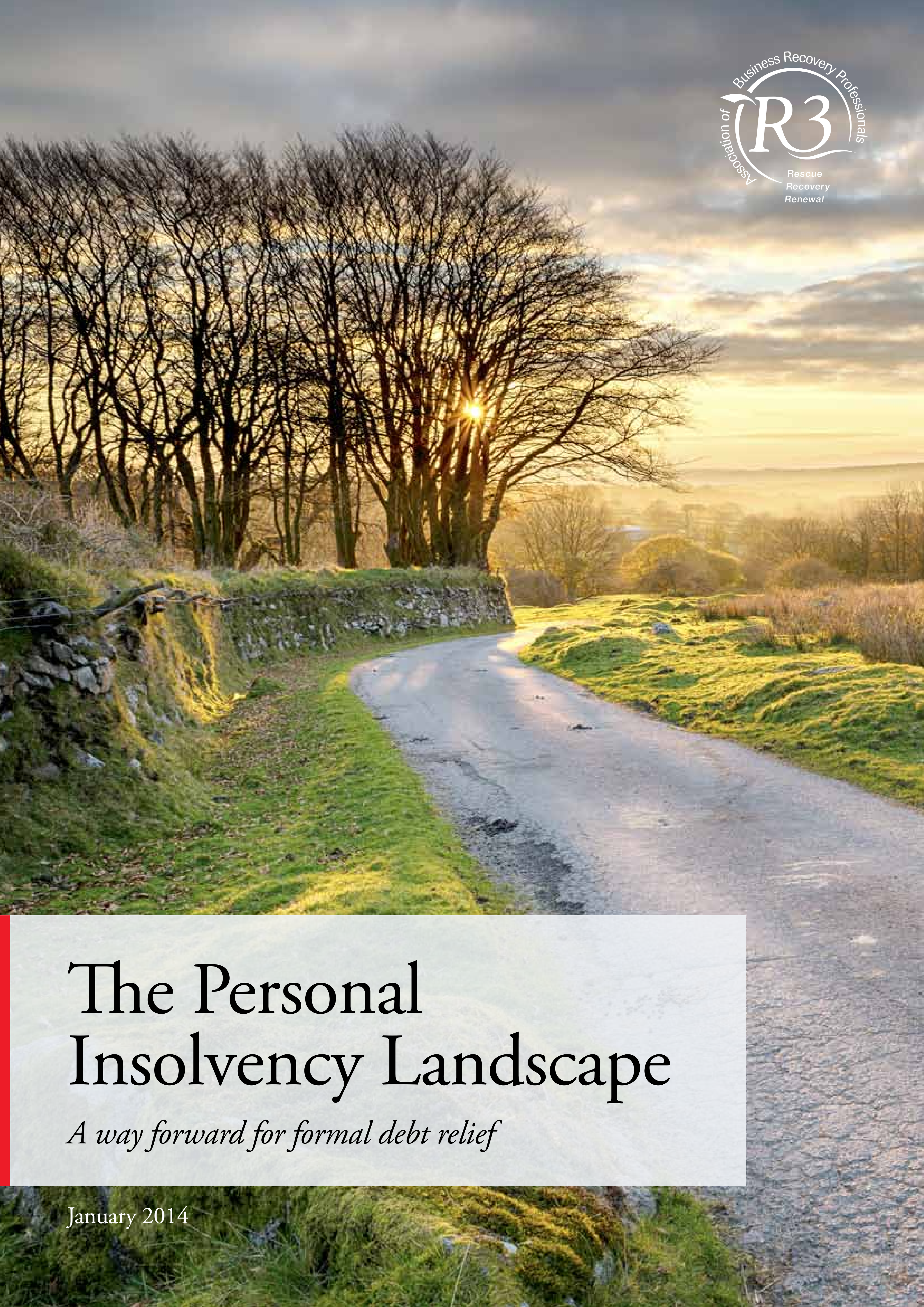

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The Personal Insolvency Landscape

A way forward for formal debt relief

January 2014

Contents

Foreword

In England and Wales, the debate about the rising cost of living and the pressures facing those living at the edge of their means has already been well documented. However little attention is given to what happens to those people once they go beyond that edge.

Falling over the edge into insolvency is far from uncommon. Over the last two decades, there has been a dramatic increase in the number of people struggling with their debts. As a consequence, England and Wales have experienced a personal insolvency explosion: in the last decade, the number of new personal insolvencies increased by almost 300%. In the twelve months to the end of September 2013 alone, over 102,000 people in England and Wales entered a formal insolvency procedure; and there were potentially thousands more not accounted for.

A successful personal insolvency regime must strike the right balance: on the one hand it should allow people to get back onto their own two feet by relieving their indebtedness, whilst on the other hand, it should seek to return to creditors what is owed to them.

Fail to get this right, and you end up with people trapped in a vicious cycle of debt, without protection from creditors, financially dependent on others and potentially pushed into inappropriate debt solutions for their financial situation. On the other side of the coin, creditors may be unable to lend or trade with confidence and will soon become more cautious about doing so – the cost of borrowing and goods then goes up for everyone.

