

# Personal debt and insolvency: fit for purpose?



Over recent years, there has been a dramatic increase in the number of people struggling with their debts. As a consequence, England and Wales has experienced a personal insolvency explosion, with the number of people entering formal insolvency increasing by 450% over the last decade.

Given the scale of the problem, it is vital that the personal insolvency system is effective and strikes the right balance between dealing with individuals in financial distress, and protecting the rights of creditors. R3 believes that four key areas should be reformed to ensure the insolvency regime supports individuals in financial distress more effectively and encourages repayment of debts wherever possible.

## 1. Finding the right solution - breathing space from creditors

The current personal insolvency system can appear complex, with many different formal and informal options to suit a range of circumstances. Given the complexity of the system, it is vital that financially distressed individuals enter the insolvency solution best suited to their financial circumstances.

However, evidence suggests that individuals in financial distress are not as aware of their options as they should be and that they can receive bad advice or make pressurised decisions, which results in them entering into the 'wrong' solution.

- R3's research indicates that 35% of individuals in a Debt Management Plan (DMP) said they were not told about other ways of dealing with their debts before their DMP began.
- 32% of those in an Individual Voluntary Arrangement (IVA) said that no-one talked to them about other options before their IVA started.
- More than one in ten individuals in an IVA (12%) say they were pushed into the arrangement by the company that arranged their IVA.
- 30% of individuals in an IVA and the same proportion of undischarged bankrupts were in a DMP before entering into formal insolvency. This 'journey' between insolvency procedures suggests that another solution may have been more appropriate from the start.

While there is merit in having a number of debt solutions to suit a range of circumstances, individuals should be able to take a decision about which debt remedy to pursue based on impartial and full advice; and in an environment that allows them to weigh up the full range of options before making a decision.

R3 believes that individuals in financial distress should be able to apply to court for a moratorium (breathing space) from creditor action for twenty eight days, during which time they are required to seek advice from impartial financial advisors who do not have an interest in promoting a particular solution. The creation of a moratorium should ensure that debtors are made aware of their options and that they do not make pressurised decisions – therefore increasing the likelihood that they enter the insolvency solution best suited to their financial situation and best able to resolve their debt problems.

There are a number of options to cover the costs of setting up this initiative and running it, including a modest fee paid by the debtor, a creditor levy, or a levy on credit cards.

## 2. Rebalancing the debtor-creditor relationship

The personal insolvency regime should balance the interests of creditors and debtors. In some areas, the balance between creditor and debtor has shifted towards the creditor. It is important that attempts are made to rebalance this inequality.

We believe that monetary limits are currently misused by creditors, allowing creditors to threaten to petition for an individual's bankruptcy on a relatively low level debt. Under the current system, a creditor can petition for an individual's bankruptcy when they are owed just £750. We believe that this threshold is now outdated, given that it was set in 1986. We suggest that £3000 is a more appropriate sum. Raising the threshold would prevent bankruptcy petitions being made on very low level debts.

We also believe creditors should be required to obtain a judgment before they issue a statutory demand. This would prevent creditors using the threat of a bankruptcy petition as an intimidating tactic rather than a genuine means to recoup money owed to them.

## 3. Encouraging repayment of consumer debts

The UK's personal insolvency regime was designed to deal with trading related insolvencies (company directors or self employed individuals entering insolvency as a knock on effect of business failure). It tends to encourage debt write off with a view to encouraging business men and women to pick themselves up and begin again as quickly as possible. However, 90% of personal insolvency cases involve consumer debt. In view of this, the personal insolvency regime needs to be modified and updated to encourage repayment of debts wherever possible. R3 calls for two key changes to address these issues:

### A simple route to repayment for consumer debt

A protocol compliant IVA is a very effective repayment procedure for insolvent individuals who have sufficient income or assets to repay



some or all of what they owe. Despite high take-up, there are still many barriers to entry into this type of IVA, with creditors rejecting IVA proposals or modifying them to the point where they are unacceptable to the debtor.

We believe that these simpler consumer cases - where debts are easily quantifiable, and there are no tax liabilities - should be able to access a statutory solution to resolve their distress - the Simplified IVA.(SIVA) By reducing the scope for creditor modification or outright rejection, SIVAs would increase the opportunity for individuals who can repay their debts to do so. Previously judged by the Government to be unnecessary, this statutory process would ensure that there is a simple repayment solution available to the majority of insolvent consumers.

