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Construction of Personal Insolvency System in China: Difficulties and Possibilities

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Abstract: *In the post-pandemic era, China's socio-economic development has significantly slowed down. The downturn in the real estate and stock markets has led to a substantial shrinkage in personal assets, and individuals' debt repayment capacity has significantly declined. As a result, the proportion of non-performing assets related to personal loans in banks and financial companies has been steadily increasing. However, due to the lack of a personal bankruptcy system in the current bankruptcy regime, personal debt recovery rates remain low, and self-employed individuals lack institutional protection when participating in the market economy, which is unfavorable for the healthy development of the overall economy. Therefore, there is an urgent need to improve the personal bankruptcy system.*

Keywords: *Personal bankruptcy system; Credit reporting system; Property declaration; Centralized processing of personal debt*

1. Introduction

In traditional Chinese ideology, personal bankruptcy is considered unnecessary, as the belief that 'the son repays the father's debts' has almost become an ingrained concept in Chinese families. However, the coordination of market economic development and legal progress is gradually changing this mindset. Personal responsibility for assets and privatization are key driving forces of market economic development, and the personal bankruptcy system serves as a protective measure for this important driver. In fact, there has long been extensive lobbying for the establishment of a personal bankruptcy system in China, both in legislative processes and academic discussions.

Since 1994, there have been numerous attempts to reform China's bankruptcy legislation, and several drafts have been submitted to the Financial and Economic Affairs Committee of the National People's Congress. These drafts aimed to protect the interests of creditors, encourage honest debtors, and reflect the rise of personal credit lending. However, concerns about moral hazard and the potential for fraud have led to the rejection of these drafts. [1] Notable Chinese scholars, such as Tang Weijian, have repeatedly advocated for the establishment of a personal bankruptcy system in China. [2] Recently, calls for such a system have been growing stronger.

2. The Necessity for a Personal Insolvency System

There are several important reasons why a personal bankruptcy system is now more necessary than in the past: First, the collapse of real estate developers, marked by the downfall of Evergrande, has triggered a series of chain reactions in China's real estate market. This has severely shrunk the total assets of the middle class, who historically relied on real estate as their primary investment vehicle, leading to a significant decline in their risk tolerance. This group forms the backbone of China's consumer market and enhancing their risk resilience is key to reversing the economic downturn.

Second, natural disasters and public health emergencies have become significant sources of risk to personal assets, such as the 2008 Wenchuan Earthquake and the COVID-19 pandemic in 2019. These events can cause substantial financial losses in a short period, and the implementation of a personal bankruptcy system would serve as a final safety net for honest yet unfortunate individuals.

Third, the unpredictability of national policies often becomes a major source of risk for personal assets. For example, China's 'Double Reduction' policy in recent years has inflicted heavy losses on

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educational institutions, causing many teachers to lose their jobs. Under the current system of unlimited personal liability, many honest but unfortunate business operators find it difficult to recover from such uncontrollable risks.

3. Challenges Faced in Establishing a Personal Bankruptcy System

In spite of the above necessity, the following difficulties still need to be solved to build a personal bankruptcy system in China.

3.1 Public Concern

As mentioned earlier, since ancient times, Chinese society has generally embraced the traditional belief of 'the son repays the father's debts,' with debt repayment seen as an unquestionable moral obligation. [3] A personal bankruptcy system could result in some creditors receiving only part of what they are owed, or, in some cases, nothing at all, which runs counter to these traditional beliefs. Failing to repay debts, or repaying only a portion, may be difficult for creditors to accept. Furthermore, due to the prevailing moral values in society, debtors may continue to carry a psychological burden even after their 'debts' are cleared.

This brand effect leads to concerns that a personal bankruptcy system could introduce moral hazards. These risks exist not only with bankrupt debtors but also with lending creditors, who may worry that debtors will pretend to be bankrupt to gain debt relief. There is also concern that the implementation of such a system might encourage reckless borrowing.

