Loughborough University

ADMINISTRATION OF RECOVERIES IN INDIVIDUAL INSOLVENCY

- Case studies of two UK banks

Keith Pond
The Banking Centre
Loughborough University
Leics.
LE11 3TU

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ABSTRACT

Against a background of greater competition, market saturation and falling margins over the past decade UK banks have sought greater efficiencies in credit and risk assessment procedures, especially with personal lending products. In the same way they have attempted to reduce costs associated with the monitoring and collection of bad debts. Failure to monitor debt recoveries adequately, however, can lead to further pressure on profits.

This paper uses a case study approach to outline key strategies adopted by two major banks in respect of formal insolvency, the "tip" of a considerable debt recovery "iceberg". The paper illustrates the reactions and changing administrative practices of banks, as unsecured creditors, and draws on empirical research that has charted the effect of the Insolvency Act 1986 as regards individual debtors.

The collection of bad debts presents banks with risks, heightened by adverse selection and moral hazard problems greater than those applicable to credit risk assessment. However, whilst the "downside risk" equates with the debt write-off plus transaction costs the "upside potential" has elements of both tangible and intangible benefit.

The paper goes on to review specific centralisation and outsourcing policies against the critical risks in insolvency. It also suggests that the bargaining power of major creditors, including banks, is increased through these activities, to the possible detriment of smaller creditors and of debtors.

KEYWORDS: INSOLVENCY, CREDIT, BANKING, VOLUNTARY ARRANGEMENTS, BANKRUPTCY.

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1. Introduction

This paper investigates a dilemma for large UK lenders and creditors when faced with the formal insolvency of a personal or small business borrower.

The dilemma emanates from the growing incidence and acceptance of the "rescue culture" for individual debtors and impacts on lenders faced with the choice of bankruptcy (liquidation of available assets) and rescue. Whilst "rescue" often allows lenders to achieve higher levels of recoveries than in bankruptcy it also introduces greater risks that must be both understood and managed.

Credit risk is a concept well understood by lenders and strategies have been adopted that reduce this to acceptable levels at the lowest possible cost. Post Insolvency risk is less well understood and cannot yet be reduced due to the high cost of monitoring that necessarily precedes formalisation of any strategy.

In the two case studies of major UK clearing banks, presented in this paper, different approaches to post insolvency monitoring of bankruptcy and Individual Voluntary Arrangement (IVA) cases are reviewed. Empirical research, industry surveys and

unique access to cases recorded by one of the case study banks help to illustrate the complexity of the problem lenders face and the potential rewards for success. The research is at an early stage and concentrates on the administration of new cases. Data to measure the success of chosen strategies are either not available (bank A) or incomplete (bank B). It is hoped that such data will feature in future projects.

2. The banking environment

2.1 The personal banking market

UK retail banks operate in an extremely competitive environment and invest heavily in gaining competitive advantage. Traditional banks suffer pressure on profit margins and growing threats from non-traditional competitors such as supermarkets and even football clubs (Howcroft & Hamilton, 1999). Competitive pressures and available technology have, in part, resulted in an orientation away from the relational banking of the "old fashioned" high street bank manager, towards the standardisation and transactional banking of the direct seller. Technical competence in lending is largely subordinated to systematic "credit scoring" and centralisation based on empirical information from a variety of sources (Leyshon & Thrift, 1999).

Whilst streamlined systems for lending can reduce costs and increase profitability in the short-term it does serve to reinforce the moral hazard problems associated with dealing with borrowers at "arms length".

The emphasis on product based, transactional banking in the 1980's and early 90's had a marked effect on bank organisational structures and sources of income. Banks

enjoyed the benefits of profitability and sales growth but suffered from a lack of customer loyalty (Howcroft & Hamilton, 1999).

Consequently, by the mid 1990's banks had begun to realise the importance of reintroducing "relationship management" and introducing customer retention policies. Although attitudes and practices are often slow to change in large organisations banks are beginning to balance the "lifetime value" of customers with the move towards individual account profitability (Stone et al., 1996). Banks also know that customer acquisition is more expensive than customer retention although few have applied this logic of this in dealing with bad debts, insolvency and defaulting customers (Doherty & Pond, 1995).

