

<b>Title:</b> Insolvency Practitioner fees- up front estimates  <b>IA No:</b> BISINSS012  <b>Lead department or agency:</b> BIS  <b>Other departments or agencies:</b> Insolvency Service	<b>Impact Assessment (IA)</b>		
	<b>Date:</b> 04/11/14		
	<b>Stage:</b> Final		
	<b>Source of intervention:</b> Domestic		
	<b>Type of measure:</b> Secondary legislation		
<b>Contact for enquiries:</b> Sam Roberts 0207 291 6822			
<b>Summary: Intervention and Options</b>			<b>RPC Opinion: Green</b>

Cost of Preferred (or more likely) Option				
Total Net Present Value	Business Net Present Value	Net cost to business per year (EANCB on 2009 prices)	In scope of One-In, Measure qualifies as Two-Out?	
£5.96m	- £5.42m	£0.49m	Yes	IN

**What is the problem under consideration? Why is government intervention necessary?**

A report by the OFT in 2010 in to the market for corporate insolvency practitioners (IPs) and a review by Elaine Kempson of IP fees published in 2013, found that the market does not work sufficiently well where unsecured creditors are left to 'control' an office holder fees and remuneration, which occurs in just over a third of cases. Unsecured creditors do not effectively engage in oversight of IPs remuneration. This lack of effective oversight leads to IPs using their market power to increase their costs and/or reduce quality by taking longer to do the same work.

This can result in over charging by the IP and inefficiencies in administering the cases, which leads to fees being higher than they might otherwise have been. This leads to a transfer of resources from unsecured creditors to IPs that for both fairness and efficiency reasons we wish to remove. Government intervention is necessary to counter this inefficiency in the market.

**What are the policy objectives and the intended effects?**

To remove the harm caused by this market failure by providing more useful information to creditors which should increase engagement by unsecured creditors and so improve scrutiny of the remuneration of IPs. It is anticipated that this will also drive behaviour by IPs and encourage the use of different bases for remuneration for handling different aspects of a case. In removing the harm, we are aiming to improve reputation, transparency and confidence in the insolvency profession. This will allow for greater challenge of fees by creditors when it is appropriate to do so.

**What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)**

1. Do nothing – this would not address the market failure identified by the OFT and Professor Kempson
2. Use of up front estimates of costs of insolvency when setting basis for remuneration (preferred option) -on whichever basis an IP is seeking his/her remuneration, it should be accompanied by an estimate of the anticipated costs, which must be approved by creditors.
3. Consultation Option: Changes to the basis for remuneration - change to the fee structure which required office-holders to take their remuneration as either a percentage of assets or a fixed fee

**Will the policy be reviewed? It will be reviewed. If applicable, set review date:** 10/2021

Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	Micro Yes	< 20 Yes	Small Yes	Medium Yes	Large Yes
What is the CO <sub>2</sub> equivalent change in greenhouse gas emissions? (Million tonnes CO <sub>2</sub> equivalent) N/A			Traded: n/a	Non-traded: n/a	

*I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.*

Signed by the responsible MINISTER



Date

6 Nov 2014

[TYPE TEXT]

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## Summary: Analysis & Evidence

## Policy Option 1

Description: Use of up front estimates of costs of insolvency when setting basis for remuneration

### FULL ECONOMIC ASSESSMENT

Price Base Year 2013	PV Base Year 2015	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -143.69	High: 131.76	Best Estimate: -5.96

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0.5	0.6	6.0
High	0.5	16.6	143.7
Best Estimate	0.5	2.2	19.7

#### Description and scale of key monetised costs by 'main affected groups'

Costs include a one off cost of £0.5m to IPs to familiarise themselves with the new requirements. An ongoing cost to IPs for producing an initial estimate of £0.48m, of which £0.43m is within scope of OITO. In cases where the cost estimates require revision, IPs will incur an additional cost in producing estimates of £0.19m which should reduce over time. The changes should lead to greater engagement from unsecured creditors so should lead to a transfer from IPs to unsecured creditors. This transfer has been estimated to be between zero and £16m with a best estimate of £1.6m. This is a cost to IPs as well as a benefit to creditors and has a net impact on business of £0.16m but it not within scope of OITO because it is indirectly caused by the legislation.

#### Other key non-monetised costs by 'main affected groups'

There are no non-monetised costs of this policy.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	0	0
High	0	16.0	137.7
Best Estimate	0	1.6	13.8

#### Description and scale of key monetised benefits by 'main affected groups'

The changes should lead to greater engagement from unsecured creditors so should lead to a transfer from IPs to unsecured creditors. This transfer has been estimated to be between zero and £16m with a best estimate of £1.6m. This is a cost to IPs as well as a benefit to creditors.

#### Other key non-monetised benefits by 'main affected groups'

Non monetised benefits are increased efficiency in the market by addressing the market failure, fair allocation of fees between secured and unsecured creditors, increased IP market confidence and greater transparency in fees leading to increased competition amongst IPs.

