Corvinus

CORVINUS UNIVERSITY OF BUDAPEST

CEWP 02/2020

# Personal Bankruptcy: Model structures and the fresh start

György Walter

http://unipub.lib.uni-corvinus.hu/5681

# Personal Bankruptcy: Model structures and the fresh start*

György Walter**

Ph.D., Habil, Associate Professor, Department of Finance, Corvinus University of Budapest

Date: 14/05/2020

## Abstract

Though it seems as if personal bankruptcy regulation was a new legislative solution of the last decades, handling personal bankruptcies has a long history and broad legislative background. The need for implementing a modern regulatory framework for handling personal bankruptcies goes back to the second part of the 20th century, when personal, consumer lending reached a massive volume, and non-performing defaulted portfolios resulted in serious macroeconomic, social, and political impact. Many countries have introduced measures to handle defaulted personal loans, and personal bankruptcy regulations were launched in most European countries during the last 30 years. Though structures are different, the general elements of such systems could be outlined. One of the most disputed principles of the systems is the handling of "fresh start" and the implicated degree of the "leniency" of the systems. In this working paper, I present the brief history, the structural elements of personal bankruptcy regulations, and the building blocks of the fresh start. I also discuss three different legislative solutions: the US, the Austrian, and the Hungarian model. I conclude that there are continuous changes in the systems regarding the handling of fresh start. While the US legislation moves to the less lenient direction, there are measures from European countries to change the laws to more debtor-friendly systems. The Hungarian version was created to follow the strict, less lenient structures in a time when some countries in the region moved towards more lenient systems.

*JEL codes: K35, G33, G18, G51*

*Personal bankruptcy, government policy and regulation, fresh start*

* "This research was supported by the Higher Education Institutional Excellence Program of the Ministry of Human Capacities in the framework of the 'Financial and Public Services' research project (NKFIH/116310/2019) at Corvinus University of Budapest."

** Contact: gyorgy.walter@uni-corvinus.hu

# History of personal bankruptcy

Going back to the history of personal bankruptcy, individuals who filed for bankruptcy were handled extremely harshly. The default was considered as a criminal offense, and –depending on the society, country, religion, and historical era – seduced different arts of punishment like forfeiture of all property, revocation of citizenship, forcing to sit in public and place baskets, wear distinguishing clothes in public, selling defaulters into slavery, forcing them into exile, a prohibition from holding public office, imprisonment, and even death penalty (Efrat, 2006)

Paying back debt obligation was many times regarded as a strict moral or religious obligation. Failing this obligation resulted in a *bankruptcy stigma*, which is a crucial element in initiating and handling bankruptcies since ancient societies until modern economies of today. However, religion and moral standards were not always enough to rule everyday life. Formal rules and regulations were also required to handle insolvency and bankruptcy issues. As the brutal attitude of handling bankruptcy had not changed until the 19th-20th century, the bankruptcy laws were also typically very harsh. Legislators usually gave very strong incentives to fulfill debt obligations. Examples could be mentioned from ancient times, from early Roman law, Babylonian or Mesopotamian times, traditional Chinese, or Jewish societies. These regulations and practices were examples of the so-called "debt bondage", involuntary servitude of the debtor. (Robe-Steiger, 2015) Specific law gave creditors the additional right to sell defaulted debtors assets in Venice in the 12$^{th}$ century, which was a new element besides debt bondage. However, the regulation and its main attitude of handling bankrupted persons have merely changed in the Middle age, although a new institution was introduced: instead of using debt bondage, debtors' prison became widespread, serving as an incentive to force payments.

The negative and harsh treatment of bankruptcy was maintained in colonial America and the Victorian era. (Efrat, 2006) The first US bankruptcy law was introduced in 1800 based on English law. It was adapted to handle commercial loan files, in favor of the creditors. However, since the very end of the 19th century (since 1898) even non-commercial debtors have been able to file for personal bankruptcy proceedings in the US, where a debt release was also a possible outcome. (Robe-Steiger, 2015) Important to mention, that the legislation had always difficulties in making formal differences between the case of commercial loan and a personal loan. Until the second part of the 20$^{th}$ century, there was no legislative distinction between a commercial or personal bankruptcy. The default of a commercial loan was handled less rigorously as it was regarded as a riskier deal and contract. Ancient and medieval bankruptcy laws applied only to commercial loans in almost all cases.

