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# Building a Personal Insolvency Framework

## Fresh Start and Beyond

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The policy frameworks for personal insolvency have evolved in an interconnected world, and that is why we see an explosion of reforms of the personal insolvency frameworks, on the one hand, and also the emergence of some general principles and rationales behind this development, on the other hand. Many legal frameworks emphasise the social insurance aspect[1] of consumer insolvency laws. According to this view, debt forgiveness provides relief to the financially stressed households existing outside the social safety net and therefore functions as an 'insurer of last resort'. There are two perspectives underlying this framework, namely, an economic perspective and the social perspective. The former maintains that debt-discharge fulfils the fundamental economic definition of insurance. It reallocates risk from a debtor (the insured) to its creditor (the insurer), for which the creditor may require recompense in the form of a higher interest rate. The debt-discharge in bankruptcy is social insurance as compared to private insurance because it is an essential aspect of the relationship between debtors and most unsecured creditors where the debt-discharge right of the former cannot be renounced. The alternative social perspective is that bankruptcy is a kind of social insurance that has more functional significance than a matter of economic theory. Hence bankruptcy framework is effectually an 'insurer of last resort', providing a kind of protection to individuals who are inadequately protected by the legal and institutional regimes designed to promote economic security. These scholars have relied less on the risk-transfer function of bankruptcy and have appraised bankruptcy more as a reflection of wider socio-economic difficulties[2]. If we consider the bankruptcy framework in the broader social insurance framework, then its optimal role in achieving the intended outcome could be examined. We may evaluate the relative costs of bankruptcy protection and those of other schemes of social safety net to conceptualise the least-cost strategy under the personal bankruptcy framework, especially the 'fresh start'. Such costs include administrative costs, costs related to self-insurance, moral hazard, and macroeconomic costs to credit and labour markets. I will argue that contemporary economic conditions present a strong case for reorienting the law towards the fresh start policy and its social insurance function.

The Global Financial Crisis and subsequent Great Recession have prompted experts to identify the negative economic consequences of the excessive level of debt in generating the crisis and in extending consequent recession[3]. More and more economists advocate the virtues of household debt forgiveness policies. Personal insolvency is an instrument to avoid the crisis. This paper emphasises the convincing case for using personal insolvency as a social insurance instrument to deal with 'debt overhang' problems[4] and reallocate more efficiently the risks intrinsic to a debt based economy. Economists have claimed that financial crises are not the only risk caused by high levels of debt. Such debt also constrains economic growth because borrowers who pay the interest and the lenders who collect it use their financial resources differently.

While the deleveraging policies were being considered by Governments in the form of targeting of social protection programmes including personal bankruptcy reforms, the COVID-19 pandemic has further complicated the peacetime reform efforts. Unprecedented fiscal policies to offset the economic impact of the COVID-19 have driven the level of global debt close to the peaks observed in the second world war. Although the IMF global database on household debt, which provides data upto 2018 only, shows that there was relative global stability of household debt, there were significant inter and intra-country variations across countries. The household debt globally was estimated to be around USD 40 trillion at end-2019[5]. The ratio of household debt to GDP ('debt ratio') was highest around the time of the Global Financial Crisis (GFC) and, after decreasing in the first half of the 2010s, has stayed more or less unchanged since 2015. While there are special and temporal variations in the debt ratio, the composition of aggregate household debt is generally alike, with mortgages accounting for a predominant proportion of total debt. The resilience of the household sector is important for both macroeconomic and financial stability in the wake of the COVID-19, as its level would affect both consumption expenditure (reduction in consumption) and debt repayments (defaults). The Governments and financial sector regulators have provided relief to indebted households by expanding the scope of social protection programmes and providing temporary moratoriums on debt payments and insolvency proceedings related to the COVID-19 induced economic shocks. The household debt to GDP ratio in India ranged between 8.68 per cent and 11.04 per cent in the last decade or so till 2018. However, the household debt levels would increase on account of the COVID-19 related employment and income shocks, and to that extent, the financial resilience would be adversely affected. It is in this context that the creation of a debt forgiveness policy becomes very important in the overall social protection framework.

Sometimes the insolvency filings are analysed through the perspectives of diverse images of the debtor, namely: the strategic, structural, and behavioural actor models[6]. These perspectives have a very profound impact on the creation of the insolvency framework. The applicability of the model would determine the policy choices for structuring the framework, and therefore, its selection is a strategic choice in building the insolvency framework[7].