The health of the personal insolvency landscape, therefore, has ramifications for the whole of society.

Room for reform

While the UK performs well on corporate insolvency – as of December 2013, the UK's corporate insolvency regime is ranked as the 7th best in the world by the World Bank – there are a number of areas of work to be done before we can say the same about personal insolvency.

The problem is manifold. It could be argued that our personal insolvency regime is too lenient: witness the prevalence of 'bankruptcy tourism' as Europeans head to England and Wales to take advantage of the bankruptcy regime and its shortened bankruptcy term; but this contrasts starkly with the fact that many ordinary British adults cannot afford to access bankruptcy, even though this would be the most appropriate debt relief solution for their circumstances.

To improve, personal insolvency in England and Wales needs added balance and cohesion. For example, debtors need better access to debt relief and creditors need better protection from those recklessly accumulating debt. The various facets of the system – from bankruptcy to Individual Voluntary Arrangements – do have the potential to work well, but they need to work well together and not in isolation.

Action is needed now

This paper offers ways to find the missing balance and cohesion for England and Wales' personal insolvency regime, which has developed in bits and pieces over the past three decades.

The ideas in the following pages are based on the contributions of the UK's Insolvency Practitioners, who work day-in, day-out with indebted and financially struggling individuals. These are the professionals that have to help deal with the fallout from personal insolvency, and have first-hand experience of what works and what doesn't for indebted people.

The official number of personal insolvencies has fallen over the past few years, but it is not clear how long this downward trend will last. Household debts have returned to their pre-financial crisis levels; five years after recession, wage growth still dawdles behind inflation; and an interest rate hike is now likely to be coming sooner rather than later. Against this backdrop, an increase in the number of people who become insolvent unfortunately seems inevitable in the near future.

If there is to be a fresh boom in personal insolvencies, however unwelcome that is, it's important that we have the infrastructure in place to deal with each case quickly and effectively, keeping the ripples from each insolvency to a minimum and restoring those affected to financial health. At the same time, it is also important to ensure that the interests of creditors caught up in the process are taken into account.

Action from the government is needed now to ensure that not only is our personal insolvency landscape ready to address the current wave of personal insolvencies, but that it is ready to help manage any future wave too.

R3 believes that this paper can make a valuable contribution to the wider conversation on personal debt; makes a persuasive case for what the government must do now and demonstrates how the personal insolvency regime can fulfil its potential for decades to come.

Liz Bingham

R3 President

Executive summary of proposals

Debt relief procedure	The problem	R3's proposals
All procedures	• Lack of consistency in calculating income and expenditure	• Universal use of the Common Financial Statement or similar across all debt relief solutions to calculate an individual's surplus income
Bankruptcy (page 8 & 12)	• Cost of entry is a barrier to entry (£700)	• Payment by instalments • Increase Debt Relief Order thresholds
	• Current system doesn't adequately consider and deal with an individual's behaviour in run up to bankruptcy	A three tier bankruptcy process: • Three year standard term (rather than current 12 months) • Three to 15 year term for the 'most culpable' individuals • 12 month term for the 'least culpable' individuals
	• Minimum income threshold for Income Payment Orders/Agreements is too low, jeopardising individuals' ability to cope with financial shocks or emergency expenditure	• Increase the minimum income threshold to £50 per month
Debt Relief Orders (DRO) (page 9 & 15)	• Entry thresholds for assets (£300) and debts (£15,000) are too low, needlessly acting as a barrier to entry	• Increase the asset threshold to £2,000 • Increase the debt threshold to £30,000
	• There is a disincentive for individuals to improve their financial situation or declare a change in their circumstances whilst subject to a DRO	• Offer individuals the option to transfer into bankruptcy if their circumstances change such that they are no longer eligible for a DRO
	• Revocation of the order is not a strong enough deterrent to individuals who seek to mislead or leave out information on their application form	• Retrospective effect of revocation of the order where the individual has provided false information or deliberately sought to mislead or leave out information on their application form
	• An individual can be made subject to a Debt Relief Restrictions Order (DRRO) at the same time that their DRO is revoked, subjecting them to the DRO restrictions for an extended period but without any debt relief	• A DRRO should only be imposed for reasons of the individual's behaviour prior to the DRO and not simultaneously with revocation of the DRO
Individual Voluntary Arrangements (IVA) (page 10 & 18)	• Creditor modifications are a barrier to entry	• Introduce simplified IVAs
	• Lack of incentive for individuals to enter this solution to repay a proportion of their debts	• Reduce the impact of an IVA on the individual's credit rating in comparison to bankruptcy or a DRO

The meaning of success

The success or failure of a formal personal insolvency regime rests on its ability to balance two competing priorities:

1) providing a means of relief and financial rehabilitation for over-indebted individuals; and

2) protecting creditors' interests and maintaining the confidence of lenders and other economic actors, through supporting the principle that debts should be repaid where possible.

The first of these recognises the fundamental fact that, where credit is available, there will always be individuals who, for various reasons, find themselves over-indebted. It also recognises that the unnecessarily draconian treatment of such individuals is not only difficult to defend from a social policy perspective, but it is also a waste of the potential contribution such individuals could make to the economy in the future.

