

Where credit's due

The number of individual bankruptcies in the UK is rising, helped in part by the Enterprise Act 2002. The effect of the new law has been to the detriment of creditors, with debt write-offs rocketing, writes Taylor Wessing's Neil Smyth for *Legal Week*

It is the start of a new year, a time for post Christmas depression, dreary weather and the arrival of credit/store card bills detailing Christmas spending we had been trying to forget.

Debt and bankruptcy are currently making headline news. Consumer debt passing the £1,000 billion mark in August 2004 (it currently stands at £1,148 billion and is increasing at a rate of 10% per year) was well publicised, as are the bankruptcy figures released by the Department of Trade and Industry every quarter. Bankruptcy has even made two appearances on Tonight with Trevor McDonald in the past year; fame indeed.

For the year to September 2005, bankruptcies in England and Wales totalled in excess of 45,000 and figures released this month are likely to confirm total bankruptcies for 2005 in excess of 60,000 - an increase of 33% on last year. An adverse credit rating for six years from bankruptcy does not seem to be deterring people from the bankruptcy route.

The number of bankruptcies has been increasing for the past few years, and predictions that the reform in bankruptcy legislation brought about by the Enterprise Act 2002 (EA) (which came into force on 1 April 2004) would accelerate this rise appear to be correct. This is ironic given that this legislation was supposed to encourage entrepreneurs, but is rather benefiting those who live beyond their means through credit.

In the US, bankruptcy legislation introduced in 1978, on which the EA was partly based, has resulted in an increase in the number of bankruptcies from 280,000 in 1980 to 1.6 million in 2004. This legislation was amended and tightened in the US last year, following pressure from financial

institutions. However, as a result of many wanting to avoid the new legislation, before it came into force in October, more than two million people (equating to one in every 50 households) went into bankruptcy in the US in 2005. In the past decade, the number of Americans filing for bankruptcy has doubled and US\$40bn (£22bn) in consumer debt has been written off every year.

It seems therefore that further increases in the number of bankruptcies in the UK are on the horizon. Many predict bankruptcies in excess of 100,000 by 2007 and if the rise continues at the current rate, that seems inevitable.

The purpose of this article is not, however, to add to the column inches of comment on the effect of the EA on debtors and bankruptcy numbers, but rather to briefly look at the effect this legislation is having on creditors, and also the general public.

The principle of bankruptcy is the realisation of a debtor's assets by a third party, a trustee in bankruptcy, for distribution to the debtor's creditors. Logically therefore, if a debtor has no assets, then there will be no distribution to creditors.

The EA, in an effort to increase entrepreneurship and to reduce the stigma associated with bankruptcy, has made it easier for individuals to petition for their own bankruptcy (which seems to be working as 80% of bankruptcy petitions are being presented by debtors, rather than

creditors), has reduced the sanctions that arise as a result of bankruptcy and has lowered the period of bankruptcy from three years to a current average of eight months.

This last reduction may be significant in 'asset free' bankruptcies as it is only during this period that a trustee in bankruptcy can apply for or agree income payments and/or realise valuable property obtained by a debtor after the bankruptcy order was made.

As the profile of an average bankrupt has changed from a middle-aged house-owning sole trader struggling to pay his tax to a 20-something with no substantial assets enjoying a lifestyle on credit they cannot afford, the return to creditors on bankruptcy, which has never been high, is dwindling.

Recent surveys suggest that in more than 80% of bankruptcies, there is no return to creditors. As the bankruptcy figures increase, fuelled by the reforms brought in by the EA, the return to creditors will inevitably therefore reduce and debt write off increase.

Quite a simple conclusion, but the ramifications of the reforms and increased bankruptcies do not stop there.

