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Agenda

Advancing economics in business

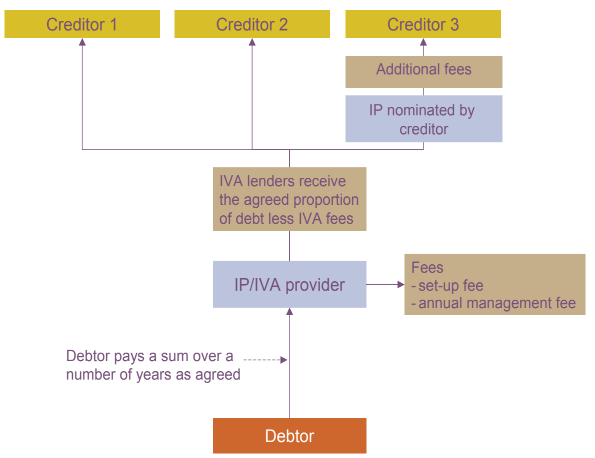
Individual voluntary arrangements: cashing in on consumer debt?

The popularity of individual voluntary arrangements in the UK has grown substantially in the past year, with over 44,000 taken out in 2006, a 118% increase on 2005 figures.[1] With IVAs being increasingly used by consumers in debt as an alternative to bankruptcy—despite recent warnings about misleading advertising by some financial management businesses promoting IVAs—what are some of the drivers of this trend?

Individual voluntary arrangements (IVAs) are intended to offer consumers protection, giving debtors in financial difficulty the option of having a proportion of their debt written off and paying back the remainder of what they owe over an agreed period, typically five years. Although consumer credit regulation and responsible lending practices are aimed at avoiding situations of over-indebtedness, in practice, there are always likely to be some borrowers who are not able to meet their financial obligations—for example, they may get into financial difficulty as a result of unanticipated events such as unemployment or divorce. IVAs, together with other arrangements such as bankruptcy, offer these consumers a way out of over-indebtedness.

In the UK an IVA is an agreement between a debtor and their creditors. This is facilitated by a debt management business (IVA provider), which acts as an insolvency practitioner (IP) (see Figure 1). The IP assesses the financial situation of the debtor and makes a proposal to the creditors of the debtor, specifying the total amount of debt the debtor can repay and the repayment period. The proposal is discussed in a formal meeting with the creditors and the debtor. If 75% of creditors (in terms of amount of debt) agree, the agreement becomes binding on all parties. If the creditors do not agree to the proposal, they can either renegotiate or recommend other solutions to the debtor.

Figure 1 Outline of the IVA process



Note: Some creditors may hire an IP to assess the proposal for an IVA (this is the case for creditor 3 in Figure 1).
Source: Oxera.

Debtors in financial difficulty have other options available to them. They can enter into an arrangement with each of their credit providers separately (a debt management plan), apply for bankruptcy through a formal court procedure, or, in some circumstances, refinance their debts. From the debtor's perspective, one key advantage of an IVA compared with bankruptcy is that it allows the debtor to retain some of their assets and avoids a public announcement of the bankruptcy order. For creditors, an IVA may be more attractive than a bankruptcy if, for example, the debtor has future revenue streams that can be used to pay off the debt. The time period of repayment for IVAs is usually five years, whereas the duration of the bankruptcy procedure is only up to one year.

The increase in IVAs could result in a cost to credit providers since they usually involve a write-off of some of the debt. Furthermore, IVAs that fail (ie, debtors are ultimately unable to pay back what was agreed and may subsequently be bankrupted) can lead to an inefficient use of credit providers' resources in terms of time spent on evaluating an IVA and fees paid to IVA providers. In the long term, an increase in costs as a result of the growth in IVAs is likely to be passed on by credit providers to consumers in the form of higher interest rates—it may also result in a restriction in the supply of credit to higher-risk consumers.

What is driving the increase in IVAs?

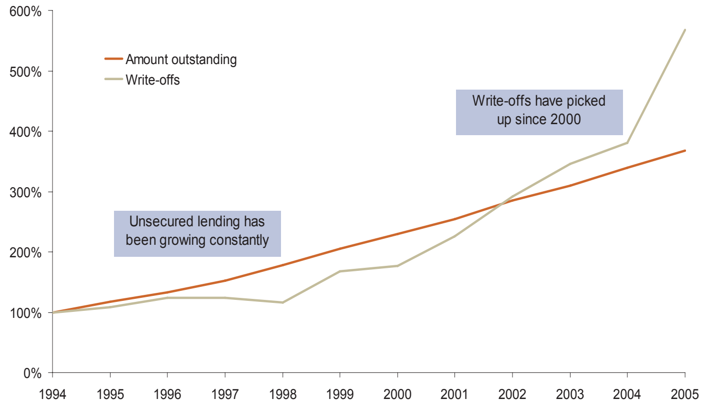
Personal insolvencies (consisting of bankruptcies and IVAs) have increased relatively rapidly in the past few years in the UK.[2] In 2006 the number of insolvencies rose by around 58% compared with 2005 figures, and in the fourth quarter of 2006, IVAs were 82% up on the number for the same period of 2005.[3] This has led to a growth in both the number of bankruptcy orders and the number of IVAs. What might be the causes of this?