The second priority acknowledges that economic interactions are based on confidence that each party will keep to its end of the bargain. Where this confidence is lacking, such as where creditors believe that individuals will not be able to repay their debts, such interactions are either less likely to occur or risk will be priced into the transaction – in the case of lending, credit will be restricted and will cost more for everyone.

Formal personal insolvency procedures have to maintain lenders' confidence by facilitating the right balance between ensuring that insolvency is not seen as a 'soft option' which promotes the accrual then 'dumping' of debt, nor a process that is unnecessarily draconian for indebted individuals, but one that provides returns to creditors where possible.

Characteristics

A successful formal personal insolvency regime also has to recognise that different individuals struggling with debts have different characteristics which a single process is highly unlikely to be able to accommodate. It seems appropriate, therefore, that there should be a number of different routes by which individuals can access debt relief depending on their circumstances.

It is useful to consider how these various characteristics might affect the overall architecture of the regime. Throughout, the two competing priorities of providing debt relief to individuals and maintaining the confidence of creditors must be borne in mind.

Impact on creditor

The greater the impact on the particular creditors involved, the more important it would seem to be to avoid perceptions of inappropriate debt avoidance by indebted individuals.

Likewise, where creditors are particularly exposed (small businesses, for example) providing returns to creditors appears particularly important.

Prior behaviour

In order to uphold the principle that debts should be repaid, and to ensure insolvency processes are not seen as a 'soft option', it would seem appropriate for the system to take into account how individuals accumulated their debts.

The system should be sufficiently sensitive to differentiate between reckless spenders and those who have merely suffered as a result of, for example, a sudden illness or spiralling costs and falling wages.

Value of assets/level of income

Where individuals have sufficient assets or income to repay at least a proportion of their debts, they should do so, in order to uphold the principle that debts should be repaid.

Where an individual is not in a position to make a contribution, a simpler process may be more appropriate.

Trader/consumer

Trading cases are likely to involve a more complex and diverse group of creditors than consumer cases.

Those who are directors of companies may have an interest in retaining their position.

It could be argued that the swift rehabilitation of trading-related debtors encourages entrepreneurship.

The current situation

Before considering how best such characteristics might be accommodated, let us first examine the current regime.

In England and Wales, there are currently three formal personal insolvency processes, ranging from debt write off in bankruptcy to procedures which involve some form of debt repayment, such as Individual Voluntary Arrangements:

1. Bankruptcy

Key characteristics:

- £700 up-front fee (£175 court fee + £525 case administration fee)
- Usually 12 months before automatic discharge, after which the debtor emerges debt free, apart from certain excluded debts such as student loans, child support payments, fines and debts incurred through fraud.
- Before discharge, individuals are subject to certain restrictions, such as being unable to act as a company director without the leave of the court and being unable to access more than £500 of credit without notifying the lender that they are subject to a bankruptcy order.
- Remains on credit history for six years from the date of the order.
- All the debtor's assets at the time of the bankruptcy order, with certain exclusions to enable them to live and work, form part of their 'estate' and are realised and distributed for the benefit of creditors.
- The estate is administered by the Trustee in bankruptcy: either an Insolvency Practitioner (IP) or a Government official, the Official Receiver (OR).
- Before discharge, an Income Payments Order/Agreement (IPO/A) can be obtained enabling surplus income over £20 a month to be collected for the benefit of creditors for up to three years from the date of the order/agreement.
- Discharge from bankruptcy can only be suspended for non-cooperation with the Trustee in bankruptcy, who is responsible for administering the debtor's estate and making distributions to creditors.
- During the 12 months before discharge, the OR can apply for a Bankruptcy Restrictions Order/Undertaking (BRO/U) which can extend the restrictions of bankruptcy for up to 15 years. This does not extend the term of bankruptcy, meaning that assets and income acquired after the initial 12 months - unless an IPO/A is in place - cannot be claimed for the benefit of creditors.

2. Debt Relief Orders (DROs)

Key characteristics:

- Designed for those with relatively low levels of debt and few or no assets:
  - Maximum debts of £15,000
  - Maximum assets of £300 (excluding a car which can be worth up to £1,000, approved pensions and basic domestic belongings such as clothes, bedding and furniture).
  - Maximum surplus income of £50 per month.

- £90 entry fee.

- 12 month term after which the debtor emerges debt free, apart from certain excluded debts such as student loans, child support payments, fines and debts incurred through fraud.

- During the 12 months, individuals are subject to certain restrictions, such as being unable to act as a company director without the leave of the court and being unable to access more than £500 of credit without notifying the lender that they are subject to a DRO.

- Remains on credit history for six years from the date of the order.

- No debtor's estate or distribution to creditors.

- If the individual's circumstances change during the period of the DRO and they no longer meet the eligibility criteria, the OR will either cancel the DRO or, if the change occurs near to the end of the 12 month period, the OR can decide to extend the DRO period for a further three months to enable the individual to come to an arrangement with their creditors.