In legislation, it was also a permanent question of how to make a difference between responsible (getting into trouble due to external factors and were unlucky) and culpable borrowers (who were irresponsible, greedy, malicious). These struggles and disputes are still

present in the debates of different legislative solutions for treating personal bankruptcies, defaults, and fresh start. The historical change of how the society and legislators regarded the issue of personal responsibility of the debtor has significantly affected the development of personal bankruptcy legislations. (Robe -Steiger 2015)

By the 1960s the number of consumer loans, debtors, and defaults had risen dramatically, which changed the attitude in the economy and society towards filing for bankruptcy and the defaulted debtors. Besides critics about the declining moral and economic pressure to handle the increasing number of cases had also become evident. (Efrat, 2006)

## Legal regulation, grouping alternatives

Before1979 the bankruptcy legal regulation in the US was based on the law of 1898. Since 1979 several changes have been implemented in the legislation and the actual law currently referred to as “Bankruptcy Code”. The last significant and notable change was made in 2005 with the implementation of the so-called BAPCPA – Bankruptcy Abuse Prevention and Consumer Protection Act. (Wagner, 2006)

From the 1980s personal bankruptcy regulations and loans were implemented one after the other in the Western European countries: Denmark (1984), Great Britain (1986), France (1989), Sweden (1994), Germany (1994), Austria (1995), Finland and Norway (1994), Belgium and the Netherland (1998-1999), Ireland (2013). From 2000 further countries have introduced personal bankruptcy legislations in Central Eastern Europe too: Slovakia (2006), Czech Republic (2008), Poland (2009), Hungary (2015), Romania (2018). Furthermore, personal bankruptcy regulation also exists in Italy, Portugal, Slovenia, Greece. Baltic countries have implemented the regulatory framework during the last 10-15 years. (Báger, 2015; Győri, 2009; Wagner, 2006)

From a legal point of view, there were two solutions in European countries. It was either the general bankruptcy (or customer protection) regulation that was extended to handle personal bankruptcy (like in Germany or Austria) or a new law was implemented and accepted specifically to handle personal bankruptcy (like in Ireland or Hungary) (OH, 2016). There is an EU (EU 2015/848) regulation on insolvency procedures to avoid the so-called "forum shopping”, the arbitraging opportunities among different county regulations.

In current terminology “*personal bankruptcy law is the legal process for resolving the debts of insolvent individuals, married couples, ... entrepreneurs, and small business owners*”, usually referred to as filers. (White, 2015 pp.3)

The key points, characters in grouping and characterizing the different bankruptcy laws, models and legislation of countries are as follows[1]:

1 IM (2005)

1. Based on the start of the procedure, eligibility criteria:
   - who is entitled to participate, to file for in the process (natural person, private entrepreneurs, special conditions, limitation due to former procedures);
   - who is entitled to initiate procedure (creditor, debtor, or legislation);
   - what the preconditions are (barriers in wealth, income, collaterals, status to start the process);
   - what the preconditions of the debt are (types of debt, volume);
   - validity for non-consumer type obligations (alimony, penalties);
   - whether it can be started in case of overdue obligations or for imminent insolvency;
   - how expensive the procedure is, and who bears the cost (fees, other costs).

2. Based on events and activities during the process
   - who conducts the process (bankruptcy offices or committees, court, municipality);
   - are all creditors included;
   - the way of reaching bankruptcy agreement (majority decision of debtors, composition proceedings);
   - the properties included in the repayment (total of properties available, or properties under-enforcement, future properties);
   - the *exemptions* during the process (properties or future incomes that a debtor could prevent creditors from recovering);
   - the length of the process (length of moratorium, agreed repayment obligations);
   - the existence of other provisions against the debtor to force fulfill repayment schedule (ban to take up loans, control all incomes and expenses, investments).
3. Based on the end, the outcome of the procedure:
   - the length of the necessary repayment obligation period;
   - the level of necessary repayment benchmark for closing (as a percentage of debt);
   - the level of debt relief due to the participation (only moratorium or partial possibly full *discharge*[2]);
   - further possible administrative steps and measures (*stigmas*: limitation in taking up loans, appearance in lists, registrations, announcements).

There is also a grouping opportunity and philosophical difference based on the general approach of the law and procedure. Whose interests, the debtors or the creditors are more defended and represented in the process? In the US legislation, the debtors' rights and interests are/were more preferred than in continental European countries, where creditor friendly personal bankruptcy legislations were traditionally preferred. These different approaches lead to different related research fields, which are permanently discussed in the literature:

- moral hazard and the question of discharge and relief of debt, the question of "*fresh start*" and its potential abuse;

2 A release of a debtor from personal liability for a certain debt. (US Bankruptcy Code)

- bankruptcy as a type of *social insurance*; the role, and the relation of welfare states to personal bankruptcy;
- the relation of bankruptcy regulation and the *incentives for entrepreneurship, effect on labor supply;*
- *the stigmatization* of the participants.

These topics are closely related and overlapping each other, the certain attitudes and answers greatly influence the practical foundation and implementation of the given model.