#### Key assumptions/sensitivities/risks

#### Discount rate (%)

3.5

The policy assumes that unsecured creditors will become more engaged in the agreement of remuneration packages. Improving the information available to creditors should remove some but not all of these barriers to engagement. There is a risk that the policy will not lead to increased engagement from unsecured creditors and so not reduce market failure.

### BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OITO?	Measure qualifies as
Costs: £0.5m	Benefits: £0m	Net: - £0.5m	Yes	In

## Problem under consideration;

1. IPs act as office-holders in insolvency procedures. To be qualified to act as an IP, the Insolvency Act 1986 requires a person to be authorised as a member of a professional body which has been recognised for this purpose by the Secretary of State. There are currently 7 of these recognised professional bodies (RPBs)<sup>1</sup>. Once authorised, IPs are regulated through a system of self-regulation by the RPBs, overseen by the Insolvency Service. Each of the RPBs has a set of rules and regulations to ensure that those individuals they authorise to act as IPs are fit and proper persons with the necessary experience, qualifications and insurance in place.
2. The OFT report into the market for corporate IPs in 2010<sup>2</sup> found that in just over a third of insolvency cases, where unsecured creditors receive a pay-out and thereby bear the cost of the IPs fees, fees are estimated to be 9% higher in like-for-like cases than where secured creditors 'control' the IPs fees. The OFT estimated that in administration cases only, this amounted to £15m per year that unsecured creditors were funding in higher fees to IPs. Despite numerous discussions with the profession and the regulators little has changed to address this market failure and concerns continue to be raised by creditors about the fees (both remuneration and expenses) charged by IPs and the impact this has on the position of unsecured creditors in insolvency situations.
3. As a result of on-going concern, in December 2012 the Government announced a review, led by Professor Elaine Kempson, into IP fees to ensure that creditors are being charged fairly and to increase confidence in the insolvency regime. In July 2013 Professor Kempson published her report<sup>3</sup> which found that the current system of controls on IP remuneration works as intended where a secured creditor plays an active part in an insolvency. In this situation there is a degree of competition, as banks are repeat customers and IPs want to join and remain on Bank panels.
4. On the other hand there is evidence that where control lies in the hands of unsecured creditors collectively, the current control mechanisms do not work as intended. In such circumstances there is little competition between IPs to take on work, no 'identifiable' client (as the IP is working to a number of unsecured creditors, most of which have no involvement) and creditors are required to work together, in circumstances where they don't know, or find it difficult to contact, each other. This results in little effective oversight by unsecured creditors of the work undertaken by IPs. IPs take their remuneration on the basis of time and rate in the majority of cases, which requires creditors to have considerable knowledge and understanding of the process in order to question the level of fees and the amount of time spent. The only current route for complaining about quantum of fees is through the courts which is costly. For all these reasons, there is little control or oversight, and higher fees are paid where unsecured creditors are responsible for paying.
5. The decisions IPs make in any insolvency procedure, where they have wide powers, can have a substantial impact on the funds available to creditors. Creditors are reliant on IPs to act fairly in their best interests. Professor Kempson acknowledges that concerns are more muted in Voluntary Arrangements, where creditor voting power has tended to be used to exercise greater control over IP fees.
6. Over the last few years, culminating in the 2010 Insolvency Rules changes, Government has been seeking to improve the position for unsecured creditors by, for example: lowering the threshold of creditor value required to challenge remuneration from 25% to 10%, or otherwise as court allows and allowing creditors (5% or more as court allows) the right to requisition further information on receipt of a report. The 2010 Rules also opened up the possibility of an IP having more than one basis for remuneration; however, anecdotal evidence suggests that this option is seldom used.

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<sup>1</sup> A small number of IPs are currently authorised directly by the Secretary of State, this arrangement is likely to be coming to an end in 2015.

<sup>2</sup> [http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.oft.gov.uk/shared\\_oftr/reports/Insolvency/oft1245](http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.oft.gov.uk/shared_oftr/reports/Insolvency/oft1245)

<sup>3</sup> <http://www.bis.gov.uk/insolvency/insolvency-profession/review-of-ip-fees>