- If a DRO is cancelled, the effect is as if it had never existed i.e. the debtor is still liable for all of their original debts.

- If an individual misrepresents their circumstances in order to obtain a DRO, the OR can cancel the DRO and can take further action, including making the individual subject to a Debt Relief Restrictions Order or Undertaking (DRRO/U), which extends the restrictions of a DRO for up to 15 years.

- DRRO/Us can also be imposed on individuals where the OR determines that they have been dishonest before or during their DRO or are otherwise blameworthy for their financial position, such as incurring debts which they had no reasonable chance of repaying, gambling, fraud, giving away assets or selling them at less than their value.

3. Individual Voluntary Arrangements (IVAs)

Types of IVAs:

There are two different types of IVA dependent on the characteristics of the debtor:

IVA Protocol compliant IVAs

The IVA Protocol was introduced in 2008 in order to provide a standardised process for dealing with straightforward, consumer IVAs and to create more efficiency by removing many of the obstacles to obtaining approval of IVA proposals in simple cases.

The Protocol provides a standardised approach for the format of presenting the debtor's IVA proposal to his/her creditors as well as providing a common approach to calculating the debtor's income and expenditure and for dealing with the individual's interest in his/her home.

By accepting the content of the Protocol, creditors and IVA providers agree to follow the processes and documentation set out in the Protocol. The IVA provider will draw up a proposal based on the Protocol Standard Terms and Conditions and creditors are expected to comply (although they are not bound to do so) with the terms of the Protocol in relation to those proposals.

The IVA Protocol process should only be used for straightforward consumer cases, which are likely to be those where the debtor receives a regular income from employment or a pension and has three or more different forms of credit with two or more creditors. Age and debt level are not factors in determining whether a debtor is suitable for a Protocol IVA and it is suitable for both home owners and non home owners. Likewise, self-employed debtors can obtain a Protocol IVA, provided their employment produces regular income.

The operation of the Protocol is overseen by the IVA Standing Committee, a group of representatives from the insolvency, creditor and debt advice sectors which is chaired by the Insolvency Service.

Other consumer IVAs and trading IVAs

There may be circumstances specific to a consumer debtor's case where the IVA provider considers that use of the Protocol would not be appropriate or where only part of the Protocol terms and conditions would be relevant.

Factors which may mean that a debtor is not suitable for a fully Protocol compliant IVA include disputed debts and the possibility of full and final settlement in the first year of the IVA. Alternatively the debtor may be self-employed and running his/her own business. In either set of circumstances, the case is less straightforward and requires a bespoke IVA governed by terms and conditions, such as those provided by R3.

Key characteristics of IVAs:

- A formal binding agreement between an individual and their creditors, typically based on the individual making manageable payments towards their total debt in order to pay off a percentage of what they owe, without incurring further interest.
- Alternatively a formal binding agreement based on an appropriate combination of debt rescheduling, contributions towards the outstanding debts by the debtor and third parties and a structured sale of assets to repay creditors.
- Can last for any period of time, but five years is the most common. On satisfactory completion the debt is settled and any unpaid balance is written off.
- The individual is not subject to the same restrictions as in bankruptcy or a DRO, although specific restrictions can be contained within the IVA proposal.
- Remains on credit history for six years.
- With the help of an IP, the individual puts together a proposal for their creditors, setting out their total debts and how much they can realistically pay back to creditors. Where appropriate, often a proposal will usually include remortgaging or otherwise realising equity in the individual's home. For example, Protocol IVAs provide for remortgaging or realising equity in the home after 54 months.
- An IVA will normally include all of the individual's unsecured debts but the rights of secured creditors cannot be affected without the consent of the creditor.
- There is a physical meeting of creditors to approve the IVA. Creditors may vote in person or by proxy.
- Creditors are able to propose modifications to the IVA proposal as a condition of voting in favour of it. If the debtor is not prepared to agree to the modification(s), the creditor will be treated as rejecting the proposal, unless the modification is withdrawn.
- Two-stage voting process to succeed:
    - the IVA needs to be supported by 75% or more of creditors by value voting at the meeting; and
    - less than 50% by value of non-associated creditors vote against the proposal.
- Approval of the IVA binds all creditors (but does not affect secured creditors' rights) whether or not they have voted in favour or at all.
- Once the IVA is in place it is supervised by an IP.

Re-shaping the system

Whilst the various formal personal insolvency routes are clearly designed with a view to providing options for debtors with different characteristics, there are a number of issues and anomalies which prevent them from fulfilling this purpose entirely effectively in their current form.

1. Bankruptcy

a) Cost of bankruptcy

The £700 cost to apply for bankruptcy is made up of two upfront fees - a court fee of £175 and a deposit of £525. The court has discretion over whether its fee may be waived in some circumstances - e.g. if an applicant is on income support - but the deposit is the same for everyone regardless of their debt, asset or income level. The amount of money needed to apply for bankruptcy increased during 2011 from a total of £600 at the start of the year to the current sum of £700.