## The "fresh start"

A central element of personal bankruptcy is the opportunity of a fresh start. The "fresh start" is thoroughly examined in the literature as a key factor leading to analyze the possible abuses, the direct connection to the social insurance, the necessity and role of stigmatization and punishment, and its relation to the incentives on entrepreneurship, labor market. The appearance of the fresh start is closely related to the level of the *leniency* of the given bankruptcy systems handling the defaults of private persons and entrepreneurs with unlimited liabilities.

A fresh start is an aggregative term that incorporates the following main blocks of the personal bankruptcy legislations:

1. The availability, the existence of **straight bankruptcy** (like Chapter 7 in the US regulation)
2. **Eligibility criteria**:
   - Who is entitled to participate, to file for in the process (natural person, private entrepreneurs, special conditions, limitation due to former procedures)?
   - Who is entitled to initiate a procedure (creditor, debtor, or legislation)?
   - What are the preconditions, barriers in wealth, income, collaterals, status to start?
   - What are the preconditions in debt (the art of debt, volume)?
   - Is it valid for non-consumer type obligations (alimony, penalties)?
   - Could it be started in case of overdue obligations or for imminent insolvency?
3. **Expensiveness** (transaction costs) of the procedure from debtor side
4. **The complexity of the process:**
   - Who conducts the process (bankruptcy offices or committees, court, municipality)?
   - How many types of creditors are included?
   - How is the way of reaching bankruptcy agreement (majority decision of debtors, composition proceedings)?
   - What is the usual length of the process (length of moratorium, agreed repayment obligations)?

5. **Exemptions** (based on threshold, property and income types, future incomes/properties)
6. **Conditions for discharge at debt restructuring:**
   - length of necessary repayment obligation, the settlement period;
   - level of necessary repayment benchmark for closing (as a percentage of debt);
   - level of debt relief due to the participation (only moratorium or partial possibly full *discharge;*
   - automatic discharge or conditional of a court decision.
7. **Stigmas** of filing and after filing:
   - existence of other provisions against the debtor to force fulfill repayment schedule (ban to take up loans, controlling all incomes and expenses, investments);
   - stigmatic name in legislation (bankruptcy, debt settlement);
   - further possible punishing administrative steps and measures (limitation in taking up loans, appearance in lists, registrations, announcements).

The list above partly corresponds to the main categories defined also by White (2007) who analyzed the systems of some selected countries (US, France, Germany, England, Canada). He compared the bankruptcy policies based on the trade-off between providing insurance to debtors versus punishing default. The seven categories for the selection he used were as follows: the amount of debt discharged, the asset exemptions, the income exemptions, the fraction of income above the exemption that debtors must use to repay, the length of the repayment obligations, bankruptcy costs, and the bankruptcy punishments.

The parameters based on the above-detailed categories show a large variety in the world but even among the European countries' legislative solutions. Efrat (2002) groups the countries in the world based on the "availability, certainty, and promptness of debt forgiveness". The first group is named "*conservatives"* where no discharge, no fresh start is available. Non-commercial personal defaulters are not allowed to file, or if allowed, no discharge is possible. In the second "*moderate group"* there is a chance for discharge and a fresh start, but whether it could be received, it is uncertain. Eligibility is strict, the process is not well-known, it could be expensive, and/or the fear of abuse is high. By the third group of "*liberals*", outcomes could lead quickly and automatically to a fresh start either via the straight bankruptcy or through repayment settlements.

The existence, the degree, the possible effects of a fresh start is heavily disputed in the theoretical and empirical literature of personal bankruptcy. One of the central points of the disputes is the hypothesis that fresh start reduces the individual risk to start an entrepreneurial activity (an investment) as it offers a "*social insurance"* to debtors. Though it encourages entrepreneurial activity, it also increases moral hazard. Therefore, as risk shifts to creditors, the lenders may charge higher interest rates or ration credit supply ("*credit rational*") as they are afraid of recovering less of their credit, they face higher credit risk. The theory states (Alexandrov–Jimenez, 2017) that if consumer protection is reduced, there are three effects on debtors. Firstly, debtors lose some of their existing protections (influencing entrepreneurship

development). Secondly, there is an indirect effect of individuals receiving lower prices, which is embodied in lower the interest rates; thirdly, there is a demand-expansion effect leading a new debtor to enter the market (credit rational).

