

## A year of unprecedented change: implication for creditors

With the UK economy in recession, there is a certain amount of inevitability about a downturn in collections and recoveries performance.

However, creditors who apply a forward looking approach and create the flexibility to identify and to address emerging challenges will be best positioned to maintain performance through these challenging times.

### **The context: the world has changed**

Economic conditions have changed dramatically – taking us all into uncharted territory. Unemployment is rising (looking set to top 3 million by 2010<sup>1</sup>) and the fall in house prices is reducing consumers' ability to refinance (we saw settlement values drop by 25% in the second half of 2008).

New groups of individuals are finding they cannot make ends meet. The average income of an IVA applicant increased by almost 10% to £23,750 in 2008 compared to 2007, almost £3000 higher than the current average income in England and Wales<sup>2</sup>. This shift toward the middle class also shows in the proportion of IVAs with a home, which increased from 34% to 51% between Q1 2008 and 2009. Furthermore, in 2008 the number of bankruptcies reached its highest level ever (67,428 in 2008)<sup>3</sup>, signalling unprecedented levels of debt distress.

For creditors, the management challenge of increasing debt is exacerbated by the dramatic slow-down of the debt sale market. Purchasers are seeing 3-year portfolio yields drop by up to 40%, are struggling to raise the cheap funding from years past, and as a result have reduced their pricing accordingly.

# Four key considerations for creditors in challenging times

## 1 Look forward, not back: make sure debt portfolios are not overvalued

The typical valuation approach is based on backward-looking accounting principles. This leaves creditors ill-equipped to make the best management decisions in a falling market. The implications are:

- **Unexpected write-downs:** with a falling market, over-optimistic expectations result in a gap, quarter after quarter.
- **Unrealistic debt sale expectations:** although prices have fallen, sale should remain an important tool as there will be times when it will offer the best long term value.
- **Out-of-date management choices:** collection strategies based on past performance are not guaranteed to deliver best results. For instance, not truly understanding the value of a debt portfolio and how it will perform in current market conditions makes it impossible to know when to work a portfolio and when to seek a sale.

While it may well be time to re-baseline the way debt is valued industry-wide, there are immediate actions individual creditors can take. Utilising up-to-date performance analytics, maintaining effective market benchmarks and revaluing more regularly will all help valuation better keep pace with change and free creditors to make better management choices.

## 2 Prepare for volume growth: increased flow is changing the recoveries market

New volumes into recoveries will grow by 20 to 40% over the next year. The increased flow will fundamentally change the recoveries market:

- **Debt will be harder and take longer to recover:** with nearly half a million people losing their jobs last year alone, over £2 billion less is available to go towards repaying debt commitments. This directly impacts debtors and the CCCS has reported an increase in the numbers who simply cannot pay.
- **New groups of indebted individuals demand new approaches:** the debtor demographic is shifting toward a group of overstretched, recession-impacted middle classes. A new mix between 'default and recover' versus rehabilitate will be required to help valuable customers through challenging times.
- **Collections agencies have gained power:** faced with increased volume, agencies are profit maximising and choosing the portfolios they work, even if this includes turning down new work or 'firing' old clients.

Faced with these challenges, creditors need to be even more analytical. Specific strategies for each segment of a portfolio will be required to hold recoveries performance steady and keep a lid on operational costs. This approach will empower creditors to focus increasingly stretched in-house teams on the debt from which they can get best results, while identifying where new approaches with third parties will be the best option.

### 3 Guard against shifting to 'one size fits all' processes in the face of increased scrutiny

Any movement to protect vulnerable consumers should, of course, be welcomed. However, it is critical that creditors do not leave themselves exposed:

- **Scrutiny has dramatically increased:** with debtors under increasing stress, the government, regulators and media are applying increased scrutiny to the sector; media stories covering personal debt have increased by 30% in the last year.
- **Penalties for non-compliance will dramatically increase:** with new safeguards for consumers being put in place, such as the 30-day breathing space from debt collectors after the appointment of a debt adviser, non-compliance could result in significant fines, loss of credit licence and reputational damage.
- **A 'one size fits all' approach, tailored to the most vulnerable debtor, is not the answer:** applying an ultra-conservative approach will reduce performance by as much as 50%.

While creditors must continue to ensure that processes are robust, transparent and fair – and capable of responding swiftly to changes in regulation – it is also necessary to continue to target those who can but simply will not pay, as well as identify those consumers who are genuinely in need of support. Never before has consumer-focused segmentation been more necessary.

### 4 Understand, then plan: better data is needed about financial difficulties to ensure effective management

The numbers of consumers seeking a structured debt solution will grow throughout 2009 – yet the detailed data needed to effectively manage these solutions is limited:

- **Debt Management Plans can no longer be ignored:** these plans will grow by 40% in 2009, yet because they are difficult to effectively review and manage, historically they have largely been ignored. As a result, limited industry data leaves both creditors and debtors vulnerable when it comes to fair and consistent practices.
- **Debt Relief Orders are a significant unknown:** anywhere between 14,000 and 150,000 applications are expected each year. At the top end, DROs would impact £1.8 billion in debt.

These structured solutions should be a priority for creditors, if they are not already. Detailed, and ideally market-wide, monitoring is required to effectively manage the impact and cost of these growing numbers.

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# Planning for the future: keeping pace

“If one thing is a given in this market, continuing with yesterday’s strategies will no longer result in yesterday’s results.”

Over the last five years, favourable market conditions have helped deliver performance improvement. Those days are gone; the market has changed. Creditors are under severe pressure to minimise debt, cut budgets and improve the customer experience, limiting their options for responding to the challenge. However keeping pace with change is critical and achieving success will be more complex. If one thing is a given in this market, continuing with yesterday’s strategies will no longer result in yesterday’s results. Times have, indeed, changed.

**To discuss any of these market themes, please call us.**

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1 CBI

2 Office for National Statistics – average national income (median): £20,988

3 The Insolvency Service