In the short-term, lenders have profited enormously from the unprecedented demand for unsecured consumer credit. Annual growth rates in credit card debt, for example, calculated as part of the money supply - M4, consistently exceeded RPI inflation by 2 to 3 percentage points between 1996 and 1998 (BBA, 1999). Over the same period bankruptcy and IVA numbers grew (See Table 1) and are now maintained at a higher level (30,246 for the year 2000) than at any time since the recession of the early 1990's (DTI, 2001). Table 1 also shows that the growth rate of IVAs exceeds that for bankruptcies for most of the period since 1986.

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2.2 The case study banks

Both Banks A and B, subjects of the case studies, are well - known and respected retail banks with branches nationwide. Both have centralised debt recovery units located outside the London area and have handled IVAs since 1993 and 1997 respectively.

Where banks hold unsecured debt the tendency in corporate insolvency has been towards liquidation (bankruptcy) rather than rescue or rehabilitation. Smaller businesses appear not to warrant bank involvement in workouts (Gladstone & Lane Lee, 1995; Gopinath, 1995) and the same policy appears to be adopted for unincorporated businesses and personal debtors. This approach is typically justified by banks on the basis that there is no point "putting good money after bad" (sic).

The financial argument for cost reduction in debt collection is clear: the amount of debt written off (debt less recoveries) can influence specific provisions for bad and doubtful debt, net profits and tax charges. Transaction costs incurred in account intervention will merely add to losses in the short-term.

In both case study banks the cost savings from centralisation and specialisation were prime drivers for strategic action. The banks had seen bankruptcy and IVA numbers rise in the early 1990's (see Table 1) and sought to reduce both the administrative and cost burdens on individual branches since the account holding branch would be the first point of contact for administration of the insolvency.

Bank A had previously established a debt recovery unit and in 1993 added formal insolvencies from retail branches to its portfolio of activity. Over time four managers

were recruited to manage the workload. Other subsidiaries of Bank A, such as its plastic card services, prefer to use their own collection mechanisms.

Bank B had also centralised small debt collection work for all of its subsidiaries some years previously. Spurred on by the efficiency gains required by its new owner Bank B added IVAs and bankruptcies in 1997. At present corporate recoveries are administered by a unit based in London.

Reducing the burden on individual branches was also a part of a wider strategy to re-designate branches as retail and customer service outlets, rather than administrative units. The reduction in numbers of, largely unprofitable, branches has also been part of this focus. Cost reduction and efficiency gains were the key driver for Bank B.

A secondary objective, especially of Bank A, was to build up expertise, consistency and rewards in dealing with insolvencies. Although cost reduction has been the key driver the wider benefits have exceeded expectations.

In 1998 and 1999 Bank A's unit handled 1,508 and 1,400 IVA cases respectively. On-going monitoring is being undertaken for around half of all cases. Bank B's workload was lower at 621 in 1998 and 400 in 1999. On-going monitoring is undertaken for around 87% of these.

For both banks the longer-term economic argument is less clear but sees write-offs as "sunk costs" and compares the risk weighted "lifetime value" of the debtor against the cost of a more detailed investment in customer rehabilitation. In a congested and

competitive market, however, a longer-term view may be more commercially viable, especially where both legislation and social values want to encourage "serial entrepreneurs" (Atkinson, 1999).

3. Insolvency Law and Practice

3.1 The Insolvency Act 1986

Since passage of the 1986 Insolvency Act insolvent UK personal debtors have had access to a statutory IVA procedure which is designed to avoid the finality and penalties of bankruptcy. The IVA between debtors and creditors was designed to allow viable sole traders to continue in business or to achieve a better and more orderly realisation of assets for the creditors. The legislative provisions followed the recommendations of a review committee (Cork, 1982) and extensive consultation (DTI, 1984) that noted the need to "rescue" debtors and to distinguish between the dishonest and the unlucky. Although the review committee also recommended a curtailed procedure for consumer debtors this was not carried through to the statute books and so the IVA "rescue" vehicle remains available to small unincorporated businesses and individual debtors alike.

The IVA is a private contract for the satisfaction of personal debts. As such it can be influenced by the quality of the relationships between lenders and debtors. In this court-supervised procedure the debtor proposes how the debts are to be satisfied, under the guidance of a licensed insolvency practitioner and under the protection of a "moratorium" on creditor action. The creditors are given the opportunity of amending and accepting or rejecting the proposal (Lawson, 1992).