3.2 The Incomplete Property Registration System

The incompleteness and fragmentation of the property registration system increase the difficulty of implementing a personal bankruptcy system in China. In fact, some Chinese scholars believe this is an insurmountable obstacle to establishing such a system. [4] A comprehensive property registration system is a crucial prerequisite for establishing a personal bankruptcy system in China, as only with clear identification of an individual's immovable assets can courts determine whether the individual meets the conditions for personal bankruptcy, that is, whether their assets are insufficient to cover their debts. The registration system is also necessary for identifying the debtor's personal assets and fairly distributing those assets to creditors.

Identifying a debtor's assets is one of the biggest challenges in a personal bankruptcy system. Compared to corporate bankruptcy, individual bankruptcy has the following characteristics regarding assets: First, the assets of individual debtors are often not publicly disclosed, and some assets may exist in the form of cash, making it difficult for others to determine their existence and whereabouts. Moreover, the debtor's personal assets are often intertwined with the assets of other family members, further complicating the identification of bankruptcy assets. This means that determining the scope of a debtor's assets in personal bankruptcy proceedings can be relatively complex.

3.3 Underdeveloped Credit Reporting System

One of the key challenges in establishing a personal bankruptcy system in China is the incomplete and underdeveloped credit reporting system. A robust credit system is fundamental to personal bankruptcy processes, as it provides accurate and comprehensive data on individuals’ financial statuses, assets, and liabilities. However, China's current system faces several critical limitations:

First, there is limited data coverage. The existing credit system in China, primarily operated by the People's Bank of China (PBOC), covers a significant portion of the urban population and large enterprises. However, rural residents and small- and medium-sized enterprises (SMEs) are often excluded. Many individuals lack formal credit records, making it difficult to assess their financial condition accurately during bankruptcy proceedings. The absence of comprehensive data on assets and debts challenges courts when determining whether an individual qualifies for bankruptcy protection.

Second, the system suffers from fragmented information sharing. China's credit reporting system has not yet achieved integrated and seamless access to all relevant financial data. The information available to financial institutions is often incomplete because credit data is not fully shared across sectors. This fragmentation makes it difficult to form a clear and comprehensive view of an individual’s total financial obligations, complicating the assessment of debts during bankruptcy filings. Additionally, the inability to cross-check information across industries can lead to incomplete debt profiles.

Third, there are inconsistent credit evaluation standards. Different financial institutions apply varying criteria when evaluating creditworthiness, resulting in inconsistent credit scores and evaluations for the same individual. This inconsistency can lead to unreliable assessments of a debtor's financial health during the bankruptcy process, making it difficult to determine whether a person genuinely meets the criteria for bankruptcy.

Fourth, the system suffers from weak enforcement and credit repair mechanisms. Although the government has introduced blacklists of dishonest debtors and implemented penalties, the enforcement of credit laws, especially in cases of fraud or unpaid debts, remains uneven in China. Without a robust system to track and enforce debtor responsibilities, it becomes challenging to prevent abuse of the bankruptcy system or to accurately determine which individuals are deserving of debt relief.

4. Legislative Pathways for Establishing a Personal Bankruptcy System

Referring to foreign legislative models, the following legislative pathways for establishing a personal bankruptcy system can be summarized.

4.1 Establishing a Separate Personal Bankruptcy Law

Adopting a separate legislative approach could better emphasize the concept of respecting and protecting human rights. However, if the average person cannot directly benefit from it, the acceptance of this model may not be high. In its early stages, it might even replicate aspects of corporate bankruptcy law, becoming a "zombie law." A core issue in independent legislation is ensuring that the applicable subjects are honest and unfortunate individuals, rather than allowing unrestricted application to all individuals. While pursuing this substantive goal, it is necessary to maximize procedural efficiency. This process should involve limitations on the time and amount of debt, with specific evaluation criteria established. When a debtor applies for bankruptcy, should the authorities conduct substantive or formal reviews of the submitted materials (income status, individual and joint property of spouses, lists of creditors and debts, basic information about dependents, etc.)? A substantive review could better ensure the authenticity and credibility of these materials, reducing the likelihood of improper application. However, a substantive review faces the challenge of balancing personal privacy protection with the state's right to investigate individual assets. It should not sacrifice private interests to protect the public interest of society as a whole.