To some extent, the growth in insolvencies may reflect general market trends such as changes in the economic climate—interest rates have risen every year since 2003—and the general increase in lending in recent years. However, insolvencies were on the rise before the increase in interest rates. Moreover, if macro conditions were to blame, one might also expect corporate insolvencies to increase somewhat, yet they rose by only 2% from 2005 to 2006.[4] As Figure 2 shows, although unsecured lending to consumers has increased since 2000, and particularly since 2004, the amount of debt written off as a result of insolvencies has grown faster still. This suggests that there are likely to be other factors driving the recent increase in insolvencies.

It is significant that the use of IVAs has grown faster than the issuance of bankruptcy orders, especially since 2004 (see Figure 3). The profile of IVA applicants has also changed. A typical IVA applicant is now more likely to be young, female, renting rather than owning a property, and employed rather than self-employed.[5]

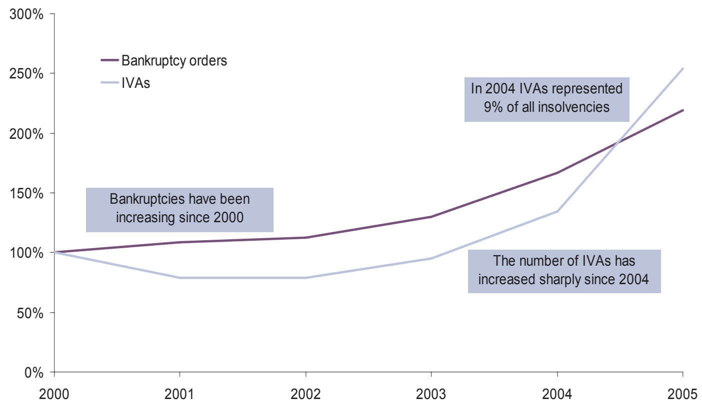
Another possible driver behind the increase in IVAs may be the aggressive marketing by IVA providers. The UK Office of Fair Trading (OFT) recently warned a large number of financial management businesses promoting IVAs that their advertisements and websites potentially mislead consumers.[6] This followed a compliance sweep undertaken by the OFT of a large number of advertisements in national newspapers and websites promoting and marketing IVAs. Examples of misleading statements include claiming that 'up to 90 percent of your debt may be written off', when, in reality, the maximum would be in the region of 60–70%;[7] failing to state that entering into an IVA also affects an individual's credit rating for six years; and failing to state that set-up and administrative fees will be incurred and deducted before the creditors receive any payment.

Figure 2 **Increase in unsecured consumer lending and write-offs**



Source: Bank of England.

Figure 3 **Increase in IVAs versus bankruptcies**



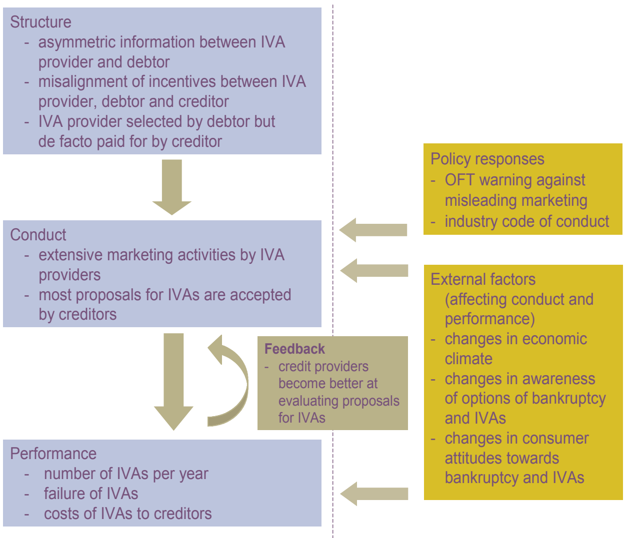
Source: DTI Insolvency Service.

A link with the structure of the market for IVAs?

An alternative way of understanding the drivers behind the usage of IVAs is to look at the structure and performance of the market together with the conduct of market participants. The structural features of the market may to some extent determine the conduct of market participants, which may in turn determine the performance of the market in terms of prices and variety of product offering (see Figure 4 below).