3.2 The nature of the IVA

The years since 1986 have seen a steady rise in the incidence and acceptance of IVAs (The Insolvency Service 1991 - 98). There is also growing evidence of their successful application (Pond, 1998a). In 1998 around 20% of formal personal insolvencies are dealt with via the IVA procedure. In 1999 this rose to 25% (see Table 1). From the database made available by bank B, however, (see Table 2) it is estimated that 89% of bankruptcies return a nil dividend to creditors. On this basis it is estimated that, where a recovery prospect exists ("live cases" in Table 2) the IVA procedure is used approximately 82% of the time.

The choice faced by an increasing number of insolvent debtors is between IVA, and the avoidance of penalties, restrictions and opprobrium connected with bankruptcy or bankruptcy itself. The choice faced by the creditor is limited by the predisposition of the debtor towards bankruptcy in the first instance and by the existence of "moral hazard" which makes the IVA riskier for the creditor. However, a successful IVA can improve creditor recoveries and increase customer retention, since income from continued employment or trade is often included as a benefit.

Moral hazard exists in the IVA situation because the creditor is forced by the Insolvency Act 1986 to make a choice between IVA acceptance and bankruptcy. If the creditors choose IVA, debtors can take actions, unobservable by creditors, which transfer greater risk to creditors. This is compounded by the lack of a formal investigation of the debtor's affairs in an IVA and the debtor's retention and possession of assets. Creditors who doubt the integrity of the debtor or the insolvency

practitioner can choose bankruptcy and the possibility of a public examination of the bankrupt in open court, although this is rare.

Bank A has learned to take special care of IVA proposals put forward by Insolvency Practitioners who have presided over failed IVAs in the past. The bank maintains extensive records to allow it to identify both good and poorly performing practitioners. This is useful when IVAs can be rejected at an early stage, avoiding the need for monitoring costs, where the risk factor associated with the Insolvency practitioner is too high.

Creditor experience of bankruptcy is rarely good as official costs and the preferential treatment of some Crown debts deplete available assets and average returns from bankrupt estates are low (SPI, 1992 - 98). This contrasts with the overall experience of IVAs (Pond, 1998b). For banks and larger lenders, with wider portfolios of debtors, successful IVAs are balanced against those that fail during their agreed term and return nothing. In this way larger creditors are more likely to favour IVA acceptance since their overall experience is positive. Smaller creditors, with their less extensive experience, may have more dichotomised views.

4. Society's view

4.1 The rationale for insolvency law

In 1984 Cork (Cork, 1982) recognised that changes in commercial life and society since passage of the Bankruptcy Act 1883 necessitated a review and refashioning of insolvency law. The 1986 reforms that Cork influenced recognised that there needed to be a balance between two separate views of bankruptcy: as a sanction against deviancy and consumer laxness (deterrence) and as a form of consumer protection (Ramsay, 1997).

In a society based on credit, bankruptcy will still exclude individuals from the credit system and act as a punishment. It will also provide a “safety valve”, recognising that credit providers share responsibility for over-commitment. The key task in achieving this balance is to distinguish between the dishonest insolvent and the merely unlucky.

The main actors in achieving this balance, apart from individual debtors and creditors themselves, are Insolvency Practitioners and their public sector counterparts the Official Receivers. Cork’s recommendation of a licensing system for practitioners and the professionalisation of the industry coincided with the government’s wish to reduce public sector involvement in the administration of bankruptcy. Whilst licensing has done much to rid the profession of some malpractice not all practitioners abide by the code of conduct (SPI, 1997) of the profession in respect of IVAs. Some even advertise for clients (Financial Mail on Sunday, 1999).

After 1986 The Insolvency Service, an Executive Agency of the DTI, wanted to concentrate on fraud and malpractice investigations as well as the investigation of failed companies and individuals. The strategy was to offer bankruptcy cases to the private practitioners but the sheer numbers of bankruptcies that failed even to pay their own costs meant that by 1999 Official Receivers were involved in the administration of an estimated 50 - 60% of all insolvencies (The proportion of bankruptcies without dividend to all formal insolvency appointments in Table 2).