It seems counter-intuitive that people who are hugely indebted can find £700 to apply for bankruptcy, unless they go further into debt and/or avoid paying other creditors. Certain charities offer to cover the cost of bankruptcy applications, but this provision is unlikely to cover all potential bankruptcies.

Case study: Due to ill health, an individual and his wife in the North West got into serious debt, which further exacerbated their health problems. Having recently sought advice from a debt adviser after suffering a serious breakdown, they were advised to go bankrupt due to their age and ill health. Despite bankruptcy being the most appropriate solution for their circumstances, they are unable to find £1400 to pay for their bankruptcy fees (£700 each). Their debt problems are getting worse, including visits from bailiffs, which has led to further health issues and severe depression. As they cannot afford to go bankrupt, they are now being forced to seek alternative debt relief solutions when bankruptcy would be more appropriate.

A survey of Insolvency Practitioners reveals that 29%[1] have seen debtors unable to afford to go bankrupt during the twelve months preceding the survey, even though bankruptcy would have been an appropriate option. Asked what tends to be the next step for the debtor in this position, 58%[2] said 'the individual does not address their debts'. This risks debtors accruing more debt, avoiding paying their creditors and being pursued by those they owe money to.

Solutions

Payment by instalments

Allowing the bankruptcy fee to be paid in instalments prior to or throughout the term of bankruptcy would enable more people for whom bankruptcy is the most appropriate solution to access it. One

[1] R3 Membership Survey, May 2011
[2] Ibid

way in which this could be achieved would be to postpone the individual's discharge from bankruptcy until they had made all of the required payments. In this way, the debtor would benefit from debt relief over the period of their bankruptcy whilst the requirement to pay the bankruptcy fee would also be met, albeit over a longer period of time.

DRO thresholds

For those with lower levels of debt and few assets, one solution may be to revise the thresholds for entry into DROs, which only have a £90 application fee. This would enable those who are currently unable to afford to go bankrupt to access an alternative form of debt relief and, therefore, be financially rehabilitated. Furthermore, it would allow a good proportion of those with few or no assets to move into this cheaper administrative procedure. Currently the cost of administering such bankruptcy cases is a drain on Government resources. This will be addressed further in the context of DROs later in the paper.

b) Prior behaviour

The current 12 month term of bankruptcy makes no distinction between those who have accrued their debts recklessly and those who have merely been the unfortunate victims of circumstance. Drawing this distinction seems crucial to maintaining the confidence of creditors through avoiding the impression that bankruptcy is a 'soft option'.

Whilst the current system does allow for reckless or blameworthy individuals to be made subject to a BRO/U, extending the restrictions of bankruptcy for up to 15 years, creditors have no claim on any assets acquired after the 12 month term of bankruptcy has ended.

The current system also lacks a middle ground. Prior to 2003, the standard term of bankruptcy was three years. This was reduced to 12 months on the grounds that doing so could help to promote entrepreneurship through allowing entrepreneurs whose initial business ventures had failed to be swiftly rehabilitated and in a position to try again. Whilst it is unclear what effect this has had on entrepreneurship, the number of trading-related bankruptcies as a proportion of overall case numbers has fallen significantly since 2003. The vast majority of cases continue to be consumer bankruptcies, for which no attempt was made to justify a reduction in the original three year term.

Solutions

A three-tier bankruptcy process

Three year standard term of bankruptcy – this would restore the balance between debtors and creditors to the situation before 2003, on the basis that the vast majority of bankruptcies continue to be amongst consumers. Whilst a return to a three year standard term may help to reduce 'bankruptcy tourism', where foreign debtors seek to be declared bankrupt in England and Wales in order to benefit from a reduced term of bankruptcy, this would mean that England and Wales would still have one of the lowest standard terms of bankruptcy in the world. By way of comparison, the term of bankruptcy in Germany is seven years and in Ireland, the term has recently been revised to three years.

Three to 15 year term of bankruptcy for 'most culpable' individuals – individuals judged to have accrued debts in a reckless or otherwise blameworthy fashion can already be made subject to BRO/Us. However, allowing the bankruptcy term to be extended when applying a BRO/U would allow any assets acquired during the extended bankruptcy period to be claimed for the benefit of creditors. This would increase returns to creditors and would act as a more robust deterrent to the individual concerned and others who may consider behaving in a similar reckless or blameworthy manner.

12 month term for 'least culpable' individuals – the OR could reduce the standard three year term to 12 months for those who have arrived at their financial situation through little fault of their own. Given that the indebtedness of such groups will, in many cases, be unavoidable, there seems little to justify the 'deterrent effect' of a more robust process. However, at the time of obtaining their discharge at 12 months, debtors could be informed by the OR or their Trustee (by a letter which is placed on their court file) that, should it come to light in the two years following their discharge that they have provided misleading information about their circumstances or provided other false information to the OR or Trustee, either the OR or Trustee could issue an application to court to restore the bankruptcy and impose a discharge period of three years. This precaution would act as a safeguard against those individuals who seek to mislead the Court, the OR or their Trustee about their circumstances in order to benefit from the reduced discharge period.

c) Income Payments Orders/Agreements (IPO/As)

IPO/As clearly fulfil a useful function within the bankruptcy regime as they allow surplus income over and above the individual's reasonable domestic needs to be claimed for the benefit of creditors for up to three years from the date of the agreement or order. This must be balanced, however, with the need to make the process work for bankrupt individuals. Under the current system, under which individuals can be made subject to an IPO/A when they have £20 or more of surplus income a month, the limit is set so low that it may severely jeopardise individuals' ability to cope with financial shocks. This argument appears to have been accepted in the case of DROs, in which the permitted limit of surplus income is £50 per month. The inconsistency between bankruptcy and DROs in this regard is unhelpful.

