Box B: The Use of Debt Agreements as an Alternative to Personal Bankruptcy

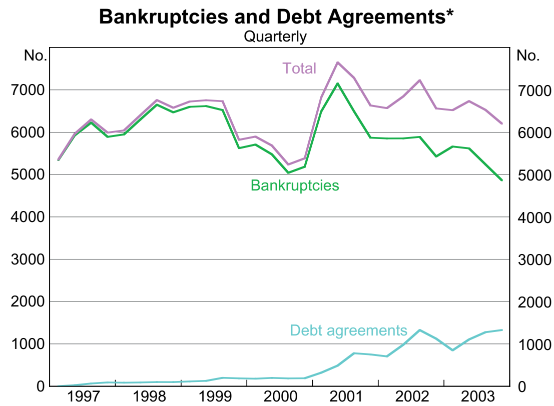
In recent years there has been growing use of debt agreements as an alternative to personal bankruptcy. A debt agreement is a statutory agreement whereby a debtor agrees with creditors to pay a specified amount over a specified period in satisfaction of the total debt. The increased use of these agreements reflects their relatively low cost and the extra flexibility they allow low-income earners with small amounts of unpaid debt, as well as their active promotion by debt-relief agencies.

Debt agreements were introduced into the *Bankruptcy Act* in 1996 to allow debtors who had a small amount of debt outstanding, a limited number of creditors, limited assets and low income to avoid bankruptcy. To arrange a debt agreement, a debtor must develop a debt agreement proposal, which may be devised in consultation with a debt agreement administrator, financial counsellor, private trustee or family friend. Together with a statement of the debtor's financial position, the proposal is then lodged with an office of the Insolvency and Trustee Service Australia (ITSA). If ITSA decides that the creditors' interests are best served by the agreement, it will arrange a meeting of the affected creditors. If the debt agreement is subsequently accepted by a majority of creditors in number and at least three-quarters in value of those voting, the debtor is released from all provable debts, and creditors – even those who voted against the proposal – cannot take any recovery action against the debtor further to that already determined by the agreement.

The number of individuals entering into debt agreements has grown substantially over the past three years, from around 200 per quarter in 2000 to around 1 300 per quarter in the second half of 2003 (Graph B1). Debt agreements are now equivalent to around one-quarter of the number of personal bankruptcies.

Debt agreements can be a better option for debtors than bankruptcy because they allow debtors to remain in charge of their own financial affairs, their credit rating is likely to be less adversely affected, and they are able to retain their assets.

Graph B1



* Provisional figures.
Source: ITSA

Debt agreements are also usually favourable from the creditors' point of view. Creditors have typically recovered an average 80 cents in the dollar where a debt agreement is in place, as opposed to 50 cents in the dollar (or less) after an individual files for personal bankruptcy. Despite this, around 40 per cent of debt agreements are terminated early, usually because the debtor has failed to meet repayment obligations.

Data on debt agreements and bankruptcies combined show a less pronounced fall over the past few years than that in bankruptcies alone. There is some risk that increased availability of debt agreements may lead households to increase their borrowing on the view that it is less costly to walk away from their obligations. Nonetheless, by allowing a more flexible means of dealing with potential default, debt agreements may ease the resolution of household financial distress which would support overall financial stability. It remains to be seen which of these considerations will be more important.