The clear objective of the fresh start in the bankruptcy systems is to encourage employees' work incentives, which intention was also confirmed by the statement of the U.S. Supreme Court at the creation of the legislation. (Chen–Zao, 2017, pp 40) Despite its importance, it is surprising, that – relative to the large number of studies examining the relation of fresh start, leniency, entrepreneurship, and credit rational – only a few papers analyze the relation of fresh start, credit rational, and labor supply. By focusing on labor incentives, there are also two inverse effects detected called "wealth effects" and "borrowing constraint effects". The wealth effect leads to reduce work efforts as debtors no longer need to work to pay back their debt and potential employees can be more selective in their job search. On the other hand, due to the borrowing constraint effect, defaulted individuals have limited access to borrowing due to their track record, and as they must work more to insure themselves against unexpected expenses. (Chen–Zao, 2017)

Finally, Jia (2015) states that the welfare impact on workers and entrepreneurs is diverse especially in Europe. It concludes that the treatment of bankruptcy due to default in business or consumption of workers should also be different. Given the large differences between the welfare impact on workers and entrepreneurs, policymakers of Europe should think about treating personal bankruptcies resulting from business failures and personal failures separately.

## Two basic model types: the US and Austrian systems

### The US model

The US model is one of the oldest systems among the modern personal bankruptcy legislative systems and regarded as one of the most lenient ones. Most of the literature relates the analysis of this system, concerning the necessary level of leniency, abuses, the effect on entrepreneurship, and the overall effect of fresh start.

In the US, the bankruptcy files currently proceed under the rules of the US Bankruptcy Code in federal courts. As usual in common law countries, besides the bankruptcy procedure for individuals, the legislation of corporate bankruptcy had been built as two different constructions incorporated by two different laws: the Bankruptcy Law and the Companies Act. Later, legislation unified the legislation into one Codex, however in two different chapters. (Wagner, 2006) (US Courts)

Based on the Bankruptcy Code there are two types of bankruptcy procedures (two chapters) an individual debtor can file. One is referred to as Chapter 7 the other is as Chapter 13. The

conditions of choosing between the two chapters changed notably in 2005 when the so-called BAPCPA[3] came into force, which made filing for Chapter 7 more difficult.

In general, if a defaulted person file for **Chapter 7**, the debtor, more precisely, an appointed trustee liquidates a portfolio of assets to pay back its obligation fully or partially. The assets under potential liquidation are defined by an exempt–non-exempt rule that varies across the states' regulations. If a liquidation of such liquid assets takes place, then the debtor will receive a discharge of most of the unsecured debt. Unsecured debts are credit card obligations, personal loans, medical bills, utility bills. The debtor is not allowed to file for Chapter 7 again during the next six years after the last filing. (US Courts) This model is like liquidation models of commercial loans for corporations adapted in most countries, also often referred to and named *straight bankruptcy*.

According to **Chapter 13** (Individual Debt Adjustment), debtor's assets remain unaffected, instead, debtors repay all or part of their debt based on their future income based on a so-called repayment plan. The repayment plan lasts over three to five years. After accomplishing the repayment plan, all remaining debts are discharged. A debtor is not allowed to file again under Chapter 13 for 180 days following the last filing. (Eraslan et al., 2014; US Courts)

Before the new law of 2005 debtors had the right to choose between the two chapters. There were many debates also in the financial literature before 2005 whether the lenient system had resulted in more economic welfare or had done harm due to increased moral hazard and credit rational. The stricter BAPCPA law imposed many changes, which have been also heavily disputed since 2005 now concerning the effect of moving to a less lenient system. The new law made fresh start more difficult from almost all aspects. It limited the choice between the chapters, made the bankruptcy process less debtor-friendly and the repayment longer. (Alexandrov–Jimenez, 2014) It introduced higher filing fees and a new test on debtors. The main objective of these changes was to reduce consumer protection, re-route debtors from Chapter 7 to Chapter 13, and to ensure that debtors with sufficient income would pay based on a repayment plan under Chapter 13. Chapter 7 has become an option only if the debtor has insufficient income, mainly compared to the state median income level. To decide whether the filing is "presumptively abusive" a so-called "mean test" is required, where an aggregated monthly income over 5 years is examined. The court may also dismiss a file for Chapter 7 – explained as an abuse – if an individual's debts are primarily consumer rather than business debts. In the case of filing for Chapter 13, the length of the repayment is also determined by the state median repayment level. If debtor's income is less than the state median, repayment could last for 3 years, if it is more, than generally for 5 years. (US Courts; Eraslan et al., 2014)

Regarding eligibility for Chapter 7, the debtor may be an individual, a partnership, or a corporation or other business entity (US Courts) with many limitations to individuals. However, after filing for Chapter 7, a discharge is only available to individual debtors, not to partnerships or corporations. The right to a discharge is not absolute, some types of debts are

3 Bankruptcy Abuse Prevention and Consumer Protection Act

not discharged. Moreover, a bankruptcy discharge does not relieve the lien on the property. Regarding Chapter 13, any individual, a self-employed, a person operating an unincorporated business, sole proprietorships are eligible for relief, if the unsecured debts do not exceed a given threshold of debt (currently about TUSD 400 unsecured debt and MUSD 1,2 secured debt). A corporation or partnership is not eligible for filing for Chapter 13. (US Courts)

Studies focusing on the functioning of the US bankruptcy model have discovered that there are many severe differences and disparities across states between the formal laws and the implementation of the laws in action. These differences are apparent despite the uniform federal legal regulation and mainly due to different legal cultures, attitudes, and practices of the government officials and other decisionmakers. (Efrat, 2003) Considering the appearance of fresh start, one major element of the discrepancy is the exemption level applied by the legislation. That could vary among the states and offers one of the most important bases for studies examining the effect of exemption level and the fresh start on the society and economy.