## Background

7. Each year IPs realise approximately £5bn worth of assets from corporate insolvency processes, and in doing so charge about £1bn in fees, and distribute some £4bn to creditors<sup>4</sup>. IPs can also advise on business restructuring and continuity prior to insolvency and are part of the wider business restructuring market.
8. An IP's remuneration can be set a) on a time-cost basis, b) as a percentage of realisations or c) since 2010, as a fixed fee. It is the IP who proposes which basis they wish to take their remuneration under and the creditors vote on the proposal. Professor Kempson found that in the great majority of cases remuneration was taken on a time-cost basis.
9. The requirement to set the basis of remuneration, for all insolvency procedures, is set out in secondary legislation, namely the Insolvency Rules 1986. This provides that an office-holder must hold a creditors meeting within 14 days of a resolution to wind up a company, or within 10 weeks of start of administration. At this meeting it is common practice for the IP to seek approval of his/her appointment and the basis for their remuneration. In bankruptcy, where an IP is appointed trustee rather than the official receiver, the basis for their remuneration should be set within 18 months of appointment. This is also the fall back position for corporate insolvency procedures where agreement has not been reached within 18 months.
10. The only existing route to challenge high fees is by an application to court. In addition, although fees can be reviewed by the court, as the process is expensive it often outweighs the benefit for unsecured creditors to challenge.
11. Given that both OFT and Professor Kempson believe that significant harm is occurring to unsecured creditors, the ability to effectively review fees has been identified as a significant reform.
12. Both the OFT report of 2010 and Professor Kempson's report acknowledge that there is no single solution to address the market failure for unsecured creditors and instead sets out a number of recommendations, which collectively would address the issues highlighted by the review.
13. The Kempson report offers a wide-ranging number of options that could be considered, but concluded that it was unlikely that a single change would be sufficient. Overall there were six recommendations, which fall into three main categories:
  - Transparency Measures and increasing creditor engagement: these concentrate around ensuring that sufficient and clear information is available generally and specific to a particular case to encourage greater engagement by unsecured creditors. This could include an estimate at the start of the case of the likely fees that will be charged.
  - Simplifying the fee structure: here Professor Kempson says consideration should be given to changing the presumed basis for remuneration (which is time and rate in almost all administration, winding up and bankruptcy cases). She proposes two options; having percentage of realisations as the presumed basis for charging fees in all cases or using different bases for different aspects of a case. For example fixed fees could be charged for statutory work where the costs are known, and a realisation percentage where the work involves asset realisation. While acknowledging the serious concerns around increasing competition in this market, she did suggest that it might be worth considering the potential for limited competitive tendering amongst IPs.
  - Enhanced monitoring of fee complaints by regulators: Professor Kempson raised the issue of whether a single regulator would be beneficial in this sector. Her main comment here is around the need for regulators to exercise a greater degree of compliance monitoring of fees.
14. Government has previously consulted on a package of measures which aimed to address these three main strands. As part of the Small Business, Enterprise and Employment Bill (introduced into the House of Commons on 25 June 2014) we are taking through changes to the regulatory regime

<sup>4</sup> Paragraph 1.5 'Market for Corporate Insolvency Practitioners – a market study' - [http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.of.gov.uk/shared\\_of/reports/Insolvency/of1245](http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.of.gov.uk/shared_of/reports/Insolvency/of1245)

for IPs to provide regulatory objectives which will provide regulators with a statutory framework within which to carry out their activities (see IA BIS InsS001). One of the objectives will ensure that there is appropriate oversight of the fees charged by IPs ensuring that they offer their services at a cost that is fair and reasonable to the recipient (see IA BIS InsS009).

15. We have previously consulted on proposals to simplify the fee structure. Issues raised by respondents to that consultation have indicated that the proposal of restricting the way in which an IP may charge his/her fees are unlikely to have the desired effect (see paragraphs 25-27 for further detail).
16. We will continue to work with interested parties to ensure that the information that is available to creditors will help to explain the role of the IP and what that entails.

## Rationale for intervention

17. Government intervention is necessary in this instance for two main reasons;

### *Market failure*

18. The first one is to address the **market failure** identified by the OFT and Professor Kempson, by which unengaged uninformed creditors are unable to exercise effective control over IPs which leads to IPs taking advantage of their **market power**, which results in increased cost and/or reduced quality of work (by taking longer to do the same job) for unsecured creditors, for the same type of service.
19. This is considered in economic terms a potential **inefficiency in the market**. IPs are obtaining fees above the market rate; the transfer of returns from IPs to unsecured creditors has the potential to deliver a more efficient dynamic economic allocation of resources as these creditors are more likely to reinvest these resources in growth driving activities. Indeed, increased insolvency recovery rates to this class of investor could well increase the absolute amounts of credit made available<sup>5</sup>, to the benefit of the wider economy. Reduction of the current profit margin in servicing unsecured creditors will also incentivise cost effectiveness/minimisation by IPs.

### *Fairness grounds*

20. In addition, there are also fairness reasons why Government should intervene in this particular case. It appears from the evidence that unsecured creditors are seemingly facing higher fees than secured creditors for the same service. From a fairness perspective this is not desirable as unsecured creditors are disadvantaged. Government intervention is necessary to redress this bias.

## Policy objective

21. The overall aim of these measures is to increase engagement by unsecured creditors and at the same time increase confidence in the work of IPs. This will be achieved through a package of measures, including the introduction of an objective within the regulatory regime which will ensure appropriate oversight of the fees charged by IPs. This impact assessment concerns the changes we are proposing to the way in which an IP agrees his/her remuneration, which will encourage engaged unsecured creditors to challenge appropriately. It is anticipated that these measures will also drive behaviour by IPs and encourage the use of different bases for remuneration for different aspects of a case.
22. It is not proposed that these measures should apply to the fees charged by the Official Receiver which are already set out in regulations. Nor should they apply in the case of an Individual Voluntary Arrangement or a Company Voluntary Arrangement, where IP fees are closely controlled by creditors. They should not apply in the case of Members Voluntary Liquidation, where the company is solvent and all creditors are paid in full.