TAKE IN TABLE 2 ABOUT HERE

The attendant pressure on Insolvency Service resources has a damaging effect on the perception of the efficient administration of estates. This may be a factor that adds to the attraction of bankruptcy for the debtor.

4.2 The stigma of bankruptcy

Although no specific UK research has been undertaken into attitudes to bankruptcy there exist a number of other factors that help to shed light onto the conflicting attitudes to bankruptcy of creditors and debtors. Factors exist that support the deterrence view of bankruptcy law, typically held by creditors, and the rehabilitation view, presumably favoured by debtors.

There is said to be a “stigma” associated with bankruptcy that supports the deterrence viewpoint. Bankruptcy, IVAs and County Court judgments, so called “black” information, are routinely recorded and included in commercially available Credit Reference databases. A Credit Reference search can highlight a previous bankruptcy

or IVA for up to six years beyond the discharge of a Bankruptcy Order or completion of an IVA (Robson, 1999). Institutional creditors often base their credit-scoring and screening on such databases. The existence of this negative information assumes an importance in decision making despite the fact that such information fails to distinguish between the dishonest and the “unlucky” debtor or the recalcitrant bankrupt and the debtor who works hard to ensure that the IVA succeeds.

Creditors’ maintenance of a bankruptcy “stigma” is under pressure from government (Atkinson, 1999) and society in general. A society based on credit generally has a greater acceptance of debt and a more permissive attitude to default (Lea et al., 1993). The sheer numbers of individuals seeking the protection of bankruptcy also serves to diminish its threat of censure (Bien, 1999; Wise, 1997). Combine this with the perceived inefficiency in official bankruptcy administration and the automatic discharge from bankruptcy after three years appears to be a favourable “exit strategy” when compared with the five years for the average IVA.

A more accessible feature of the equation, for UK creditors is the institutional credit-trust relationship between lender and borrower. Initial lending relationships between banks and new customers are likely to be deterrence based but will develop into knowledge based relationships where personal contact and repeated interaction are prevalent (Erfat, 1998). Personal lending by UK banks is rarely relationship based, however and most “arms-length” consumer credit transactions will remain deterrence based.

When the value of the deterrence diminishes, however, as society's view changes and as bankruptcy law favours rehabilitation the trust relationship breaks down. In addition the deterrence-based relationship is unlikely to engender any emotional or moral input by the borrower making the bankruptcy "fresh start" principle more accessible.

5. Experience of IVAs

The active creditor's decision to accept or reject an IVA is based on an assessment of the risk of IVA failure and the creditor's own predisposition to the debtor. Most IVAs will offer better dividends than the bankruptcy of the same debtor; indeed, many courts will not sanction IVAs that fail this simple test. The information available to the creditor at the point of IVA acceptance is, therefore, an important factor in the risk assessment.

5.1 Creditor influence in IVAs

On receipt of the IVA proposal the creditor has a limited time to judge whether it is realistic and whether the proposed dividend is acceptable. To help creditors a positive report from the insolvency practitioner appointed (nominee), prior to the creditors' meeting, should indicate that the statement of affairs is accurate, the proposal has a real prospect of success and that the proposal is fair (SPI, 1997).

Creditors can further strengthen their position by drafting and submitting modifications to the proposal for consideration at the creditors' meeting.

One very prominent feature of the 1998 study (Pond, 1998a) was the turnaround by creditors from their fairly indifferent attitude of 1989 (Pond, 1989). In 1989 average attendance (both actual and by proxy) at creditors' meetings in accepted IVAs was 56.3% with only 23% of meetings actually modifying the proposal. By 1998 average attendance had risen to 81% with 53% of cases reporting over 50% attendance. In addition, 71% of study cases were modified at creditors' meetings. This latter finding may have much to do with the policy of some creditors to insist on modifications to all IVAs. As the creditors' only opportunity of influencing the IVA, however, this is not surprising. This finding indicates that creditors are not "risk neutral" due to their broadly spread portfolio of investments but "risk averse", seeking to reduce the flexibility of the debtor in the IVA.