The strategic model is founded on the utility-maximiser rational individuals in the neo-classical tradition. Therefore, their behaviour can be predicted as a systematic reaction to regulatory inducement. The inference is that debt forgiveness policies may give rise to ‘perverse’ incentives for unprincipled manipulation[8]. Sometimes, traces of this approach are found in the contractualist requirement of a quid pro quo in mandating sanction for the behaviour conditionality, like mandatory time gap between two insolvency applications. It is another matter if these conditionalities are effective in sustaining the required behavioural change. Teresa A. Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook, in their seminal study (1989), came to the conclusion that the cases of bankruptcy abuse are rare and that bankruptcy law is not an efficient instrument to bring about the desired behavioural change in people as they do not respond to incremental changes. They also do not find any evidence of bankruptcy recidivism (Sullivan et.al., 1989, pp.192-95). Only about 8 per cent of their debtors were previously adjudged bankrupt. Moreover, the authors state that only about a third of that 8 per cent are ‘true repeaters’- which they define as persons who received a discharge, acquired additional debt, and then again applied for bankruptcy. They contrast this category with a larger group that managed to repay debts between Chapter 7 discharges[9]. They contend that bankrupts are not obsessive wealth maximsers (Sullivan et.al., 1989, pp. 243)[10].

The structural model is consistent with the idea of a rational individual, but it posits that the individuals may not have flexibility to act strategically due to their situational limitations as they do not have too many options between different opportunities. The behavioural model employs social psychology to adapt the assumptions of the rational individual model. Individuals are characteristically disposed to over-optimism, and their preferences are circumscribed by present-biases, restricting their reaction to regulatory incentives. This trait encompasses incentives for strategic welfare abuse, as well as those targeting to counter such abuse. The proponents and opponents of liberal personal insolvency law are influenced by these contrasting approaches, and several concepts such as means test and anti-abuse provisions are routinely advanced in the effective framework for personal insolvency. If the structural or behavioural debtor models were valid, the legal framework would have been structured on the concept of social insurance, whereby the legal framework for debt forgiveness should assign risk between the debtor and her creditors with a view to easing the *ex-post* effects of financial failure. *Per contra*, if the strategic actor model was valid, the law would also create *ex-ante* motivations, including those for avoiding the strategic abuse.

Considering the Indian situation, it would be fair to assume that the image of the average potential applicant does not match with the concept of a strategic individual, but rather he is part of the most vulnerable groups in society. As structural debtors, they enter into insolvency situation because they are the sufferers of financial shocks, or, as behavioural debtors, they are the victims of their own behavioural biases as they overly estimate their repayment capacity. The Situation Assessment Survey of Agricultural Households in NSS 70$^{th}$ Round (January, 2013 - December, 2013) looked at the level of living of farm households as measured by household consumer expenditure, income, productive assets, their indebtedness, farming practices, farming preferences, resource availability, their awareness of technological developments and access to modern technology in the field of agriculture. Nearly 70 per cent of India's 90 million agricultural households spend more than their income on average each month,[11] pushing them towards debt. These households, who spend more than their earnings, own less than 1 hectare of land. The economic stress of such farm households is exacerbated by additional loans that such households take to address the health issues, leaving them with a reduced capacity to invest in the farm business. While the outstanding loans for health related issues doubled over a decade to 2012, the loans for the farm business decreased by about half during the same period. The expenditure incurred on the productive assets used in the farm and non-farm business by the agricultural households belonging to the bottom 80 per cent in terms of monthly per capita consumption expenditure was reported to be lesser than that of the all India average. The reported expenditure on the productive assets for these households during July, 2012 - June, 2013 ranged from about one-fourth to two-third of the all India average of Rs. 1087. The survey revealed that about 52 per cent of the agricultural households in rural India were estimated to be indebted. The average amount of outstanding loan per agricultural household was estimated to be about Rs. 47,000. These facts emphasise the importance of undertaking complementary policy reforms to supplement the social insurance policy of 'fresh start'.