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<sup>5</sup> [http://www.offt.gov.uk/shared\\_offt/reports/Insolvency/oft1245](http://www.offt.gov.uk/shared_offt/reports/Insolvency/oft1245)

23. All administration cases, creditor voluntary liquidations, bankruptcy and compulsory liquidations completed by an IP will be covered by the legislation. The number of cases in 2013/14 covered by the legislation is shown in table 1.

**Table 1:**

Creditor Voluntary Liquidations	11,428
Bankruptcy	2,587
Administration	2,362
CVLs following administration	947
Compulsory liquidations	772
<b>Total</b>	<b>18,096</b>

### **Description of options considered and dismissed (including do nothing);**

#### **Do nothing option**

24. Do nothing would be to continue with the status quo whereby IPs are able to charge higher fees to unsecured creditors. Given the weakness for unsecured creditors of the current regime, identified by the OFT and more recently by Professor Kempson's review, doing nothing is not considered a credible option as it would allow the current inefficiency and unfairness in the market to continue unchecked. On these grounds this option was dismissed.

#### **Consultation Option: Changes to the basis for remuneration**

25. We consulted on a proposed change to the fee structure which required office-holders to take their remuneration as either a percentage of assets or a fixed fee in all insolvency cases with the exception of:

- Cases in which a creditors committee is established, as these committees oversee the remuneration of the office-holder; or
- Cases where secured creditors will not be paid in full and so remain in control of fees. The market works well in this instance so we do not want to interfere with the ability for secured creditors to successfully negotiate down fees. If however it later becomes apparent that secured creditor(s) will be paid in full, at this point office-holders would be required to seek approval from unsecured creditors for the basis and percentage (if relevant) for their remuneration going forward. The basis would need to be either percentage of realisations or fixed fee; or
- IVAs, CVAs, or MVLs

26. The consultation stage impact assessment (BIS InsS009) sets out the full details of how we anticipated this proposal working. However, consultation responses from a range of stakeholders (including the profession and creditor organisations) expressed concerns that the impact of this proposal would not have the desired effect going forward and that it would not lead to higher returns to creditors nor would it improve the reputation of insolvency practitioners. Instead responses suggested that the proposals could cause 'harm' to creditors (where an IP may have over-estimated the fixed fee required for a case against the work needed; or the percentage of asset realisation taken did not reflect the nature of work needed); small insolvency firms would be driven out of business because low value cases would be uneconomic to process; that the 'noise' around IP fees would not be reduced; that the proposals could lead to out-sourcing of work previously carried out by IPs to unregulated individuals or companies; and that IPs may be disincentivised from taking action against delinquent directors.
27. For these reasons, following consultation we have met several times with stakeholders and have dismissed this option as not the appropriate way forward.

## **Preferred Option: Use of up front estimates of costs of insolvency when setting basis for remuneration**

28. Engaged and informed creditors are better able to exercise an appropriate level of control over an IP's fees. Elaine Kempson's report identified that the current information that is routinely sent out to creditors is formulaic, often of no use and does not give them the information they need to scrutinise fee levels. Moreover, creditors only tend to receive information about the fees and costs of a case after those charges have been incurred. The profession is on the front foot and believes that more could be done in this area.
29. The proposal going forward is that on whichever basis an IP is seeking his/her remuneration, it should be accompanied by an estimate of the anticipated costs, which must be approved by creditors as part of the proposal for agreeing the basis for remuneration. There must be a positive agreement to this; if no creditors respond then the IP would have to seek agreement from the court.
30. The estimate should be accompanied by a summary of the work that will be undertaken and the likely time it will take, the grade of staff that will be undertaking the work and a breakdown of the likely costs (e.g. advertising, legal costs, agents' costs).
31. Where the IP becomes aware that his/her fees will be higher than the estimate, s/he will need to go back to creditors for approval of the increase. An explanation and justification for the increase should accompany this request.
32. The benefits of this system would be to ensure that IPs' fees are transparent and clearly communicated to creditors at an early stage in a case. This will allow unsecured creditors to exercise oversight over fees by providing them with more information about how fees work and why they are being charged. Overall, this will help to increase confidence in the insolvency regime and will promote engagement, transparency and fairness. We are aiming to implement these changes in October 2015, which will link with the proposed commencement of the regulatory objectives contained within the Small Business, Enterprise and Employment Bill.