Bank A has a pro-active approach and will always vote at creditors' meetings. Voting is normally by postal proxy, never by bank attendance, and sometimes by instructing a meeting service to attend. Most large insolvency firms offer meeting services to creditors, whereby an experienced insolvency specialist attends creditors' meetings on behalf of the creditor. The attendee exercises a proxy vote where appropriate. Most meeting services are free to creditors and can include summary reports of all cases attended.

Bank A is fully aware of the additional costs involved in operating a specialised unit, however it considers the most salient factor to be net returns. To this end bank A has adopted a "Champion Challenger" benchmarking strategy wherein 10% of IVAs are

"outsourced" to a major insolvency firm, enabling the bank to compare potential and actual returns after costs.

Bank B uses meeting services exclusively and relies on meeting specialists to scrutinise IVA proposals, recommend action and attend and vote at creditors' meetings. Like Bank A voting is by proxy but the vital difference is that Bank B's approach is to authorise voting and modifications against a standardised requirement of a 25p minimum dividend. Bank A judges cases on their individual merits.

By handing over the scrutiny and voting power to the meeting services bank B avoids considerable expense. Based on Bank A's resource commitment this could represent savings of over £200,000 annually. The bank does, however, lose some degree of control over cases and is reliant on the practitioners' expertise and the efficiency and timeliness of their reporting. Advantages of out-sourcing also include the benefit of the enhanced voting power of the meeting service as votes are combined with other creditors.

5.2 IVA risk factors

Analysis of IVA cases commenced in 1994/95 (Pond, 1998a) indicated an overall failure rate of accepted IVAs of 31%. An unknown proportion of this risk is exogenous. IVAs can falter if a downturn in trade or unplanned unemployment intervenes to stem the flow of income on which many enhanced dividends rely. There can also be an opposite effect - the domestic house price boom of the late 1980's in the UK intervened to return higher than expected dividends in some early IVAs (Pond, 1993; Flynn, 1993).

The research has also revealed significant endogenous factors associated with higher levels of failure risk including debtor non-co-operation following acceptance of the IVA by creditors, the principal reason for IVA failure reported as shown in Table 3.

TAKE IN TABLE 3 ABOUT HERE

This information is of little use to the creditor trying to decide whether a proposal has a realistic chance of success since non-co-operation occurs after the creditors' meeting. The current case studies show that creditors can use their own data on the debtor and build up a profile of the supervising practitioner well enough to make a judgement about the integrity of the proposal.

Another major factor that could bear heavily on co-operation by the debtor and is affected by other IVA measures, is the size of the forecast dividend. Average dividends, to unsecured creditors, anticipated at the outset of the IVA were 30.69p in the £ for IVAs in 1998 (Pond, 1998a) (47.62p in Pond, 1989). This contrasts with 14.35p if bankruptcy had ensued for these individuals in 1998 (22.06p in 1989). These data correspond to average dividends reported in a series of industry-wide surveys carried out by the Society of Practitioners of Insolvency (SPI, 1992–98).

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The smallest cases are associated with the smallest dividends and with the smallest of benefits over bankruptcy, measured by the difference in anticipated dividends. In

addition the cases with assets below £20,000 show a greater chance of failure during the course of the IVA (39%). Where more than £20,000 is offered in the IVA the failure rate falls to 26%. There appears, therefore, to be little reason, in terms of revenue, for backing particularly small IVAs (i.e. those with asset values below £20,000).

One of the most significant findings of the 1998 study (Pond 1998a) was the increased chance of failure of the IVA where the difference between the IVA and bankruptcy dividends exceeds 20p (See Table 3). A proposal offering a dividend of 10p to 20p more than in bankruptcy has a 16.9% chance of failure, whilst a proposal offering over 20p more than bankruptcy has a 37.8% failure chance. Such cases are interpreted as being "over ambitious" since they promise to deliver far more than the equivalent bankruptcy. Linked with the incidence of debtor non-co-operation over ambitious IVAs appear to be far riskier based on 1998 study evidence (Pond, 1998a). Creditors must have a realistic idea of what is possible and what is over - optimistic. Whilst likely asset realisation values are more certain the problems appear to lie with the income stream of the debtor in the future.