The above description of the situational analysis of the indebtedness points towards the existence of the market failure rationale, which justifies the 'fresh start' to the debtors freeing them from the sub-optimal bargains formed by the imperfect credit markets. It is argued that information asymmetries between lenders and borrowers and behavioural biases of consumers will systematically produce inefficient credit contracts[12]. Consequently, the costs of over-indebtedness are not just shared by parties to credit transactions but also by third parties, implying that rather than implement market allocations, personal insolvency could lead to internalisation of negative externalities. These social costs are diverse, including the cost to the public social welfare systems in providing for the basic requirements of the financially stressed households. The established relationship between debt and health problems implies that ubiquitous over-indebtedness may also strain healthcare systems.

The preponderant concerns of policymakers[13] are broader systemic macro-economic costs of over-indebtedness. Chronic indebtedness may reduce employees' economic productivity, forcing debtors out of the workforce, either by making work uneconomical or through problems caused by ill-health, which may make employees unfit for work. By allowing debt relief, the law reallocates costs of over-indebtedness from debtors to creditors, who have greater capacity to avert default from occurring (through the efficient credit appraisal of borrowers) and bear costs of the default. This enables efficient redistribution and internalisation of social costs of credit markets and induces creditors to reduce incidence of default and over-indebtedness.

While the overarching logic of social insurance aspects of personal insolvency law has been generally accepted, there are two major objections that may come in the way of full adoption of debt relief[14]. These are moral hazard and credit market impact. The mitigating policies to address the first objection include imposing reasonable restrictions on debtor access, investigation and probable sanction of guilty debtors, and the debtor's sacrifice to creditors of non-essential income and assets. A second perpetual objection to introducing debt relief reforms is the claim that they will increase the cost of and reduce access to credit[15]. The counter argument is more nuanced. It asks, considering the experience of great recession and 'debt overhang', whether a reduction in less costly household credit would adversely affect economic activity more than the fall in demand caused by overly leveraged households' declining consumption[16]. Viewed from these perspectives, personal insolvency law may reduce debt flows and ensure that credit markets' costs are internalised through truer pricing, rather than implement market bargains indiscriminately.

A major policy issue unearthed in the global proliferation of personal insolvency law reforms during the last 30 years relates to the debtor with little income and meagre assets who may be unable to afford bankruptcy in those jurisdictions where access to the individual bankruptcy system is not costless. These 'Low Income-Low Asset' debtors (LILAs) or 'No-Income-No Asset' debtors (NINAs) may represent a multitude of debtors globally, and the World Bank identifies this group as a policy challenge. The NINA phenomenon raises questions of structure and financing of debt relief. While bright-line rules and criteria exist, such as individuals with no significant realisable assets and no disposable income to repay debts, or with income below a certain level, there is an apprehension that they may be over or under inclusive. The 'fresh start' process under the Insolvency and Bankruptcy Code, 2016 (IBC) provides a composite criteria of income, assets, and the outstanding debt, and these need to be flexibly fixed. There may be a question if a sole proprietorship should be distinguished from individual debtor as there may often be a mixture of business and household debt in sole proprietorships. It is felt that there may not be a solid reason in principle to eliminate sole proprietors from access to the NINA Procedure. The World Bank identifies five approaches[17] to the financing of personal insolvency systems: (a) state funding of the process (including both creditor and debtor costs); (b) cross subsidisation of low value insolvencies by higher values estates; (c) state subsidies to professionals involved in the process and writing off court costs where there is an inability to repay; (d) levies on creditors, such as taxation of distressed debt to fund these cases where individuals have no ability to pay; and (e) no state support beyond any general public good funding of the court system. Considering the need to have an efficient and timely discharge of indebted individual debtors, an administrative adjudication framework, funded with state financing, is more desirable compared to the tribunal based adjudication system under IBC. This would also enable equality of access to small but highly indebted individuals compared to other resource-rich debtors who have greater access to the insolvency system.

The experience of the simplified and administrative adjudication mechanisms for personal insolvency systems in other countries indicates that, although it is a simplified procedure, the access of individuals may be greatly facilitated from the support of a professional intermediary to prepare applications and pilot through the system. The adjudication process for the fresh start may be greatly facilitated by online technology and may also reduce costs, but vulnerable debtors may still require face-to-face help in completing the simplified fresh start process. Therefore, going beyond the mediation and judicial adjudication of personal insolvency, as recommended by the Working Group on Personal Insolvency, constituted by Insolvency and Bankruptcy Board of India, a completely administrative adjudication process with a cadre of adjudicators would be more efficient. These administrative officials would not only improve access but also acts as conscientious gatekeepers[18] to allow entry of only eligible applicants. The administrative adjudication mechanism should be supplemented with debt counselling of individuals applying for the 'fresh start'. A longitudinal study in the UK by Gaby Atfield, Robert Lindley, and Michael Orton (2016) found[19] that although debt counselling may not in itself have enabled people to become debt-free, it helped them to manage their finances until their personal circumstances changed. The participants who thought that they were 'managing' their debt, generally through payment plans and cautious money management, found debt advice principally valuable in helping them live with the experience of being in debt, often over a long period of time. For many of those who were still in debt at the end of the project, debt advice tried to focus on avoiding crises and helping them to manage the experience of living in debt.