## The Austrian model

The Austrian model, launched in 1995, is a prototype for the continental legislative solution of handling personal bankruptcies in Europe until its reform of 2017. First, I present the original form of the system, then I focus on the main pillar of the reform, which substantially softened the strict construction of the procedure.

The system involves different options on how and where the procedure could continue based on the decision of the debtor, creditors, or the court/administration. In all procedures for starting any proceeding, a "good faith" is required, which is a recurring element of all personal bankruptcy procedures.

There is no option for straight bankruptcy. The starting point of the proceeding is arranged "out of the court", that existed before the law was created in 1995 and it is like the German legislative solution. It is an *amicable settlement*, basically a restructuring of the obligation based on an agreement between the creditors and the debtor. A repayment plan could be settled with a maximum length of 7 years, with a majority decision of the creditors, and in the case of successful completion of the plan with a discharge at the end. In this case, the debtor maintains its sovereignty in the management of his/her wealth, incomes, and costs to fulfill the agreed repayment plan, however official debt advisors are helping the process. (Győri, 2009; Hetes-Gavra et al., 2016)

If amicable settlement fails, there are different ways to follow the proceeding on the court. To apply for a judicial procedure the debtor must prove that the default occurred, its wealth covers the cost of the proceedings, and the amicable settlement failed. The possible first process is a "*forced composition*" ("Zwangsausgleich"). The debtor must offer to the creditors, that it pays back 20% in 2 years or 30% in 5 years of its obligation based on a

recovery plan. For approval a majority vote is needed, different thresholds are defined. In this case, there is no asset sale. (Győri, 2009; Hetes-Gavra et al., 2016; Wagner, 2006)

If the attempt for forced composition fails, the next possible proceeding is the *repayment plan* “Zahlungsplan”). In this case, the wealth, the assets of the debtor are registered, and sale is possible except for those, which are regarded as basics. Furthermore, a repayment plan of a maximum of 7 years must be prepared (no minimum recovery ratio is defined) and must be approved by majority voting of the creditors. During the accomplishment, the debtor still acts without the supervision of the creditor and receives a full discharge at the end of the successful completion of the plan.

If the repayment plan is rejected, then the final possible process is the *absorption process* (“Abschöpfungsverfahren”). A minimum income is determined by the court. Above this threshold, all payments are assigned to the officially appointed trustee and are directly transferred to the creditors. The process is under the supervision of the trustee and the creditors, the debtor must live on a minimum level. The length of the process is 3-7 years, and success and final discharge depend on the fact, how many percents of the obligation was paid back. In the case of 3 years, 50% of obligations (from sales and incomes) must be recovered. If the repayment within 7 years does not reach the 10% of unsecured obligation, there is no automatic discharge. It could take in force only based on a possible court decision based on inequity, however, the court could also lengthen the repayment period. (Győri, 2009; Hetes-Gavra et al., 2016) In this type of procedure, there is no need for the approval of the creditors, however, it is strictly controlled by the regulation and there are strict eligibility requirements for the filers (track record of another filing in the past, non-abusive, fair, responsible behavior). (Wagner, 2006)

Since the implementation of the first model, there had been several critics about the system due to its strict limitations and hurdles of a successful outcome. After decades of disputes, finally, a fundamental reform was implemented at the end of 2017. Several classic hurdles against fresh start – that are typical for European systems – were scrapped in the new model. The former circumstances concluded that low-income default filers have limited access to a procedure and had a low chance to gain a discharge at the end. The reform allowed that low-income filers can immediately proceed to the absorption process. The requirement in the absorption process was eased considerably, the minimum of 10% recovery was erased, the original 7-year long repayment period was shortened to 5 years. Besides these softer rules, allowances in the administrative cost were also introduced. (Kilborn, 2018) These measures were taken to move the legislation to a more lenient system and increase the number of filers.

## The Hungarian model

Legislative solution for handling the personal default existed in Hungary before World War II but was erases in the socialist regime. The idea of implementing a new legislative framework

appeared during the financial crisis of 2009 when the non-performing retail loan portfolio had increased dramatically. Furthermore, many neighboring countries in the region had already implemented personal bankruptcy legislation. (OH, 2016) The current Hungarian model was launched in 2015, its basic principles, objectives correspond to the continental models of Germany, Austria, Ireland, Spain. One of the most highlighted aspects of the model is to consider the interest of the creditors more, which is also typical for European legislation examples.