One method of improving IVA size, where an income stream is available, is to extend the duration. What is clear from Table 5 is that IVAs are becoming longer. In 1993 51.22% of IVAs studied were completed in less than one year. In his 1992 text on IVAs Stephen Lawson wrote, *"It will only be in exceptional circumstances that a voluntary arrangement will last for longer than two years"* (Lawson, 1992, p.23). The longer duration of IVAs is associated with two design features – The increased

reliance on income from the debtor and the increased use of property re-valuation as sources of funds.

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In 1998, however, only 10.34 % of cases were due to be completed in under one year whilst 44.13% were designed to exceed the three year mark. Three years had always been seen as a benchmark as this is the likely duration of a full bankruptcy.

Only the shortest IVAs (one year or less) had a significantly lower failure rate (13%) than the overall average 31% failure rate shown in Table 5. Although not certain, this could be because they relied on the liquidation of assets rather than the expectation of income in the future. Duration alone is not a significant indicator of failure risk, however. This observation does provide support for the notion that debtor co-operativeness and IVA duration are linked. Longer IVAs are more likely to strain the relationship between the debtor, the practitioner.

5.3 Creditors' meeting modifications

The imposition of modifications *per se* is not, necessarily linked with an increased chance of failure. Table 3 shows that where modifications are made at creditors' meetings only 33% of IVAs fail subsequently against an average of 31% failing.

The major modifications reported in the 1998 study (Pond, 1998a) related to: Changed duration; increased income contribution; real property; windfall gains and administration of the IVA. The "administrative" modifications are unlikely to impact

on the debtor as much as those modifications that extend the duration of the IVA or increase the income contribution. Table 6 shows failure rates of IVAs linked to specific modifications of proposals (Pond,1998a).

INSERT TABLE 6 ABOUT HERE

Perhaps the most visible sign of creditor power in the IVA is the opportunity to table modifications to the proposal for agreement by the debtor. Heavily modified IVAs do have the chance, however, of being far more favourable to the creditor than the debtor originally intended.

Both Banks A and B use modifications extensively to “improve” proposals. . Bank A will request modifications in the 14 - 28 day period between notification of the creditors' meeting and the meeting itself. The bank supplies nominees with pro-forma list of acceptable modifications after review of the case.

Many of the modifications put forward by both case study banks are “administrative” in nature, such as limiting the Supervisor's fee or ensuring that the Supervisor retains sufficient funds too petition for bankruptcy should the IVA fail. Defining IVA failure is also a common modification. Such modifications have been borne of experience. Other modifications seek to improve the prospect of recovery by increasing the assets available, increasing the income contributed or extending the term of the IVA. A third type of modification is a contingent modification, including, "windfall gains" clauses and an undertaking to value the debtors house equity after a certain period with a view to re-mortgage or sale to realise this for the benefit of creditors.

Modifications to extend the IVA are linked to slightly greater co-operation of the debtor (Pond 1998a), although the chance of failure of the IVA is still average. Longer IVA periods indicate that some debtors will work hard to avoid bankruptcy. A greater proportion of IVAs is now seen in business and professional services, compared with other trades, due to that fact that licenses to practice of professionals such as lawyers and accountants are withdrawn under bankruptcy but not under IVA regulations. In 1994/95 an estimated 15.9% of all IVAs related to Business and Professional Services (Pond, 1998a), whilst only 6.94% of bankruptcies related to this sector in the same period (The Insolvency Service, 1995 and 1996).

Greater pressure appears to be placed on the debtor, however, when modifications seeking increased monthly contributions from income are included as the level of co-operation is likely to fall. This is also the case with property related modifications. Typical clauses call for revaluation of the family home towards the end of the IVA, and a re-mortgage or sale of the property if sufficient equity is apparent. These clauses are agreed by the pressurised debtor at the creditors' meeting, but on reflection, appear to erode the debtor's benefits under the IVA. This erosion puts the debtor closer to the position under bankruptcy and offers no compensating advantage, especially when the bankruptcy discharge period is generally shorter and the stigma much diminished.

The knowledge that so many creditors seek to apply modifications also leads insolvency practitioners to incorporate common clauses in proposals at the outset. This suggests that IVAs are far more "creditor friendly" than in the past and that they

reflect less and less the wishes of the debtor. Short term “victory” in getting the debtor to agree to certain modifications may be pyrrhic.