Solution

Increase IPO/A threshold to £50 per month

For the sake of consistency and to achieve a more appropriate balance between debtors' and creditors' interests, it would seem sensible to equalise the permitted level of surplus income for IPA/Os in bankruptcy and the surplus income level set in DROs at £50 per month.

d) A common tool to calculate income and expenditure

At present, the calculation of a debtor's overall income, assets, expenditure and liabilities can vary depending on which debt solution they enter. For example, in many Debt Management Plans and IVAs, the calculation of surplus income available for debt repayments, after all expenditure has been accounted for, is based on a budgeting tool called the Common Financial Statement, which is administered by the Money Advice Trust, the British Bankers Association and the Finance & Leasing

Association. However, other solutions, such as bankruptcy, may use a different form of calculator, meaning that there can be a lack of consistency in how income and expenditure are accounted for across the variety of debt solutions, both formal and informal.

Solution

Universal standard calculator for income and expenditure

For the sake of consistency, the Common Financial Statement or similar could be used as the standard tool to calculate a debtor's surplus income across all personal insolvency solutions, both informal and formal.

2. DROs

a) Asset and debt thresholds

The current asset and debt thresholds of £300 and £15,000 respectively act as a barrier to entry. On the one hand that is their function. As there is no 'estate' in a DRO, meaning no distribution to creditors, it is clearly not an appropriate solution for people who do have significant assets and could make a contribution towards repaying their debts. Furthermore, as DROs are a streamlined, largely administrative procedure, the levels of investigation one would expect in bankruptcy take place only to a very limited extent. It seems reasonable, therefore, that there should be a certain level of debt beyond which more thorough investigations need to be undertaken.

However, whilst this makes a strong case for the existence of thresholds, there would still seem to be good reason to revisit the levels at which they are set. As we have discussed, the £700 cost of bankruptcy prevents what is believed to be a significant number of people, with modest levels of debt and few assets, from accessing bankruptcy; yet they are also unable to obtain a DRO due to the entry thresholds.

There are also large numbers of bankruptcy cases – over 50% according to statistics from the Insolvency Service[3] – which have few or no assets. These are cases where the individual's assets are insufficient even to meet the OR's cost of administering the case, meaning that any possibility of distribution to creditors is out of the question. Subject to the need for debts beyond a certain point to be subject to investigation, it would seem preferable for such cases to go through the DRO procedure, with less of a cost to both the individual and the taxpayer.

Solution

Increase asset threshold to £2,000

£2,000 is the point at which the OR begins to apply the 'Secretary of State fee' to bankruptcy cases. This fee goes towards subsidising cases under this level, which are unable to cover the cost of their

[3] Insolvency Service Annual Report 2010/11

own administration as they have few or no assets to realise. Increasing the DRO asset threshold to £2,000 would increase access to DROs, whilst reducing the number of bankruptcy cases requiring cross-subsidy from those cases with realisable assets.

Increase debt threshold to £30,000

The median unsecured debt in bankruptcy is currently around £38,000[4]. Given that over 50% of bankruptcies involve individuals with few or no assets, it is reasonable to assume that a significant proportion of financially distressed individuals have few assets but debts of between £15,000 and £30,000. It is also reasonable to assume that, given their low level of assets, this is precisely the group most likely to be locked out of debt relief by the up-front bankruptcy fee on the one hand and the current DRO debt threshold on the other. Raising the DRO debt threshold to £30,000 would enable these debtors to access debt relief at a more feasible cost.

b) Change in circumstances

At present, if an individual's circumstances change during the period of their DRO, for example, their monthly surplus income increases above the £50 threshold due to a salary increase or a new job or they obtain further assets, such as an inheritance or a windfall, which push them beyond the asset limit, they will no longer fulfil the DRO eligibility criteria. The OR will then need to decide whether or not to revoke the DRO.

If their change in circumstances occurs near to the end of their DRO, the OR can decide to extend the 12 month period for a further three months to enable the individual to come to an arrangement with their creditors. However, the OR retains the option to revoke the DRO. If the DRO is revoked, the individual will become liable to their creditors once again and subject to enforcement action by creditors for their outstanding debts previously included in the DRO.

The prospect of a DRO being revoked acts as a significant disincentive to an individual seeking employment or better-paid work during the terms of their DRO – this was even recognised in the Insolvency Service's report into DROs in 2010. It would also appear to discourage individuals from notifying the OR of increased income or newly acquired assets.

