debts are excluded from a discharge, such as debts arising from maintenance agreements, fraud, court fines, taxes and student loans. Although there can be a social justification for such exceptions, they should be kept to a minimum. A discharge with too many restrictions and surviving debts may not sufficiently assist the debtor in making a fresh start. Testing whether the debtor acted in good faith could be more appropriate in some circumstances.

**Waiting period** The waiting period is the minimum period between two discharges permitted by law. In some jurisdictions, a discharge is a once in a lifetime opportunity: in other jurisdictions there is a minimum waiting period, for example ten years, before a debtor will qualify for a new discharge, or even to enter insolvency proceedings which may lead to a new discharge.

**Restrictions imposed** Conditions may be imposed upon the debtor both during the proceedings or as a condition for a discharge, either by way of recommendation by the trustee or administrator or by the court, including restrictions on the ability to obtain new credit, to leave the country or to carry on a business for certain period of time. Although these restrictions may be for the good of the debtor, they should not restrict the debtor in his fresh start.



**Anti-abuse provisions** A number of debtors or debts may be denied the benefits of a discharge, although these should be limited and well defined.

In general, these are a consequence of fraudulent activities by the debtor.

**Reaffirmation of debt** A debtor and a creditor may reaffirm the debtor's obligation previously discharged. In some jurisdictions, these contracts are not enforceable. In other jurisdictions, the debt is not discharged, but remains in existence in a form referred to as a "natural obligation".

## THE THIRD PRINCIPLE

### Extra-judicial rather than judicial proceedings

There are obvious advantages in preferring extra-judicial to judicial proceedings where both are available on substantially the same terms. Extra-judicial or out-of-court proceedings take less time of the courts and the judiciary, are less expensive and can be better designed for a more integrated approach of the problems the consumer debtor is facing, which are more often of a non-legal than of a legal nature. In general, there should be delegalization and dejuridification of consumer debtor problems.

#### ***Recommendation 6***

***Legislators should encourage extra-judicial or out-of-court proceedings for solving consumer and small business debts problems.***

Extra-judicial proceedings have clear advantages for both debtors and creditors. In such proceedings, a creditor should be assured that it would receive that to which it is entitled under judicial proceedings, that its rights are protected and be dealt with in an effective and efficient manner. For a debtor it should be clear which sacrifices are required to be made, and that by doing so, he/she is entitled to a discharge and that the creditors will accept this.

This may require facilitating out-of-court schemes of arrangement or rehabilitation procedures that mirror the provisions of full insolvency laws. Court



approval of such schemes or procedures can be given in cases where creditors unanimous approval would otherwise be required but such vote is not obtainable. A dissenting creditor should be able to be overruled if its position in and the outcome of extra-judicial proceedings are not materially different from judicial proceedings. This is likely to be the case when extra-judicial proceedings have incentives for both parties. These procedures will be less expensive and less time-consuming.

In some jurisdictions, it is compulsory that efforts are being made to effect an out-of-court settlement before court proceedings will be started. A consumer debtor is not allowed to enter into an insolvency procedure leading to discharge, unless he shows to the satisfaction of the court that an out-of- court settlement could not be obtained.

The same result could be obtained by introducing a “cooling-off” period, allowing the parties, through mediation or another form of alternative dispute resolution, to attempt to reach a settlement or rehabilitation plan.

Special attention should be given to the costs involved and the necessity of debtor’s representation. Costs should never be an obstacle for a debtor to solve his debt problems through an extra-judicial procedure.

### ***Recommendation 7***

***Governments, quasi-governmental or private organisations should ensure the availability of sufficient competent and independent debt counselling.***

The problems a consumer debtor faces are often complex and usually not only of a legal but of a socio-psychological nature. This requires the input of professional independent debt counsellors, specialised in negotiating arrangements with creditors and knowledgeable about the specific problems of consumer debtors. Their work requires expertise in the legal, financial and social aspects of consumer debt problems and they should be able to give information and advice on all aspects of budgeting-aid, debt settlement and welfare laws.

Governments, quasi-governmental or private organisations should create bodies to train, finance and supervise these professionals, to develop standardized norms and practices and codes of conduct, against which the assistance is tested. This requires licensing and supervision by the court or an independent body. Special attention should be given to the remuneration of trustees, administrators and/or debt counsellors to ensure that sufficient time is available to assist the debtor in a proper manner.

Since consumer debtors are often in a weak and vulnerable social position, they easily become victims of unprofessional or even corrupt debt counsellors.

## THE FOURTH PRINCIPLE

### Prevention to reduce the need for Intervention

Although there has been a changing attitude towards insolvency over the last decade, especially among young people, insolvency still carries a stigma that can be avoided. It requires the cooperation of legislators, local and national governments, lenders and creditors' associations together with representatives of debtors in

- Setting-up educational programmes
- Critically reviewing how, to whom and under which conditions credit is made available
- Monitoring the debt collection process
- Generally improving the social environment
- Data collection and publication to ensure transparency and an understanding between stakeholders.

#### ***Recommendation 8***

***Governments, quasi-governmental or private organisations should set up educational programmes and improve information and advice on the risks attached to consumer credit.***

Based on the principle that prevention is better than cure, informed advice on the technicalities of credit installments, credit cards, large expenditures, etc is essential. Educational programmes may be a compulsory element of a discharge or be offered on a voluntary basis, either pre- or post-insolvency. Educational programmes are in many form and shape. They may range from budgeting-advice, budgeting-support or budgeting-administration. Special attention should be given to vulnerable groups of society, including the young, the elderly and minorities.

Financial literacy can be taught: it is essential for successful functioning in our world's economy, where money is the key factor and lack of money is regarded as failure. Education is therefore an integral part of a genuine fresh start, as it enables the debtor to function more effectively in society.

#### ***Recommendation 9***

***Lenders should observe the way credit is made available to consumers and small businesses, information is presented and the way these credits are collected.***

Lenders should be very much aware that they are in a position to influence the risks taken by consumers. By using accurate scoring models, lenders are capable of controlling their risks and reducing their costs. However, through aggressive marketing and sophisticated solicitation techniques, they reach less and less credit worthy debtors and higher charge-off rates. These charge-off rates are just part of the business of the lender and are taken into account in the conditions under which credit is made available. For the consumer debtor who cannot repay his debts, it may result in a personal tragedy.

Lenders should therefore be clear about the conditions subject to which credit is made available. Tightening standards will result in a slower consumer debt growth for consumers in the danger-zone and will consequently reduce consumer loan delinquencies.

Lenders should however also regularly review their own codes of conduct on all levels, including the way credit is marketed and their collection tactics.

***Recommendation 10***

***Organisations of lenders and consumers should set up joint programmes to monitor consumer loan delinquencies.***

Monitoring consumers with debt problems by a body controlled by representatives of both lenders and consumer organisations will ultimately be beneficial for all parties.

Data collection will ensure transparency and an understanding of how the system is operating and, recognizing privacy, data on debtors and creditors are therefore essential. Statistics will reveal important information that will assist the parties to the system and society as a whole.

Such a body would have to operate under strict conditions and guarantee privacy for consumers while providing reliable information to lenders about previous delinquencies to protect consumers and improve the efficiency of the credit system.

In addition, there should be arrangements made by lenders organisations to make reliably accurate credit reporting and scoring information available to individual debtors to enable them to understand the credit system better.

## **FEEDBACK**

INSOL International invites feedback on this report and its recommendations. Comments can be communicated to INSOL via its web site at [www.insol.org](http://www.insol.org) or in writing to: -

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