However, it is argued by some experts that the fresh start is an incomplete tool to alleviate financial distress. Using primary longitudinal data, Katherine Porter and Deborah Thorne (2006)[20] examine the fresh start concept against the realities of life after bankruptcy. They found that just one year after bankruptcy, one in four debtors was finding it difficult to pay routine bills, and one in three debtors was reportedly either in the financial situation similar to or worse than when that debtor applied for bankruptcy. Their analysis established that regular and sufficient income is important to improved post-bankruptcy financial health. Factors that caused decline in household income, such as unemployment and underemployment, illness or injury, and old age, weaken the chances of financial recovery. They conclude that bankruptcy is an incomplete instrument to rehabilitate those in financial distress and propose adjustments to bankruptcy law and social programs that will improve the fresh start outcomes for individuals after financial failure.

In another study, Katherine Porter (2010) found[21] that even after the debt discharge, the consequences of bankruptcy continue. The bankruptcy transforms the borrowing behaviour. After bankruptcy, the overall credit use by such bankrupt households is restrained compared both with other Americans generally and with pre-bankruptcy borrowing of such households. While the modest use of credit could signify a difficulty in accessing credit markets, it is an indication of self-inflicted restraint on bankruptcy debtors, even in the face of enticement by lenders and the continued financial stress of such debtors. This indicates that people who have suffered financial failure may curb their future economic activity.

The longitudinal studies indicate the centrality of income augmentation policies to supplement the fresh start in India. The behavioural self-imposed restraint on accessing fresh credit even when such access is provided by lenders, further continuance of bankruptcy details on the credit registry system over a long period, say, beyond five years, would all reduce credit access of bankrupt individuals. NSSO Situational Assessment Survey brought out the income-expenditure gap and the decline of productive investment of small farm households owing to an increase in health related expenditure. Hopefully, the *Ayushman Bharat* and *Jan Suraksha* life-insurance schemes of the Government would alleviate the health expenditure related expenditure, encouraging productive expenditure by fresh start beneficiaries. In this context, it is important that the public policies should also augment investment in rural economy. Chand, Kumar, and Kumar (2012) estimated[22] the total factor productivity (TFP) for major crops in India for the period of 1975 to 2005 and its critical importance in increasing agricultural production. They had precisely analysed how investment in agricultural research encouraged TFP across crops. They found that with an increase in investment in agricultural research, the real agricultural production costs declined in the range of 1.0 - 2.3 per cent. The Internal Rate of Return of investment in agricultural research was assessed at 42 per cent., and this gave a fair possibility for a positive investment scenario in Indian agriculture. If the targeted growth rate of production in agriculture is to be achieved, a substantial proportion of that would come from TFP Growth. Contribution of agricultural research to the realisation of self-sufficiency in food and growth in TFP as well as high payoff to investment in agricultural research and extension are solid justifications for adequate funding for research and extension in agriculture. Therefore, a much higher allocation of public resources to agricultural research system of the country would be necessary to achieve higher TFP growth in agriculture and augmenting incomes of farm households.

The above analysis demonstrated the usefulness of the fresh start process to alleviate the individual indebtedness in India. It would be appropriate that the process is simple and cost-effective with some element of debt counselling. However, in view of the evidence collected in the longitudinal studies, the fresh start as a social insurance instrument needs to be supplemented by other social insurance policies. Such studies may be conducted in India also on a regular basis to make the course correction in framing and modifying the social protection policies. However, any debt-free life after the fresh start cannot be imagined without focussing on income augmentation policies for such financially distressed individuals. This holistic approach would not only be welfare-enhancing for financially distressed people but would also alleviate the debt overhang problem and would be growth-promoting.

## NOTES

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