6. Options for creditors

There are a number of options faced by creditors in receipt of notice of a creditors' meeting in respect of an IVA. The debtor’s full proposal and the Nominee’s (practitioner) report accompany the meeting notice. Creditors are given between 14 and 28 days to decide how to vote at the meeting.

The options range from the do-nothing "Bin it" strategy to full investigation and scrutiny. In both cases common benefits are the opportunity to recover any VAT element of the debt and eventual receipt of a dividend whether or not a vote is cast. Beyond this the "Bin it" strategy can only boast that it has no financial outlay but to say that it costs nothing is an overstatement. The potential for loss under the "Bin it" strategy is enhanced since good IVAs could be rejected for lack of support. In addition the creditor may increase the moral hazard problem by failing to share information about assets or the debtor's history. Although other creditors will decide the outcome of the IVA meeting and, perhaps the likelihood of its success, this may be a strategy that even sophisticated creditors adopt where they only hold a small percentage of the total debt and the recovery is likely to be small.

The "Full scrutiny" strategy, such as that practised by Bank A, promises to be very costly in terms of staff time, not only at the time of receipt of the notice but afterwards in monitoring progress of the IVA over a period of years. It does, however, allow a

creditor to build up an expertise in this area and make more informed judgements on voting decisions and, importantly, modifications to proposals at the creditors' meeting. Organisations that always scrutinise and vote on IVA proposals enhance their bargaining power and practitioners may even anticipate their response by designing IVAs with particular creditors in mind.

"Full scrutiny" creditors need, however, to temper their expertise and power with the observation that some specific modifications, agreed by pressurised debtors at creditors' meetings, may increase the chance of debtor non co-operation and IVA failure.

7. IVA outcomes

Both case study banks are understandably sensitive about the administrative costs of their respective centralised units. Bank A was also sensitive about recovery levels although the continued benchmarking of their own outcomes against insolvency professionals suggests that centralisation is considered to be worthwhile.

Results that Bank A was willing to divulge indicated that 70% of accepted IVAs remained on target during their life cycle (ie: within 20% of forecast dividends). The recoveries also showed significant improvements on the original proposed levels put forward by debtors.

Bank B data is reported in table 2. The full database indicates that most cases achieve the 25p minimum dividend required and that forecast dividends are roughly in line with national averages reviewed by the SPI surveys (SPI, 1998).

At one level bank B's strategy is highly successful since it has reduced the bank based resources and costs associated formerly with the administration of insolvencies. Forecast recoveries appear to be around the national average but bank B has lost effective control of its own IVAs and is not in a position to act quickly to change its stance should problems arise with particular IVAs or with IVAs in general.

The bank relies on the prudence and expertise of the meeting services it employs and must ensure that it undertakes regular and thorough analysis of reported cases and recoveries in order to inform policy in the future and ensure that the projected recoveries have the best chance of materialising.

8. Conclusions

Changes in insolvency law have often come about following the abuse of existing legislation by debtors; creditors and those placed in control of debtors' estates. The 1986 Insolvency Act reflected the need to stem actual and potential abuses and to reflect society's changing view of bankruptcy. Rescue and rehabilitation for debtors was a primary driver for the review committee.

Since 1986 a variety of pressures, including the focus exercised by some creditors and professional insolvency practitioners, has worked to make IVAs the primary vehicle

for dealing with the insolvency of individuals where a recovery prospect exists. The case study banks have acted to streamline and centralise the administration of formal insolvency both for reasons of cost control and to improve recovery prospects.

The asymmetric bargaining power of larger creditors, a result of their corporate experience, centralisation and specialisation and their increasing use of professional “meeting services”, offered by Insolvency Practitioners, also helps banks to influence the acceptance of IVAs more readily. Generally, larger creditors are able to use their experience and select only IVAs that have a realistic chance of returning better dividends than bankruptcy. In these cases, their recoveries are likely to be greater.

The paper also provides evidence to indicate that the large creditors studied are risk averse and work to modify IVA proposals to improve recovery prospects. In this way the case study creditors are pro-active and illustrative of creditors generally who are taking an increased interest in IVAs.

Finally the paper indicates that some specific modifications can be seen as counter-productive as they are associated with a higher chance of IVA failure and overall lower dividends. Creditors are advised to temper their short term aims to maximise returns with the longer term need for the IVA to run its course.