In such cases, there would seem to be a strong case for introducing a mechanism whereby individuals who declare a change in circumstances, enabling them to make a contribution to creditors, are able to do so without losing the benefit of their DRO. This would recognise the difference between individuals who do the right thing in declaring extra income or assets whilst retaining the deterrent of revocation for those who seek to cheat the system.

Solution

Transfer to bankruptcy

Individuals who declare a change in circumstances during their DRO could be given the option to be moved into the bankruptcy system, thereby making them subject to a bankruptcy order and the protection from creditors afforded by that order. The relevant date for discharge from bankruptcy would be the date on which the DRO was made, not the date of the subsequent bankruptcy order.

[4] http://www.publications.parliament.uk/pa/cm201314/cmhansrd/cm130516/text/130516w0001.htm#13051676001424

Recognising that bankruptcy involves a higher entry fee than a DRO, one way in which the burden of any requirement to pay the increased fee could be alleviated would be to allow the debtor to pay by instalments over the term of their bankruptcy or, for example, by postponing the individual's discharge from bankruptcy until they had made all of the required payments. In this way, the debtor would still benefit from debt relief over the period of their bankruptcy whilst the requirement to pay the bankruptcy fee would also be met, albeit over a longer period of time.

c) Providing false information or withholding information on a DRO application

The OR may also revoke a DRO where the individual deliberately left out information on their application form in order to falsely demonstrate that they met the entry criteria, or provided false information to the OR about their eligibility for a DRO. This situation is distinct from what could be termed an 'innocent' change of circumstances previously described involving, for example, an income increase or obtaining new assets during the period of the DRO. Whilst revocation of the DRO is a deterrent to behaviour which seeks to mislead the OR at the time of the DRO application, there may be scope for the deterrent effect to be increased.

Solution

Retrospective effect of revocation

In circumstances where the debtor has provided false information or deliberately sought to mislead or leave out information on their application form, the effect of revocation of their DRO could apply retrospectively without any limitation period. This would mean that if, for example, a debtor held an undeclared asset worth more than £300 at the time of obtaining their DRO but this fact did not come to light until after the DRO had come to an end and their debts had been written off, the OR would still be able to pursue revocation of the DRO. The relevant date for revocation would be the date on which the debtor had provided the false information. The prospect of being made liable for all of their debts once again, even in cases where the DRO has already ended, may act as a strong deterrent to those debtors who consider lying or withholding information on their application forms. In cases where the DRO is revoked, other debt relief procedures, such as bankruptcy, would still remain available for the debtor.

d) Debt Relief Restrictions Orders (DRROs)

DRROs are akin to Bankruptcy Restrictions Orders (BROs) under the bankruptcy system, where the bankrupt individual can be made subject to the restrictions of bankruptcy for an extended period of between two and 15 years for blameworthy behaviour, such as fraudulent activity or gambling, leading up to the bankruptcy. An individual can only be made subject to a BRO when they have been made bankrupt, meaning that whilst they will be subject to the restrictions of a BRO, they will also continue to receive the debt relief provided by the bankruptcy order.

Unlike BROs, however, a DRRO can be applied to an individual who has had their DRO revoked. This would leave them subject to all of the DRO restrictions for up to 15 years, but affords them no debt relief at all – they would still be liable for all their existing debts which had been included under their DRO prior to its revocation.

Solution

DRROs only applied to those subject to a DRO

Whilst revocation or a DRRO may be appropriate in certain circumstances, it seems an inequitable discrepancy within the current DRO system that both could be applied simultaneously. Revoking a DRO should be reserved for those who are ineligible for the order (they have misrepresented their position on their application or have failed to inform the OR of a change of circumstances). DRROs should, like BROs, be based on the prior behaviour of the individual and should only apply to individuals who are still subject to a DRO – granting them access to debt relief but extending the restrictions that accompany it.

3. IVAs

a) Barrier to entry for consumers

When originally conceived, IVAs were designed as a debt solution for more complex cases involving trading or business-related debtors. However, over recent years, IVAs have shifted towards becoming a debt solution for smaller, consumer debt cases. This increase resulted in the introduction of the IVA Protocol in 2008, the purpose of which was to provide a standardised process for dealing with straightforward, consumer IVAs and to create more efficiency by removing many of the obstacles to obtaining approval of IVA proposals in simple cases. However, notable barriers persist in all forms of IVA, preventing many consumers from accessing IVAs or leading to their IVA becoming unworkable.

The main barrier to entry currently affecting IVAs is the influence which creditors and their agents have over IVA approvals. When voting on an IVA proposal, creditors are able to vote against the proposal or request that the terms of the arrangement are amended before they will approve it. In the case of modifications, whilst the debtor is able to decide whether they will proceed with the IVA following changes requested by creditors, unrealistic modifications can push a debtor into a corner – either they accept the changes and obtain the IVA or they refuse and must find another debt solution. Alternatively, they may accept the conditions, such as an increase in their monthly contributions, but the demands made of them under the modified proposal may ultimately prove unsustainable and the IVA fails.