## **Monetised and non monetised costs and benefits**

### **Costs to Business**

#### **Familiarisation costs**

33. IPs will have to spend some time learning about the new legislative requirements to produce up front estimates of the cost of IP work for every case. The final structure of how the estimates will be produced and presented will be discussed with IPs and creditors so there will be a degree of foreknowledge of the new requirements.
34. Based on informal discussions with IPs and internal analysis by the Insolvency Service it has been estimated that the costs of learning about the new requirements will be relatively moderate as in many cases IPs produce estimates of the work they will be undertaking for their own budgeting purposes. Therefore the industry has the pre existing infrastructure in place to produce estimates and so there will no additional set up costs for business. All the information that will be needed for the estimates is already available to IPs so there will be no additional costs of gathering information. The marginal change will involve learning how this information will need to be presented to creditors in the future. IPs and creditor groups will be involved in the process of determining exactly how the information should be presented so familiarisation costs should be minimal. As of 1 January 2014 there were 1,355 appointment taking IPs, it has been estimated that all of these IPs will on average spend 1 hour learning about the changes at a rate of £375 per hour. This is based on the average hourly charge out for an IP firm at director/partner level.<sup>6</sup> This means **total familiarisation costs of £0.5m. All of this cost is a direct cost to business of the legislation and is within scope of OITO.**

#### **Ongoing costs of producing estimates**

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<sup>6</sup> Based on a 2012 data provided to Elaine Kempson report 'Review of IP Fees' July 2013 and uprated to account for inflation

35. In addition to the one off costs of learning what would need to be done, the requirement to produce an estimate would be an ongoing cost for IPs that would ultimately mean less money being available for distribution to creditors. Usual business practices would imply that IPs will be making an assessment of the likely revenue and costs to their business for taking on case work so much of the work involved will already be completed. Much of this work will be uniform across cases so the additional burden of producing the estimates is likely to be small. Discussion with IPs has established that much of this work is completed by support staff with oversight by partners or managers.
36. Finally the intention is to incorporate the requirement to produce an estimate in to the existing process of when an IP seeks agreement from creditors for remuneration, all of which implies the ongoing additional burden should be small. The work is likely to be an administrative task extended from the existing practice to produce estimates for business planning so we believe the work is likely to be completed by support staff within practices. It is estimated that the task will take around 15 minutes per case at a rate of £106 per hour. Based on the average hourly rate for support staff at an IP firm.<sup>7</sup> This would mean a total ongoing cost for the 18,096 IP cases affected of £0.48m. This cost adds to the fixed costs of completing IP work and will result in less money being available to distribute to creditors. The cost will be passed on completely to creditors through higher fees and this direct cost to business of the policy is within scope of OITO.
37. IPs distribute funds to a range of creditors according to a prioritisation set out in statute. The groups include secured creditors (often banks), preferential creditors such as former employees, floating charge holders (again usually banks) and unsecured creditors including HMRC and other businesses. All of these groups will be impacted by the reduced funds available for distribution but not all of them are within scope of OITO, which purely relates to direct business impacts.
38. Analysis of a random un weighted sample of 125 records filed at Companies House over a 3 year period and a OFT market study<sup>8</sup> of insolvency practitioners estimated that non businesses accounted for around 10 per cent of the returns to creditors. **Therefore the ongoing cost to business creditors of producing the initial cost estimate that is within scope of OITO will be around £0.43m.**
39. IPs will need to make every effort to ensure that the initial estimates accurately reflect the work that will be completed but inevitably sometimes cases will have unforeseen work or will take longer and thereby incur greater costs than were initially forecast. In these cases IPs will be required to justify any increase and again receive approval from creditors. IPs will be required to produce a revised estimate which will place additional cost on creditors and IPs. It is difficult to estimate how often this will be needed ex ante but we assume the majority of cases would not require additional estimates because each case must follow rules governing the procedure so every case has a core element of work that IPs will know what it involves and the likely timelines and costs. Some types of cases such as administrations have fixed time lines and require approval for extensions.
40. When producing the initial estimates IPs will use their experience of the average time period to complete work and the statutory time frames for certain tasks. Analysis of the average length of Insolvency cases shows the following:
- Around 60 per cent of CVL cases are concluded within 2 years
  - Around 50 per cent of administration cases are concluded within 1 year
  - Around 60 per cent of compulsory liquidations are concluded within 2 years
  - Around 55 per cent of bankruptcy cases are concluded within 2 years<sup>9</sup>
41. IPs would naturally build in some certainty in to their estimates but it is reasonable to assume that cases that go beyond this average time period are likely to involve additional costs and require an additional estimate from IPs.
42. CVL cases that follow an administration are almost always managed by the same IP. This means that the IP will have significant knowledge about the business from the administration work. This should result in a much more reliable estimate of the costs of the CVL work and should mean there will be no need to produce a secondary estimate of the work. Therefore it is assumed that CVL cases will not require a secondary estimate from the IP or incur additional costs.
43. Experience of producing these estimates should result in greater accuracy over time. This should mean a reduction in the number of cases that will require a secondary estimate over time. In an

<sup>7</sup> ibid

<sup>8</sup> [http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.oft.gov.uk/shared\\_oftr/reports/Insolvency/oft1245](http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.oft.gov.uk/shared_oftr/reports/Insolvency/oft1245)

<sup>9</sup> The percentage of bankruptcy and compulsory liquidation cases have been estimated from Official Receiver cases not IP led cases due to a lack of reliable data on the length of time for an average IP led bankruptcy and compulsory liquidation.

attempt to account for this we have assumed that the number of cases requiring an additional estimate will decrease by 5 per cent a year.