Acknowledgement

This project would not have been possible without the access to records, co-operation of managers and assistance given by practitioners allowed by the two banks reviewed.

Table 1: Individual Insolvency statistics 1987 - 2000

	1987	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Bankruptcy	6994	7717	8138	12058	22632	32106	31016	25634	21933	21803	19892	19647	21611	22042
IVA	404	779	1224	1927	3002	4686	5679	5103	4384	4466	4545	4901	7195	8204
Deed of Arrangement	29	11	3	2	6	2	8	2	2	2	4	1	0	0
TOTALS	**7427**	**8507**	**9365**	**13987**	**25640**	**36794**	**36703**	**30739**	**26319**	**26271**	**24441**	**24549**	**28806**	**30246**
%IVAs	5.44%	9.16%	13.07%	13.78%	11.71%	12.74%	15.47%	16.60%	16.66%	17.00%	18.60%	19.96%	24.98%	27.12%
Bankruptcy growth		10.34%	5.46%	48.17%	87.69%	41.86%	-3.40%	-17.4%	-14.4%	-0.59%	-8.76%	-1.23%	10.00%	1.99%
IVA growth		92.82%	57.12%	57.43%	55.79%	56.10%	21.19%	-10.1%	-14.1%	1.87%	1.77%	7.83%	46.81%	14.02%
TOT. growth		14.54%	10.09%	49.35%	83.31%	43.50%	-0.25%	-16.3%	-14.4%	-0.18%	-6.97%	0.44%	17.34%	5.00%

Source: DTI Statistics Directorate.

Table 2: Comparative IVA and bankruptcy dividends

	Case Study Bank B cases 1998/99	% of total cases	% of "live" cases	Case Study Bank B average anticipated dividends	Comparative dividend from 7th SPI Survey (SPI, 1998)
Accepted IVAs	1034	33.44	82	37.62p	43p
Bankruptcy with dividend	*227*	*7.34*	18	9.67p**	26p
Bankruptcy without dividend	*1831**	*0.0*	-	0	n/k
Total Bankruptcy	2058	66.56	-	-	n/k
TOTAL / AVERAGE	3092	100	100	-	

** Official Receivers appointed in 95% of cases.*

*** This includes cases where dividend was forecast but not quantified. A nil dividend was entered. If such cases are excluded a 36.42p dividend results.*

Table 3 IVA failure risk factors

		Chi - square		
Factor	**Fail %**	**Pearson's r**	**DF**	**Sig.**
Debtor not co-operative	56.8	50.99719	2	.00000
IVA dividend = bankruptcy dividend	66.7	19.44784	2	.00006
IVA div. > 20p more than bankruptcy	37.8	19.44784	2	.00006
Assets / Income <£20,000	39.4	2.70417	1	.10009
Modifications at creditors' meeting	33.0	0.50755	1	.47620

Source: Pond, 1998a

Table 4 Anticipated dividends in IVAs and Bankruptcy*

SIZE OF IVAs (Income + Assets)	IVA dividend (av.)	Est. bankruptcy dividend (av.)	IVA / Bankruptcy Difference
< £10K	5.02	4.65	+0.37
£10K <= £20K	42.2	17.75	+24.45
£20K <= £50K	31.76	10.4	+21.36
£50K +	39.46	18.65	+20.81
Not known	14.29	1.14	+13.15
TOTAL / AV	30.69	14.35	+16.34

Source: Pond 1998a

Table 5 Duration of IVAs

Duration of IVAs (months)	1993 study (%)	1998 study (%)	1998 failure rate (%)
up to 12 months	51.22	10.34	13
12 to 24 months	8.54	13.1	37
24 to 36 months	23.17	24.14	37
36 to 48 months	6.1	15.17	14
over 48 months	10.98	28.96	38
Not known	-	8.28	38
TOTAL/OVERALL	100	100	31

Source: Pond 1998a

Table 6 IVA modification failure risk factors

Modification	**Fail %**	**n.=***
Windfall clause	23.81%	21
Property re-valuation	48.57%	35
Increased income contribution	35.38%	65
Increased duration	38.71%	31
Other modifications	36.84%	57

* n= number of cases where clause noted. Total sample cases = 145.

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