Fresh Start in Bankruptcy

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Fresh start

- The opportunity to begin a new financial chapter
- The term is used in the context of “discharge” – how many years does an individual have to wait before being discharged of debts.
- This typically includes an element of *debt forgiveness*

Models of fresh start

- Conservative camp
  - No bankruptcy protection for non-merchant individuals (e.g. Brazil)
  - Individuals can petition for bankruptcy, but not entitled to debt forgiveness (e.g. Czech Republic)
- Moderate camp
  - Consumers can apply for forgiveness, but no guarantee that it will be granted (e.g. most European countries)
- Liberal camp
  - Forgiveness offered with a high degree of certainty, and relative promptness (e.g., Chapter 7, USA)

Concerns of abuse

BAPCPA in 2005 in the US which limits and regulates access to debt relief

- means-testing
- limit repeat filings
- place limits on and create new protections for involuntary creditors

Discharge vs. Waivers

- “Fresh start” is used in the context of “discharge”
- Another concept is complete “waiver”.
- For example Debt Relief Orders (DRO)
- In the UK, this is designed for those with relatively low levels of debt and few or no assets
- Discharge after twelve months apart from certain excluded debts, however remains on credit history for six years from the date of the order.
- No distribution to creditors

Part I

Evidence on fresh start

Why fresh start?

- Social insurance: To relieve financial hardship
- Risk taking: To promote entrepreneurship
- Cost: To prevent incurring the costs of the procedure, when recoveries are likely to be lower.

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The big question

What is the impact of the policy of fresh start on

- Social insurance function?
- Entrepreneurship?
- Cost of credit?
  - To the once-bankrupt (who has used the fresh start provision previously)
  - To a new borrower (who could potentially get a fresh start)

Social insurance function

Porter and Thorne (2006)

- Assess how families fare in the year after their bankruptcies
- Interview 359 debtors one year after bankruptcy filing
- More than one-third reported similar or worse financial situations
- This was because of lack of adequate steady income.
- It matters why a person entered into bankruptcy!
- Two factors have been important in the US for the rise in consumer bankruptcies: a) job loss and b) medical expenses.

Entrepreneurship

- Fan and White (2002)
  - Exemptions on assets that are sheltered from Chapter 7 vary by states in the US.
  - Use this variation to test if individuals are more likely to be entrepreneurs if they live in states with higher exemptions.
  - They find probability of households owning businesses is 35% higher in states with higher exemptions
- Armour and Cumming (2008)
  - Investigate the relationship between bankruptcy laws and entrepreneurship data
  - Use data from 1990-2005 on 15 countries in Europe and North America
  - The more “forgiving” personal bankruptcy laws are, the higher seem to be the self-employment rates.

Cost of credit to the once bankrupt

Cohen-Cole and Duygan-Bump and Montoriol-Garriga (2016)

- Available consumer credit does decline
- But this decline becomes insignificant within 18 months.
- 65% of individuals in the lowest credit score bracket receive more credit after bankruptcy
- Some reasons:
  - Lenders quickly offer credit after bankruptcy – rely on riskier households as a source of revenue through penalty interest rates and fees.
  - Individuals have cleaner balance sheets after bankruptcy, than those who did not file.

Cost of credit to new borrowers

- Surprisingly little evidence.
- Partly because rising bankruptcy has occurred in an environment of deregulation of credit markets, and greater technology use
- This has meant that credit is now given to a lot more people. Termed as "democratisation of credit" (Livshits, MacGee, and Tertilt, 2014)
- There seems to be some effect – stricter bankruptcy regimes lower cost of borrowing
- But they take away bankruptcy's role as partial insurance against bad otherwise uninsurable shocks.

In summary

- Some impact as social insurance
- Greater evidence on impact on entrepreneurship
- Limited impact on cost of credit – impact goes away after some time.
- Not enough evidence on overall cost of credit – partly because of credit booms because of deregulation and technology.

Part II

India and the IBC

The debt situation

- All India level, banks share of loans is 37%
- Large presence of informal sector loans
- Continued presence of money-lenders
- Low average size of a loan

Loan waivers and their costs

- History of loan-waivers.
- The last big waiver was the 2008 Debt Relief Program for Small and Marginal Farmers
- Kanz (2012)
  - This loan waiver did not affect savings, consumption and investment
  - Lead to greater reliance on informal financing.
- Gine and Kanz (2014)
  - Post-program loan performance declined faster in districts with greater exposure to the program
  - Loan defaults become significantly more sensitive to the electoral cycle
  - Anticipation of future such interventions leads to moral hazard.

The need in India

- Social insurance function – several households may be too poor to be able to repay
- The costs of bankruptcy may be higher than recoveries for these households.
- Moral hazard from random waivers is high – also politically motivated.
- Need for a quick discharge when an IRP/bankruptcy is entered into to promote entrepreneurship
- A system that provides for
  - Quick and predictable discharge from debts
  - Quick and predictable "waivers" when the household is indigent
  - Discharge and waivers are not "free" - the household bears some cost

Fresh start in the IBC

- Fresh Start
  - Complete debt forgiveness.
  - Thresholds coded in the law.
  - Recorded for a short period of time.
- Discharge
  - Quick discharge in IRP – negotiable between creditors and debtors.
  - Twelve months to discharge in bankruptcy
  - Recorded for a short period of time.

Speculating

- Reasonably large “fresh starts”.
- Fintech, small banks, P2P lending should not affect credit availability
- Quick and predictable discharge should serve as social insurance, as well as promote entrepreneurship.
- Problems with hardcoded thresholds
- Real challenge is in the implementation.

Questions/Comments?

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