According to an R3 survey[5] of over 300 IPs, 33% had seen creditors or their agents modifying IVA proposals so severely that they became unworkable and 32% had seen cases where the IVA proposal was rejected outright by the creditor or their agents. Similarly, an IVA Protocol Review conducted by The Insolvency Service in 2009 reported that 97%[6] of IVA proposals were modified before they were accepted by creditors.

Solution

Simplified IVAs (SIVAs) for consumers

Under the current IVA process, creditors holding 25% or more of the total debt can block approval

[5] R3 Membership Survey, May 2011
[6] IVA Protocol Review, Insolvency Service, December 2009

of the arrangement, at best forcing the debtor to enter a different debt solution; at worst enabling a creditor to force the debtor into bankruptcy. However, under the SIVA as previously proposed by government, only a simple majority of creditors (over 50%) would be required to approve the proposal, which could go some way to reducing the number of proposals which are rejected. The SIVA process would also not allow modifications to the proposal by creditors. Eligibility for the procedure would depend on a debtor having less than £75,000 of debt. Such a threshold would allow the process to capture the vast majority of consumer debtors, many of whose total debts fall well below this threshold.

b) Credit rating

As we have established, the principle that those who can make a contribution should do so to the fullest extent is central to maintaining the confidence of creditors in the formal personal insolvency regime. IVAs, on average, deliver higher returns to creditors than other formal personal insolvency procedures. They are also the only process in which some degree of repayment is, in effect, mandatory, as well as being the only process which requires creditor consent.

It seems sensible then to encourage those for whom the IVA route is suitable– in other words, those with realisable assets and ongoing incomes – to choose this path rather than bankruptcy, where returns to creditors are likely to be lower. There are already incentives for doing so: an IVA does not come with the same restrictions as bankruptcy or a DRO, meaning that, among other things, individuals can remain directors of companies. There could be an argument, however, that the additional contribution made by individuals via IVAs makes them less of a credit risk than those who have entered other formal personal insolvency processes. Formally recognising this would be a further incentive to encourage those who are able to take the IVA route to do so.

Solution

Reduce impact of IVA on credit rating

Whilst a DRO or bankruptcy remains on an individual's credit file for six years from the date of the order, an IVA should remain on the credit file only for the duration of the process (likely to be five years). This would recognise the further contribution to creditors that individuals make via IVAs in comparison to other formal personal insolvency processes.

Conclusion

Given the increase in the number of indebted individuals in England and Wales over recent years, coupled with the increase in the number of people entering formal insolvency processes over the last decade, R3 believes that now is the time to review the range of personal insolvency solutions to ensure that the system strikes the right balance between helping individuals in financial distress and protecting the rights of creditors . R3 believes that the package of reforms suggested within this paper will go some way to help rebalance the personal insolvency landscape, ensuring that the appropriate solution is available to debtors without the current barriers to entry whilst at the same time ensuring that those who can repay a proportion of their debt are facilitated to do so, striking a balance between both debtors' and creditors' interests.

About R3

R3, the insolvency trade body, represents over 97% of insolvency practitioners. R3's full members are all regulated by their recognised professional bodies, they can be licensed insolvency practitioners, solicitors, chartered accountants or certified accountants. They have extensive experience of helping businesses and individuals in financial distress. **www.r3.org.uk**

A reformed regime – what would it look like?

DRO

Key characteristics

12 month term

£90 fee

Asset threshold - £2,000
Debt threshold - £30,000
Surplus income - £50 p/m or under

Declared change of circumstances – option of transfer to bankruptcy

Restrictions apply

DRROs for 2 to 15 years for blameworthy prior behaviour, not accompanied by revocation. Revocation with retrospective effect for false information or withholding information on DRO application.

Remains on credit history for six years

Likely debtor characteristics

- Consumers or traders unable to repay even a proportion of their debt
- Low/no income; low/no assets and low debts

IVA

Key characteristics

Any term – usually five years

Creditors vote on and can modify all proposals

2 stage voting process: 75% or more by value of creditors voting at the meeting, then less than 50% by value of non-associated creditors vote against the proposal.

No restrictions apply (can remain as company director etc.), albeit specific restrictions can be set out in the IVA proposal.

Remains on credit history for term of IVA

Likely debtor characteristics

- Traders/self-employed who can afford to repay a proportion of their debts
- Income stream
- Debts over £75,000

Bankruptcy

Key characteristics

Three year standard term
12 months for 'least culpable'
Three to 15 years for 'most culpable'

£700 fee – payable by instalments

Restrictions apply

IPO/As when £50 or more surplus income p/m

Remains on credit history for six years

Likely debtor characteristics

- Consumer or trader with uncertain future income stream
- Unable to readily realise assets.
- Debts over £30,000 and/or assets over £2,000

SIVA

Key characteristics

Any term – usually five years

£75,000 maximum debt

Creditors can vote on proposals – one stage requiring a 50% majority of non-related parties by value at the meeting

No restrictions apply, albeit specific restrictions can be set out in the IVA proposal.

Remains on credit history for term of SIVA

Likely debtor characteristics

- Largely consumers who can afford to repay a proportion of their debts
- Income stream
- Relatively modest debts (below £75,000)