It is estimated that 60% of all bankruptcies in England & Wales relate to consumer debt. Provision made by financial institutions for

As the profile of an average bankrupt has changed from a middle-aged house-owning sole trader struggling to pay his tax to a 20-something with no substantial assets enjoying a lifestyle on credit they cannot afford, the return to creditors on bankruptcy, which has never been high, is dwindling

Berlin

Jägerstrasse 51
D-10117 Berlin

Tel +49 (0)30 88 56 36 0
Fax +49 (0)30 88 56 36 46

Brussels

Trône House
4 Rue du Trône
B-1000 Brussels

Tel +32 (0)2 289 6060
Fax +32 (0)2 289 6070

Cambridge

24 Hills Road
Cambridge CB2 1JW

Tel +44 (0)1223 446400
Fax +44 (0)1223 446401

Düsseldorf/Neuss

Königsallee 92a
D-40212 Düsseldorf

Tel +49 (0)211 83 87 0
Fax +49 (0)211 83 87 100

Am Krausenbaum 42
D-41464 Neuss

Tel +49 (0)2131 7 40 30 0
Fax +49 (0)2131 7 40 30 50

Frankfurt a. M.

Senckenberganlage 20-22
D-60325 Frankfurt a. M.

Tel +49 (0)69 971 30 0
Fax +49 (0)69 971 30 100

Hamburg

Neuer Wall 44
D-20354 Hamburg

Tel +49 (0)40 3 68 03 0
Fax +49 (0)40 3 68 03 280

London

Carmelite
50 Victoria Embankment
Blackfriars
London EC4Y 0DX

Tel +44 (0)20 7300 7000
Fax +44 (0)20 7300 7100

Munich

Isartorplatz 8
D-80331 Munich

Tel +49 (0)89 2 10 38 0
Fax +49 (0)89 2 10 38 300

Paris

42 avenue Montaigne
75008 Paris

Tel +33 (0)1 72 74 03 33
Fax +33 (0)1 72 74 03 34

Representative offices:**Alicante**

Paseo Explanada de España No. 1, 4-Izda E-03002 Alicante, Spain

Tel +34 (0)96 51 42 805
Fax +34 (0)96 52 00 248

Shanghai

15th Floor United Plaza
Unit 1509
No. 1468 Nanjing West Road
200040 Shanghai, China

Tel +86 (21)6247 7247
Fax +86 (21)6247 7248

Associated office:**Dubai**

www.keydixon.com

www.taylorwessing.com

bad debt runs into billions of pounds each year. However, despite the write offs and press criticism, financial institutions are continuing to make profits; so what effect does this have on those who do pay their debts?

Two possible reactions by financial institutions are to recoup their losses by increasing their charges or alternatively to reduce the risk by tightening their credit policies. There has been recent press coverage on both of these issues.

Various credit card companies have recently agreed to share information with credit reference agencies as well as themselves, with a view to identifying poor credit risks, and it is claimed that the larger financial institutions are becoming stricter in their lending policies.

It therefore appears that credit will be harder to come by in the future and this is supported by recent statistics from the Bank of England that, in November 2004, the rate of growth in consumer credit fell to its lowest level since 1994.

As for increased cost of credit, just before Christmas, the Competition Commission raised concerns about the level of interest rates on store cards and recommended that cards with interest rates in excess of 25% per annum should carry warnings alerting customers - so called 'wealth warnings'. Despite a competitive market, a recent survey has also shown that credit card default charges have increased by 40% in the last three years.

Consumer debt and bankruptcies continue to increase however and if, as many anticipate, the UK market follows the US, then bankruptcy numbers look likely to continue to rise. Assuming that consumer

debt accounts for the same, if not a higher, proportion of those bankruptcies, consumer debt write off also looks set to continue to rise.

This is likely, in turn, to affect the general public's ability to obtain credit and may result in an increase in the cost of credit. If costs do escalate then this will, in turn, increase consumer debt and possibly bankruptcy numbers; good news for the various debt consolidation companies for which other peoples' debt is big business, bad news for the consumer debtor.

It is not just creditors therefore who will continue to be adversely affected by an increase in bankruptcies and debt write off, caused in part by the bankruptcy reforms introduced by the EA. Those individuals who are able to manage their financial affairs and live within their means will equally be affected.

This article was authored by Neil Smyth and was first published in *Legal Week* on 2 February 2006.

Legal Week



Neil Smyth

Tel +44 (0)20 7300 4921
Email n.smyth@taylorwessing.com

© Taylor Wessing 2006

This publication is intended for general guidance only and no responsibility is accepted by Taylor Wessing for any errors or omissions. The information in this publication should not be relied upon to replace professional advice on specific matters.