The usual principles for basic eligibility criteria are the amicable behavior, cooperativeness with the authority, and the creditors, and respect all laws and regulations. Objective eligibility requirements are strict and precisely regulated based on the types, structure of debts, and the volume of obligations. Obligations must come from products of personal loans, consumer loans, or the obligation of private entrepreneurship. Restrictive criteria, which must be all fulfilled, are e.g. the minimum and maximum amount of overdue debt[4] (HUF 2-20 million); its ratio to the wealth of the debtor (not more than 200%); structure (with an overdue obligation of a minimum of HUF 0,5 million, not more than five subordinated obligations). There is a list of disqualifying conditions mainly related to the presence of other similar procedures ongoing or in the past (criminal, legal procedures against the debtors, etc.).

There are three possible procedures (in due course) defined and available. Like the Austrian model, the first possible step is (1) *an amicable settlement*, the restructuring of the obligation based on an agreement among the debtor and creditors without juridical, court intervention. Court procedure could start only if the amicable procedure fails due to the failure of agreements, or because there is no major creditor. The practice of encouraging the amicable agreement is common in Europe (like in the UK, Germany, France, Austria). It is implemented as a procedure either outside the governmental institutional system or involved. (Báger, 2015; MNB, 2015)

The process must be initiated by the debtors by informing the major creditor (practicable the mortgage lender pledging the real estate). A special authority helps to accomplish a study about the incomes and wealth status of the debtor. The major creditor must accept the role of a coordinator for the agreement among the debtor and other creditors. The possible agreement is registered by the special authority. Though the control on the debtor is less strict, no trustee is appointed to control the everyday payments and incomes, and the real estate is not necessarily sold, there are strict requirements for the agreed repayments. Debtors are obliged to involve all their wealth and (future) incomes into the settlement procedure. Only a basic level of income could be spent on everyday living, no new obligation can be taken. Besides administrative fees, taxes, insurances, utility costs must be regularly paid, and a precisely defined minimum monthly debt service payment of the outstanding debts (initial market value of the real estate × (7,8%/12=0,65%) ) must be met. In the case of successful fulfillment of the agreement, the debtor is discharged from the obligations at the end.

4 In the UK the debt is not required to be overdue. (Győri, 2009)

The second step after the failure of amicable settlement is the (2) *judicial procedure*. Its first phase is the (2a) *debt settlement procedure* ("adósságrendezési eljárás"), which is managed by the trustee and the possible agreement is valid for all creditors participated in the procedure. It is finally (but not necessarily) approved by the court. The agreement includes all conditions, regulations of the repayments, possible sale-plan of pledged properties, the planned usage of incomes, maturities, controls, and possible restructuring, allowances.

During the accomplishment of the agreement, the life, incomes, spending of the debtor is highly controlled by the trustee mandated by the authority, having full control over the bank account, on incoming revenues and spending. A threshold for basic needs and spending is calculated (per person), and banking and cash transactions are approved based on these volumes. Real estate is not necessarily sold, it could be held or exchanged into a lower value real estate. All unexpected income, a new property must also be reported and turned to repayment. Any extraordinary payment must be approved by the trustee. Those creditors who did not join the agreement are not allowed to execute any collection activity against the debtor. There is a list of exemption of incomes and properties which represent and cover the basic needs of debtors and their families. Until the debt settlement procedure is accepted by the court, the minimum repayment obligation corresponds to the amount defined in amicable settlement (initial market value of the real estate ×(7,8%/12=0,65%)). Additional payment obligations, insurances, fees, taxes must also be paid. In exchange, the debtor receives bankruptcy protection against collection measures. If the debtors severely violate their obligation (act in bad faith, malicious acts, etc.) the procedure is invalidated, and former collection procedures could be continued.

If no agreement is achieved in the debt settlement procedure, then a new procedure starts within the debt settlement procedure, the so-called (2b) *debt repayment procedure* ("adósságtörlesztési eljárás"). Based on the proposal of the trustee, after a negotiation with the debtors and creditors, a *repayment plan* ("adósságtörlesztési terv") is elaborated and approved by the court. Repayment plan details the grouping and splitting of revenues and properties, it defines the exempted level of incomes, the properties for sale, the rules of sharing the incomes among creditors, the minimum incomes that could be used by the debtor, the repayment structure, all important tasks, and obligations. The repayment plan lasts typically for 5 years but could be lengthened by 2 years in case of approval of creditors. Houses, real estates could be held if "legitim reasons" exist, like creditors are not in active age, there are children (or family members over 70 years) in the family, or obligations do not reach the initial market value of the real estate. In the case of a sale, there is a possibility to buy a smaller home of a legitimate size, again, subject to the approval of the creditors.