4.2 Integrating Personal Bankruptcy into Corporate Bankruptcy Law

Besides independent legislation, a unified legislative model could be adopted, incorporating personal bankruptcy into corporate bankruptcy procedures as a subset of the current corporate bankruptcy law. [5] This would reduce the waste of legislative resources, as a comparison between the Shenzhen Special Economic Zone Personal Bankruptcy Regulations and the existing Enterprise Bankruptcy Law shows significant overlap in content. This approach would not only promote overall unity in bankruptcy law but also help address future inconsistencies in the review process. However, if personal bankruptcy is integrated into corporate bankruptcy law, a logical relationship between the applicable subjects must be found. This raises the question: does the nature of business entities align with the broad scope of natural persons? Corporate bankruptcy law has a strong commercial legal nature and mainly applies to business entities. Including related entities such as corporate legal representatives and partners under corporate bankruptcy law is consistent with the nature of business entities. However, including ordinary individuals who become bankrupt due to consumption or borrowing under corporate bankruptcy law may be less appropriate, as their connection to business entities is not as strong. [6]

4.3 Adopting a Classified Legislative Model

To address the different attributes of natural persons, a classified legislative approach could be considered. When legal representatives or partners bear joint liability due to corporate bankruptcy, they can be included within the scope of corporate bankruptcy law. When a natural person, as a consumer or borrower, faces bankruptcy, a separate law could be modeled after the Shenzhen Special Economic Zone Personal Bankruptcy Regulations. However, it is worth noting that with the rise of e-commerce platforms

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and online media, new forms of sales such as online sales and personal purchasing agents are becoming increasingly popular. More individuals simultaneously assume the roles of ordinary consumers, legal representatives, partners, and business operators. While theoretical classifications may be ideal, accurately distinguishing between the roles of individuals in different situations may be difficult in practice. Therefore, caution is advised when adopting a classified legislative model.

4.4 Reforming the Existing Civil Enforcement System

The fourth option is not to establish new regulations but to adapt the existing participation distribution system, termination of enforcement system, and compulsory enforcement system to personal bankruptcy procedures. This approach would be more easily accepted by the general public in China. Although at first glance, it seems to complicate bankruptcy procedures in enforcement cases, it would actually allow for better determination of whether a natural person qualifies for personal bankruptcy. Additionally, the participation distribution system in enforcement procedures is already based on bankruptcy procedure principles, and although internalized within the enforcement system, it essentially serves the same function as bankruptcy procedures. Finally, appropriate adjustments could address some of the differences between participation distribution and personal bankruptcy.

Both participation distribution and compulsory enforcement procedures have accumulated practical experience in implementation, making this fourth option highly feasible. However, without theoretical analysis and discussion, the mission of the participation distribution system may either conclude with the introduction of a personal bankruptcy system, or the bankruptcy process may be continuously weakened as the participation distribution system improves. [7] The core issue of using either of these two methods is how to build a system that the general public can accept and recognize, ensuring it truly rescues honest but unfortunate individuals facing bankruptcy.

5. The Possibility of a Personal Bankruptcy System in China: The Shenzhen Special Economic Zone Personal Bankruptcy Regulations

The Shenzhen Special Economic Zone Personal Bankruptcy Regulations is indeed China’s first written legislation related to personal bankruptcy. This regulation was officially implemented in Shenzhen in 2020, marking the first legislative step in China’s personal bankruptcy field. The regulation provides a legal path for honest but unfortunate debtors to discharge their debts, while also protecting the interests of creditors.