Like many markets in the financial services sector, the market for IVAs is characterised by certain market failures. Market failure is a situation in which markets do not efficiently organise production or allocate goods and services to consumers. For example, there may be asymmetric information between the IVA provider and debtor—debtors may find it difficult to understand the advantages and disadvantages of an IVA and the differences between the IVA providers in terms of quality of advice and level of charges. This is exacerbated by an incentive misalignment between the IVA providers and their customers (ie, creditors and debtors). While the debtor wants to minimise repayments and the

Figure 4 Structure, conduct and performance of the IVA market



Source: Oxera.

creditor maximise them, the IVA provider may have an incentive to increase the number of IVAs irrespective of whether this is in the debtor's or creditor's interest—furthermore, the IVA provider may be less concerned than the debtor and creditor about the failure of an IVA.[8]

Another characteristic of the IVA market is the way IVA providers are selected and paid. Providers usually charge a fee for setting up the IVA and an administration fee for 'supervising' it—the debtor typically makes the agreed repayments to the IP, which are in turn passed on to the creditors. Most IPs require that at least a certain amount of the fixed fee is paid in advance of setting up the IVA, with the rest added to the arrangement. The administration fee may be a fixed amount per year or a percentage of the value of the IVA.

Debtors are not normally expected to pay the fees directly. IVA fees are usually deducted from the standard monthly payments. In other words, IVA fees are added to the total amount of debt and are therefore effectively paid for by the creditors. The higher the fees, the less creditors receive from the debtor.

Thus IVA providers are selected by the debtors, but their fees are paid for by the creditors. This may affect the degree of competition between providers. Although creditors can request modifications to the proposal (including the fees paid to the IVA providers), the level of fees may be considered relatively low compared with the amount of the loan that the debtor proposes to pay back, possibly resulting in limited competitive pressure on the IVA provider's fees. IVA providers may use the fees charged to creditors to fund their marketing activities, which could explain the currently extensive marketing of IVAs in newspapers, and on radio and television.

Concluding remarks

It is possible that the recent increase in IVAs is temporary and that the market will adjust itself. In December 2006, the British Bankers' Association and representatives of the IVA industry agreed to work together to create industry standards to regulate how responsible debt practitioners market and advertise their services. The standards will cover the quality of advice customers receive from IVA providers, as well as the transparency of the charges and fees incurred.

There are some indications that the market is adjusting. Month-on month growth of IVAs slowed to just under 4% in the last quarter of of 2006, compared with an average quarterly rate of around 19% for the preceding two years.[9] Furthermore, there are indications that at least some creditors have become more hard-line about approving IVAs, and are taking a tougher stance on IVA providers' fees. Over time, creditors may become proficient at evaluating whether an IVA is in their interest and at assessing the probability of an IVA being successful. Approval rates for IVAs recently fell from 94% to 78% towards the end of 2006—however, they have since returned to around 85%.[10]

However, it is also possible that the high level of IVAs will persist, which will ultimately affect the price of credit for consumers. Assessing the extent to which this is due to structural characteristics of the market requires further research.

[1] Source: Department of Trade and Industry (DTI) Insolvency Service, available at http://www.insolvency.gov.uk/.
[2] Insolvency is defined as having insufficient assets to meet all debts, or being unable to pay debts as and when they are due. In legal terms an individual is insolvent if they are unable to discharge their debts as they become due. Bankruptcy is one type of insolvency procedure in which a court of law imposes a bankruptcy order on an individual. The insolvency figures in this article comprise the total number of incidences of insolvency types: bankruptcy; IVAs; and sequestration and trust deeds in Scotland. Source: Association of Business Recovery Professionals (2006), 'Understanding Insolvency', December.
[3] Source: DTI The Insolvency Service, available at http://www.insolvency.gov.uk/.
[4] Ibid.
[5] PricewaterhouseCoopers (2006), 'Living on Tick: The 21st Century Debtor', May.
[6] Office of Fair Trading (2006), 'OFT Warns IVA Providers over Misleading Adverts', press release, January 17th.
[7] Ibid.
[8] The incentive misalignment with the creditor may be offset to some extent if the IVA provider's fees are related to the amount of the repayments—the IVA provider will then have an incentive to maximise repayments. However, they still have a strong incentive to sell an IVA while other options such as bankruptcy or a debt management plan may be more appropriate.
[9] Source: DTI Insolvency Service, available at http://www.insolvency.gov.uk/.
[10] *Financial Times* (2007), 'Little Surprise as Insolvency Soars', February.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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