Besides the cooperative, fair behavior of the creditors, the basic condition of the discharge is the fulfillment of minimum recovery of the creditors grouped in a different hierarchy (mortgage, privileged, other, subordinated). Major creditors are practically the mortgage lenders backed by pledged assets, collaterals. Recovery is regarded as successful if the recovery during the repayment period reaches the initial market value (calculation is regulated

by the law) of the property, real estate. Before paying the mortgage obligation, taxes, fees, costs of the former, and current collection, sale procedures must be also paid. Other obligations must be recovered at a level of 38%, subordinated obligations at 5%, and privileged obligations at a level of 120% of the recovery from other obligations. By calculation, the volume of penalty fees, default interest rates must not be included.

The excepted income for ensuring a basic level of living is also strictly regulated. It corresponds to the minimum level of pension per person.[5] In some special cases, it could reach its double. Besides the cost of living, utility costs, insurance cost, maintenance-related certified regular expenses could be also exempted from sources of repayment.

It must be reported immediately if there is a change in the income status of the creditor (more than 10%), there is an extraordinary income, or there is any new property received. The mandated trustee can check and supervise the creditor at any time. Creditors must report semi-annually about the execution of the repayment plan, asset sale, repayment status, and all relevant aspects and events.

As the repayment plan must be approved by the court, the court will decide also on the final discharge at the end, whether the repayment plan was accomplished. In the case of success, all obligations that were not included in the repayment plan are discharged. For the obligation of creditors who did not join the debt, the settlement procedure is not forfeited, collections are not allowed to be executed during the procedure.

In summary, the Hungarian system is close to the former Austrian system and reflects the usual strict elements of the European systems and structures. The basic lines of the process are identical. After filing for the procedure, the legislation prefers agreements out of the court, if it fails, then on the court. Even without a mutual agreement, the could be a repayment plan by court decision at the end.

Subjective eligibility criteria are similar to all structures: fairness, cooperativeness, no fraudulent behavior. On the other hand, the objective eligibility criteria are very detailed and restrictive. Studies (Báger, 2015; MNB, 2015) show that the forecasted ratio for eligibility in the introduction year of 2015 was about 10-14% (15-20 000 potential files) of the total NPL (mortgage loan) portfolio. Final numbers are a fraction of the forecasted (about 3300 files). Exemption structures, the maturity of the repayment plan, discharge conditions are in line with the mainstream of European solutions. The range of necessary repayment period for discharge is between 1-8 years, the applied 5 year-long period is like in several countries in the region (Poland, Czech Rep.). (Báger, 2015) The minimum repayment obligation for accomplishment (and also the possibility of a property sale or hold) is linked to the initial value of the real estate for the most important creditor segment of mortgage lenders. In other countries, it is defined as a percentage of the obligations. Knowing the high loan-to-value ratios of the former and later defaulted loans, especially the foreign currency loans, it seems that many loan obligation (even with the regulated interest rate) exceeds the former value of the real estate. This automatically would lead to an asset sale. It seems to result in a stricter

5 In 2019 it is 28.500 forint/person.

discharge condition relative to e.g. the Austrian thresholds of 10-20-50%. However, the differences should be examined more in detail with further empirical research.

Finally, we must note, that the whole structure of the procedure, conditions, requirements are extremely complex. The dense content of leaflets, the long information materials, articles, the controversial or not clearly defined statements, some mistakes in formulation perfectly mirror the complexity of the whole procedure. Understanding all details and outcomes is also a challenge for professionals in finance.

## Conclusions

Bankruptcy systems vary among countries. The main characteristics of the systems could be outlined based on some central criteria. One key aspect is creditor/debtor friendliness, the opportunity to gain a "fresh start". The existence and the conditions of the fresh start could be tracked based on some key elements of the systems. The opportunity for a fresh start could be described by many dimensions: access to the straight bankruptcy process, legibility criteria, expensiveness, degree of complexity, the structure of exemptions, debt settlement conditions, and the harshness of stigma. The degree of strictness of these dimensions determines the level of the "leniency" of a legislative solution.

The US solution differs from typical European systems. The US solution with the opportunity of straight bankruptcy is regarded as one of the most lenient systems, however, in 2005 the reforms had made it less debtor-friendly. On the other hand, European systems are typically less lenient. Interestingly – contrary to the US reform – some of these systems have shifted to the more lenient structures during the last decade, and several debtor-friendly changes were made in some European countries.