The regulation demonstrates the following potential innovations and trends in China's personal bankruptcy legislation:

5.1 The separation of corporate and personal bankruptcy laws

Many scholars in China suggest enacting a separate national personal bankruptcy law, while others propose adjusting certain aspects of the current Enterprise Bankruptcy Law to meet specific case needs. However, although non-bankruptcy law and existing enterprise bankruptcy procedures might achieve the microeconomic function of personal bankruptcy, these laws and procedures cannot fulfill the macro socio-economic goals related to individual cases. The Shenzhen Ordinance establishes a feasible model for separate personal bankruptcy legislation aimed at achieving all the objectives of a functional personal bankruptcy system. Including personal bankruptcy law as a separate chapter within a comprehensive bankruptcy code may reduce the legislative effort required and allow for a unified bankruptcy management approach, providing a middle ground for this debate.

5.2 The relaxation of restrictions on debtors

Agricultural workers make up the majority of China’s population, and ensuring they have access to bankruptcy protection is a contentious issue in the legislation. Some argue that there are substantial challenges in determining whether agricultural workers qualify for bankruptcy protection, as this involves the assessment of their assets and income. Others oppose excluding agricultural workers from the category of eligible debtors, while some believe individuals with primarily consumer debt should not qualify for bankruptcy relief. However, with the rise of commercialization, the lines between consumers and individual businesses have blurred, sparking controversy over whether consumer debtors should be excluded from personal bankruptcy legislation.

Some scholars suggest a classified approach to personal bankruptcy, while the Shenzhen Ordinance offers a unified solution. The Ordinance provides relief for all Shenzhen residents, including consumers and business individuals, representing a substantial step forward in China. National legislation could reflect this as well.

5.3 The establishment of an Insolvency Administration Department

The Shenzhen Ordinance introduces the involvement of administrative agencies as a fundamental aspect of personal bankruptcy procedures, in stark contrast to the marketization and liberalization trends seen in corporate bankruptcy. This reflects a uniquely Chinese approach to personal bankruptcy system design. Debtors in personal bankruptcy cases often face more severe financial hardship, and creditors and other financial institutions lack the incentive to participate or assist in the management of personal cases. In 'no income, no asset' cases, hiring third parties to manage the debtor's property is both difficult and pointless. However, even 'no income, no asset' debtors must undergo thorough investigation to obtain discharge, making mandatory and low-cost administrative intervention useful in such bankruptcy proceedings. The World Bank report explains that 'administrative processes can introduce a stable bureaucratic body capable of accumulating experience, identifying cases worth investigating, and providing impartial advice and information to both debtors and creditors. It can take proactive measures to prevent system abuse and address moral hazard issues.'

Drawing from the administrative involvement models of the UK and US, the Shenzhen Ordinance establishes an Insolvency Administration Department, though scholars remain divided on the concept of an administrative bankruptcy system. Professor Xu Yangguang argues that an administrative bankruptcy management approach is not suitable for China's current conditions. [8] While the personal bankruptcy department aims to improve efficiency and convenience, it may also introduce issues of bureaucracy, particularly given the incomplete separation of power between China's administrative and judicial branches. A national bankruptcy administration agency may not only fail to reduce the courts' burden but also risk diminishing the fairness and efficiency of procedures. This issue will be a critical institutional challenge for China's future personal bankruptcy legislation.

6. Conclusion

In recent years, the growing social and economic pressures in China have increasingly highlighted the necessity of a personal bankruptcy system. Like legislators in other countries, Chinese lawmakers are also striving to address the 'negative impact of the rapidly rising personal debt crisis.' China has continued its exploration of personal bankruptcy systems in cities like Wenzhou, Taizhou, and especially Shenzhen, where the country's first personal bankruptcy regulation was introduced. [9] This initiative has provided valuable experience for future national legislation. Nonetheless, China still has a long way to go in designing its personal bankruptcy system, particularly in terms of the division of responsibilities between the government and the courts in bankruptcy proceedings. The courts should take the lead in such proceedings, and balancing fairness with efficiency will be a critical issue for the future of the personal bankruptcy system.

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