44. As above these costs will incur additional costs to IPs which they will pass on directly to creditors in higher fees. The impact on creditors is a direct cost to business of the legislation and within scope of OITO. Business creditors account for around 90 per cent of the returns to creditors with the remaining creditor impacts out of scope of OITO. The tables below show a breakdown of the cost estimates in year 1 and the 10 year profile of costs.

**Table 2:**

Case Type	Proportion that are likely to require an additional estimate	Number of cases that are likely to require an additional estimate based on 2013/14 data	Cost of producing a new estimate at 15 mins of support staff time at a rate of £106 per hour
CVL	40 per cent	4,571	£0.12m
Administrations	50 per cent	1,181	£0.03m
Bankruptcy	45 per cent	1,164	£0.03m
Compulsory Liquidation	40 per cent	309	£0.008m

**Table 3:**

Year	Cost in CVL cases (cost within scope of OITO) £m	Cost in Administrations cases (cost within scope of OITO) £m	Cost in Bankruptcy cases (cost within scope of OITO) £m	Cost in Compulsory Liquidation cases (cost within scope of OITO) £m
0	0.12 (0.1)	0.03 (0.03)	0.03 (0.03)	0.008 (0.007)
1	0.12 (0.1)	0.03 (0.03)	0.03 (0.03)	0.008 (0.007)
2	0.11 (0.1)	0.03 (0.03)	0.03 (0.03)	0.007 (0.007)
3	0.10 (0.09)	0.03 (0.02)	0.03 (0.02)	0.007 (0.006)
4	0.10 (0.09)	0.03 (0.02)	0.03 (0.02)	0.007 (0.006)
5	0.09 (0.08)	0.02 (0.02)	0.02 (0.02)	0.006 (0.006)
6	0.09 (0.08)	0.02 (0.02)	0.02 (0.02)	0.006 (0.005)
7	0.08 (0.08)	0.02 (0.02)	0.02 (0.02)	0.006 (0.005)
8	0.08 (0.07)	0.02 (0.02)	0.02 (0.02)	0.005 (0.005)
9	0.08 (0.07)	0.02 (0.02)	0.02 (0.02)	0.005 (0.005)

45. Under existing legislation IPs are required to regularly feed back to creditors on the progress of work and creditors currently have the right to challenge/dispute fee levels presented in progress reports. The requirement to produce an estimate will fit in to this existing process and so there is likely to be no additional cost to business from the requirement to seek agreement for cost estimates.

### Reduced fees

46. The greater transparency on cost may result in greater engagement and challenge from creditors over the fee, which could lead to a reduction in the fee level charged to creditors. This will mean a cost to IPs in terms of fee reduction. This will be a monetary transfer from IPs to creditors and therefore it has also been considered on the assessment of benefits.
47. According to the OFT report, there is an overall overpayment in fees from unsecured creditors to IPs of £15m (9% more than secured creditors fees). The new up front estimate on fees is expected to reduce this overpayment; however no data is available to quantify the extent of the reduction
48. The Insolvency Service consulted on three scenarios over the size of this benefit:
- High case scenario: the new fee structure reduces the overpayment by 100% - fees charged by IPs are £15m less (£16m in 2013 prices) a year (where unsecured creditors control fees) compared to the Do nothing.

- Low case scenario: the new fee structure reduces the overpayment by 10% - that is £1.5m reduction in IPs fees (£1.6m in 2013 prices)
  - Middle case scenario: the new fee structure reduces the overpayment by 60% - fees charged by IPs are reduced by 60% of the £15m a year. That is £9m (£9.5m in 2013 prices)
49. The change in policy from the consultation is likely to lead to a smaller transfer of benefit from IPs to creditors and consultation evidence (based on the change in fee structure) indicated that the size of the transfer would be towards the lower end of the published range. Therefore the best estimate for benefit to creditors of IPs providing an upfront estimate of costs has been estimated to be the low range estimate of 10% of the **overpayment or £1.6m (2013 prices) per annum transferring from IPs to creditors.**
50. It is possible that very few creditors will make use of the up front estimates to actively engage in the remuneration of IPs which will result in very little or no benefit to transfer to creditors from IPs. **Therefore a low end estimate is assumed to be zero transfer from IPs to creditors.**
51. In the event that creditors use the information to become more engaged and informed participants in insolvency proceedings would result in 100 per cent of the estimated over payment from IPs being transferred to creditors or a **£16m (2013 prices) annual benefit.**
52. As argued in paragraph X and X not all creditors are businesses around 10 per cent of the money distributed to creditors goes to non business creditors such as HMRC. This means that the transfer in fees from IPs (100 per cent businesses) to creditors (90 per cent business, 10 per cent non business) will not have a neutral impact on business as 10 per cent of the costs to business are not transferred. This means that the business net present value for this impact will be negative with a net cost to business under the three scenarios of –
- Low cost – zero impact on business Net Present Value
  - Best estimate - overall cost of £0.16m on business Net Present Value
  - High estimate – overall cost of £1.6m on business Net Present Value
53. This cost is indirectly the result of legislation as it relies on a behaviour change by IPs and unsecured creditors. The behaviour change would result from either unsecured creditors using the new information to dispute fee levels with IPs and so transfer some of income to themselves or the greater transparency provided by IPs over fee levels may make them reduce fee levels via competitive pressures. Both effects are indirectly related to the policy change and so are out of scope of OITO.
54. As mentioned in the consultation, it is important to note that the £15m figure only represents the overpayment in administration cases, and does not reflect the other procedures to which this policy will apply and is therefore likely to be a significant underestimation. The OFT reported that the level of fee overpayment was likely to be similar for creditors voluntary liquidation (CVL), as the procedures in both CVL and administration are similar<sup>10</sup>. With CVLs accounting for around half the level of IP fees compared to administration, this is likely to mean the level of overpayment is around an additional £7.5m (half of £15m) for CVLs. This amount would be similarly increased by the overpayment in bankruptcy cases, to which this proposal will apply. However due to the paucity of data, the overpayment has only been calculated for administration.