The Hungarian system corresponds to the former Austrian system and reflects the usual elements of the European system and structures. It could be concluded that the Hungarian personal bankruptcy legislation belongs to the strict, less lenient group of European regulations in its main elements (e.g. no straight bankruptcy complexity, strict eligibility, long restructuring period, strict exemption rules). Interesting to note that the system had been launched with its strict conditions for a fresh start just some years before Austria and other countries (like Slovakia) introduced more-lenient-type reforms due to internal critiques.

There are several further research scopes to continue. One important research question would be to measure the degree of fresh start opportunity and leniency of the systems in specific countries. It could be also measured how changes affected the degree of leniency due to the different reforms taken. If changes are measured, then the effect of changes in the labor supply or entrepreneurship could be also better analyzed and understood.

## References

Alexandrov, Alexei – Jimenez, Dalie (2017): Lessons from Bankruptcy Reform in the Private Student Loan Market, Harvard Law & Policy Review \\jciprod01\productn\H\HLP\11-1\HLP108.txt unknown Seq: 2 2-FEB

Báger, Gusztáv (2015): A természetes személyek adósságrendezési eljárásának hazai bevezetése. Pénzügyi Szemle 2015/4

Chen, D. – Zhao, J. (2017): The impact of personal bankruptcy on labor supply decisions. - Review of Economic Dynamics, 26, p. 40–61

Győri, Péter (2009): Magáncsőd a végső megoldás (előadás) http://www.gyoripeter.hu/home/docs/debt/insolven letöltve: 2019.09.01)

Efrat, Rafi (2003): Legal Culture and Bankruptcy: A Comparative Perspective – 20. Bankr. Dev. J., 351 – HeinOnline https://heinonline.org/HOL/LandingPage?handle=hein.journals/bnkd20&div=16&id=&page=

Efrat, Rafael (2002): Global Trends in Personal Bankruptcy. American Bankruptcy Law Journal, 81

Efrat, Rafael (2006): The evolution of Bankruptcy stigma. Theoretical Inquiries in Law 7.2

Eraslan, Hülya – Kosar, Gizem – Li, Wenli; Sarte – Pierre-Daniel (2017): An Anatomy of US Personal Bankruptcy under Chapter 13. International Economic Review, August, Vol. 58, No. 3

Hetes-Gavra, Roxana – Avram, Alexandru –Avram, Costin Daniel (2016): Personal Bankruptcy Regulations in Central and Eastern Europe, "Ovidius" University Annals, Economic Sciences Series Volume XVI, Issue 1/2016

Jia, Y. (2015) : The impact of personal bankruptcy law on entrepreneurship. Canadian Journal of Economics, 25 October

Robe, Michel – Steiger, Eva Maria (2015): Insolvency and its Consequences: A Historical Perspective1 Dice Report, Journal for Institutional Comparisons, Volume 13, No. 4 Winter

Wagner, Ildikó (2006): A magáncsőd intézménye. Közgazdasági Tanszék Konzulens: Lőrinczi Gyula THEMIS 2006 december

White, M. (2007): Bankruptcy reform and credit cards. Journal of Economic Perspectives 21(4), p. 175–99

Papers, regulatory documents of authorities, laws:

IM (2005) - Igazságügy-miniszter, ifjúsági, családügyi, szociális és esélyegyenlőségi minister IM/IGKOD/2005/IGKÜ/24. Előterjesztés a Kormány részére a természetes személyek

fizetésképtelenségi eljárására vonatkozó szabályozás koncepciójáról, 2005. április 11. (downloaded on 2019.09.15)

OH - Országgyűlés Hivatala, (2016): Infojegyzet. Magáncsőd 22016/52. 2016. október 13. (downloaded on 2019.10.15)

Családi Csődvédelmi Szolgálat honlapja: http://www.csodvedelem.gov.hu/informaciok/1 (downloaded on 2019.10.15)

US Bankruptcy Code: Glossary of Bankruptcy terms
http://www.njb.uscourts.gov/content/glossary-bankruptcy-terms (downloaded on 2019.10.15)

US Courts: https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-13-bankruptcy-basics (downloaded on 2019.10.15)

Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings, https://eur-lex.europa.eu/legal-content/hu/TXT/?uri=CELEX%3A32015R0848 (downloaded on 2019.11.06)

2015. évi CV. törvény a természetes személyek adósságrendezéséről.
https://net.jogtar.hu/jogszabaly?docid=A1500105.TV (downloaded on 2019.10.15)

MNB (2015): Pénzügyi stabilitási jelentés, 2015 május. https://www.mnb.hu/letoltes/penzugyi-stabilitasi-jelentes-2015-majus.pdf (downloaded on 2019.11.06)

MTI (2019): Jelenleg több mint 3300 embernek nyújt védelmet a magáncsőd.
MTI2019.02.16. 07:15