### Incentivising repayment

Many claim that bankruptcy has become 'too easy' compared to other repayment insolvency solutions - providing an opportunity to be free from debts after a short period of time (individuals are discharged after 12 months, and some are discharged before this point).

To incentivise repayment, R3 believes there is merit in considering returning the period of bankruptcy from one year to three years. The 2002 Enterprise Act decreased the bankruptcy period to one year, with the hope of promoting enterprise. This was misconceived given that the vast majority of bankrupts are domestic, consumer bankrupts. Lengthening the bankruptcy period would incentivise repayment by effectively serving to make bankruptcy less appealing than repayment options (IVAs, DMPs).

We also propose that individuals entering an IVA should no longer be subject to the same negative impact on their credit rating as those individuals entering bankruptcy. This would recognise the key differences between the procedures - i.e. that individuals in an IVA make a long and concerted effort to repay their debts whereas bankruptcy involves considerable debt write off.

## 4. Debt Management Plans: better regulation

Debt Management Plans have an important role to play in the debt and insolvency landscape. However, there remain worrying practices in the debt management market, as evidenced by an OFT report and the findings of R3's research:

- Research among Insolvency Practitioners find that 57% have seen individuals whose DMP had failed because the amount of debt they were in was simply too high to make a DMP a feasible option in the first place and 46% have seen DMPs fail because the monthly payments set up as part of the plan were simply unaffordable
- Research among individuals in DMPs also suggests that there is bad practice within the DMP industry. For example, 22% of individuals in a DMP say the organisation that set it up did not ask for proof of income and expenditure before the plan began and 10% of individuals in a fee-charging DMP say they were not told that they would be charged until after their plan began.

Unlike other insolvency procedures, DMPs are not regulated by the Insolvency Service. Instead the OFT issues Consumer Credit Licences and debt management guidance. R3 believes that the OFT's regulation and enforcement activity is insufficient to tackle bad practice within the market, mainly because the bulk of the investigative work is reactive rather than proactive. DMP providers are not regularly monitored and once a Consumer Credit Licence has been granted there is little to deter bad practice.

We think it is undesirable that while IPs are subject to rigorous ongoing regulatory and compliance requirements in order to practice within the personal insolvency market, the regulation of DMP providers and the unregulated debt advice market is far less stringent, even though both deal with individuals in financial distress and the provision of insolvency solutions.

R3 calls for DMP providers to be regulated to the same standards as Insolvency Practitioners and believe that the regulation of this market should be removed from the OFT and become the responsibility of the Insolvency Service. This would ensure that all insolvency solution providers are regulated to the same standards and deter bad practice within the industry.

## Key insolvency terms

### What is an IVA?

An Individual Voluntary Arrangement (IVA) is a formal agreement between debtors and their creditors. Both parties come to an arrangement whereby debtors make payments towards the total amount of their debt to pay off a percentage of what they owe. Usually after 5 years the debt is settled and the remainder written off. Due to its formal nature, an Individual Voluntary Arrangement (IVA) has to be supervised by a licensed insolvency professional.

### What is a DMP?

A Debt Management Plan (DMP) is an informal agreement between debtors and their creditors. Both parties come to an arrangement whereby debtors make repayments towards the amount of debt they owe over an agreed period of time (there is no set limit). DMPs may or may not involve debt write off, dependent on what is agreed between the debtor and creditors. DMPs can be set up by licensed insolvency professionals, fee-charging DMP companies or not-for-profit agencies.

### What is bankruptcy?

Bankruptcy is a formal court procedure which can be started by the individual concerned or by certain of their creditors. The debtor's assets will be sold to help pay creditors, however they will usually be allowed to keep their personal belongings such as the contents of their home. The debtor's assets will be dealt with by a licensed and regulated Insolvency Practitioner or by a government official and some repayments may be made over a set period of time (up to 3 years) if there is sufficient income to do so. Bankruptcy usually lasts for 12 months. Once the debtor has been freed from bankruptcy, with certain exceptions they are released from their debts.



## About R3

R3, the trade body for Insolvency Professionals, represents over 97% of Insolvency Practitioners. R3 members are trained and regulated accountants and lawyers who have extensive experience of helping businesses and individuals in financial distress.