## Benefits to creditors

55. The only quantifiable benefit identified is the 9% or £15m overpayment in fees by unsecured creditors to IPs.
56. The benefit, and conversely the cost, of these proposals is a transfer of funds (£15m) from IPs back to unsecured creditors. As stated in the costs section, we are unable to quantify by how much these proposals will reduce or extinguish the overpayment by unsecured creditors, and therefore the same scenarios as in paragraphs 48 to 50 have been used.
57. At the top end (high case scenario), all excessive fee charging would be prevented and the full £15m would be returned back to creditors. This would equate to an additional 0.1 pence in the pound recovery rate for unsecured creditors<sup>11</sup>. At the lower end if creditors fail to increase engagement with IPs there will be no transfer of benefit from IPs to creditors.

<sup>10</sup> [http://www.of.gov.uk/shared\\_of/reports/Insolvency/oft1245](http://www.of.gov.uk/shared_of/reports/Insolvency/oft1245)

<sup>11</sup> [http://www.of.gov.uk/shared\\_of/reports/Insolvency/oft1245](http://www.of.gov.uk/shared_of/reports/Insolvency/oft1245)

## Non monetised benefits

### Efficiency

58. Although a transfer from one group to another, it is expected that these reforms will correct the market failure by allocating resources more efficiently which will in turn provide a net benefit to the economy.
59. We cannot define exactly what impact on the economy this might have, but we feel it is a reasonable assumption that creditors will reinvest these funds back into the economy. It could be argued that this investment will be more productive than payment to IPs, given that currently this payment exceeds the market/competitive rate.
60. The OFT report states that some unsecured creditors say that if their recovery rate from insolvency increased, they would extend more credit. While this effect is likely to be slight, even a small increase in the £80bn<sup>12</sup> of unsecured credit extended by SME's could amount to many millions of pounds.
61. There may be additional efficiency gains if the removal of the IPs' excessive market power versus unsecured creditors means that they would be forced to produce efficiently, given they had previously been able to operate without needing to minimise costs. Effectively productive efficiency could increase.

### Fairness

62. It is possible to argue that the transfer of resources from the unsecured creditor to IPs is unfair as unsecured creditors are being disadvantaged versus secured creditors for no apparent reason. Whilst unsecured creditors are disadvantaged against secured creditors by legislation in terms of order of priority of disbursements, there is no reason why they should pay higher fees on like-for-like cases compared to secured creditors for the same service.
63. We have not included any quantification of benefits from a fairness standpoint in the IA. This is because no evidence is available in order to attach a value for redistributing money from IPs to unsecured creditors. Both parties tend to be companies so it would not be possible to compare the relative prosperity of IPs against unsecured creditors in order to make a distributional adjustment as suggested by the Green Book.<sup>13</sup> Other factors would need to be taken into account in terms of weighting the relative costs and benefits to each group.

### Market Confidence

64. One benefit the OFT anticipated from reforms is an increased market confidence in IPs, leading to businesses making more use of IPs' other services. The OFT expects this to lead to businesses in trouble seeking earlier advice from IPs than they currently do. This is expected to lead to better business outcomes for these businesses, potentially saving a business from an insolvency proceeding and leading to a positive impact on the economy. It would also lead to an increase in demand for IP advisory services increasing their fees.
65. The provision of an upfront estimate will act as a cap on fees and alleviate the concerns of creditors that some types of remuneration chosen by IPs are not easily controlled. This increased transparency will make greater engagement from creditors easier and hence make it more likely that they will be able to negotiate with creditors over fee levels. This should result in a general improvement in the market confidence of creditors.

### Risks

66. The OFT contends that the 9% higher fees arise as a consequence of the reduced market power unsecured creditors face relative to secured creditors. Whilst these changes will increase the market power enjoyed by unsecured creditors, in no way will this replicate the level of market power enjoyed by secured creditors who tend to be repeat customers and have the power to appoint IPs in many

<sup>12</sup> [http://www.of.gov.uk/shared\\_of/reports/Insolvency/oft1245](http://www.of.gov.uk/shared_of/reports/Insolvency/oft1245)

<sup>13</sup> See Annex 5 of the Green Book for a full discussion of distributional impacts and their calculation. [http://www.hm-treasury.gov.uk/data\\_greenbook\\_index.htm](http://www.hm-treasury.gov.uk/data_greenbook_index.htm)

cases. It is also very difficult to assess exactly what impact the changes will have on the amount of fees charged by IPs. For this reason we can only estimate a likely range of between zero and £15m on which these proposals will impact.

67. It should however be noted that the £15m is only an estimation of the harm in administration cases so is likely to be much higher when you include CVL and bankruptcy cases, so perhaps the degree of harm alleviated is closer to the £15m estimated in the OFT report.
68. Some stakeholders have argued that engagement from creditors is already insufficient and the provision of additional information on costs will not increase this engagement. A failure to engage will not minimise the effects of market power by IPs and so will not deliver the transfer of benefits to creditors. This can be mitigated by making the information provided as clear and succinct as possible to make it more likely that creditors like actively engage with IPs over setting of remuneration levels.

#### **Direct costs and benefits to business calculations (following OITO methodology)**

69. The preferred option is likely to impose direct cost to business (IN) that are within scope of OITO These are the following:

- IPs will incur a one off familiarisation cost of the new regulatory requirements to produce an upfront estimate of the costs of IP work estimated to be £0.5m
- An ongoing cost to business of producing these estimates for all applicable cases, which has been estimated to be £0.43m
- IPs are likely to get better over time at producing cost estimates leading to a reduction in the number of cases that are likely to require an additional estimate but unforeseen circumstances are always likely to lead to additional estimates having to be produced to account for unanticipated cost. This 10 year cost profile that is within scope of OITO is shown below:

Year	Cost within scope of OITO £m
0	0.17
1	0.16
2	0.16
3	0.15
4	0.14
5	0.13
6	0.13
7	0.12
8	0.11
9	0.11

- The benefits to business of reduced fees to unsecured creditors are a transfer from IPs to creditors and have been scored as a cost and a benefit. A small part of this transfer (around 10 per cent) will end up with non business creditors (for example HMRC, employees). This net cost to business is out of scope of OITO because it is an indirect effect of the policy change. The policy relies on unsecured creditors using the greater transparency to more closely scrutinise fees levels to ensure the transfers occurs, and so an indirect impact under the Better Regulation Framework manual.
- Overall the EANCBS score has been estimated to be £0.49m

#### **Small and Micro Business Assessment**

70. The proposed changes to the fee setting process will be achieved via secondary legislation. We would anticipate a commencement date of 1 October 2015. This would link with the anticipated commencement date for the changes to the regulatory regime currently within the Small Business, Enterprise and Employment Bill.
71. The proposed changes to the fee setting process will impact on both IPs and creditors in relation to a transfer of benefit from IPs to creditors

72. Numerous micro and small businesses will have an interest in insolvency outcomes both as creditors and debtors in those cases. This proposal aims to reduce the harm suffered by unsecured creditors as a result of their weak market power. As a result the changes are expected to lead to better, fairer and more consistent outcomes for creditors, debtors and all those with an interest in insolvency cases. The creditor profile of most insolvent businesses is reflected by the general business population meaning that the vast majority of creditors can be expected to be small or micro businesses and according to the BIS Business Population Estimate 2013 small and micro businesses accounted for 98% of all private sector businesses in the UK (with fewer than 49 employees). It is unsecured creditors who are expected to gain from the reduction in IP fees, being a straight transfer from the IP to the creditors, so it would be detrimental to unsecured creditors if we were to exempt businesses that are micro or small from gaining from these proposals (as this is the exact group we are trying to benefit from changing the fee charging structure for IPs).
73. R3, the Association of Business Recovery Professionals which represents 97% of the IP profession, estimate that a significant proportion of its IP members can be classified as micro and small businesses. Figures provided by R3 show that 46 per cent of members firms had less than 50 employees making them small or micro businesses.
74. As a significant number of IP firms are small or micro businesses, to exempt these firms from being bound by the new charging structure, would have the effect of making the new system redundant. It would also be inequitable to allow smaller firms to not provide transparent cost estimates to creditors whilst restricting it to larger firms – this would give smaller firms a commercial advantage. This would not address the market failure identified in two independent reports and is likely to add to the significantly compromised position of unsecured creditors as by their very nature these creditors are nearly always small businesses.

### **Option implementation options**

75. A partial or temporary exemption would not achieve the overall policy outcome as sufficient benefit would not be transferred to the main body who we are trying to protect – unsecured creditors. No small or micro business would want a temporary or partial exemption.
76. If a partial or temporary exemption were given to IP firms, this would give a commercial advantage to those firms over others. A partial exemption is not applicable as there is no way of partially applying the proposals –either the current or new structure would apply to the charging basis for IPs. The proportion of the industry which could potentially apply for a temporary exemption is so high that it would remove any benefit proposed.

### **Wider Impacts**

77. It has been assessed that there will not be any wider impact on society, the environment, the economy or the justice system other than those described in this impact assessment.