**BANKS AND INSOLVENT CORPORATE CUSTOMERS: EXPERIENCE OF
THE RESCUE CULTURE**

Dr Keith Pond
The Banking Centre
Loughborough University
LOUGHBOROUGH
Leics.
LE11 3TU

Tel: 10509 223290
Fax: 01509 223962
E.Mail: K.Pond@lboro.ac.uk

BANKS AND INSOLVENT CORPORATE CUSTOMERS: EXPERIENCE OF THE RESCUE CULTURE

ABSTRACT

Over the last twenty years UK banks have reviewed and streamlined traditional credit assessment techniques for Small and Medium Sized Enterprises. In pursuit of margin and market share, today's due diligence relies increasingly on centralised data and statistical "certainty" than on the more qualitative approach of the local bank manager.

During this same period the nature of the banks' "safety net", the sanction of insolvency proceedings has changed too. The effect of this is not only to increase the potential for recovery, in respect of bad debts, but also to increase the moral hazard problem. However, increased risk is masked by creditor power in recovery situations.

This paper draws on theoretical and empirical research from legal, ethical and economic viewpoints and suggests that a reappraisal of this aspect of the banker-customer relationship is essential to restore trust, prudence and long-term profitability.

BANKS AND INSOLVENT CORPORATE CUSTOMERS: EXPERIENCE OF THE RESCUE CULTURE

Introduction

The relationship between a banker and a customer has its foundations in well-established UK case law (Roberts, 2003), reinforced, since 1997, by a statement of principles for business customers (British Bankers Association, 1997, updated in 2001 and 2002). All major British Banking Groups have accepted the principles.

The banks' commitment in the principles reflects the need for transparency and good communication at the various stages of the relationship: agreeing the facility, monitoring the borrowing, financial problems and insolvency action. The tenor of the principles echoes a much-ignored plea from lenders for customers to give early warning of debt problems. Amongst the motivations for making this plea is that problems can be averted and a customer retained. Some banks, including the subject of the case study explored later in this paper, recognise a *self-defeating prophecy* when bankers fail to support business customers in financial trouble. Failure to give appropriate support leads, ultimately, to a destruction of the bank's client base as businesses fail and acquisition of new borrowers is prejudiced by reputational damage.

Coincidentally, early warning of problems allows lenders to act to their own best advantage by taking individual action for debt recovery before the competing claims of other lenders level the playing field with the collective nature of insolvency procedures.

This paper focuses on the law and practice surrounding the debtor – creditor relationship between banks and Small and Medium Sized Enterprises (SMEs). The paper looks closely at the banker – customer relationship at a crucial time of

crisis (customer insolvency) and surveys the various influences placed on bankers including competition in the marketplace and society's changing attitude to debt and insolvency.

The paper also looks at some statutory choices faced by insolvent SME debtors and their creditors and goes on to review the general economic factors that have coloured creditor behaviour during the last decade. It touches on the operational handling of insolvency situations, the creditors' policies towards problem debt and the ethical and commercial considerations that guide them.

The paper concludes by arguing that in the current competitive environment, where SME relationships are more important to both parties than pricing considerations, banks can do much to regain the trust that can lead to profitable long-term relationships with customers.

The banker - SME relationship

Bankers and SMEs have a mutual dependency. Recognised as the "engine of economic growth" SMEs require external finance, business advice and money transmission services from their inception. Banks provide all three, and do so for the benefit of their own shareholders.

The SME banking market in England and Wales has been described, however, as a complex monopoly that acts against the public interest and against the interests of SMEs. (Competition Commission, 2002). Four major banks dominate a market where barriers to entry are high and "excessive prices and interest rates" are charged. Nationally the "big four" banks¹ account for 83% of the market, with higher percentages in some local markets (Cruickshank, 2000).

Competitive pressures in consumer banking markets and available technology have, in part, resulted in an orientation away from the relational banking of the "old fashioned" high street bank manager, towards the standardisation and

transactional banking of the direct seller. Technical competence in lending can be subordinated to systematic “credit scoring” and centralisation based on empirical information from a variety of sources (Leyshon & Thrift, 1999). There is also substantial evidence that bank lending to SMEs is highly secured (Competition Commission, 2002), leaving the impression that the profits gained from SME business are a rich reward given the level of risk actually undertaken.

Whilst streamlined systems for lending can reduce costs and increase profitability in the short-term it does serve to reinforce the moral hazard problems associated with dealing with borrowers at “arms length”. The Competition Commission also noted, however, that it is the long-term relationship with one provider of external finance and money transmission was high on the list of factors affecting demand of SMEs for banking services (Competition Commission, 2002). This factor ranked above price.

With a widely publicised code of conduct in place, bankers and their customers should be more certain about their legal and practical relationship. Emphasis in the banker-customer relationship, bank training and professional education, has typically focussed on “beginnings” (the initial lending decision) and “endings” (the effective use of security). Whilst these are undoubtedly important it is the “middle” (the quality of relationship) that must now be developed.

The emphasis on product based, transactional banking in the 1980’s and early 90’s had a marked effect on bank organisational structures and sources of income. Closure of bank branches due to the changes in the consumer market had an effect on SMEs. SMEs demanded local representation and contact, features that disappeared as the physical presence of local banks was extinguished.

By the mid 1990’s banks had begun to realise the importance of reintroducing “relationship management” and introducing customer retention policies. Although attitudes and practices are often slow to change in large organisations banks are

¹ Barclays, HSBC, LloydsTSB and RBS Nat West.

beginning to balance the “lifetime value” of customers with the move towards individual account profitability (Stone et al., 1996). Banks also know that customer acquisition is more expensive than customer retention although not all have applied this logic of this in dealing with bad debts, insolvency and defaulting customers.

US research has indicated that the long-term success of firms, in terms of sustainable competitive advantage, is associated with investment in relationships with customers and suppliers (Beckett-Camarata et al, 1998). In banking, customers and suppliers are synonymous in certain circumstances since funds deposited in accounts are used by banks to fund lending. Fine-tuning of communications with customers also gives benefits. Specialised training and the focused deployment of staff can, therefore, help to engender the trust, satisfaction and commitment that banks desire in their relationships with customers (Smith, 1998).

Insolvency Law and Practice

Since passage of the 1986 Insolvency Act insolvent UK corporate debtors have had access to a statutory Corporate Voluntary Arrangement (CVA) procedure that was designed to assist the “rescue” of corporates and their businesses. The CVA between corporate debtors and creditors was designed to allow viable businesses to continue in order to achieve a better and more orderly realisation of assets for the creditors or the survival of the company. The legislative provisions followed the recommendations of a review committee (Cork, 1982) and extensive consultation (DTI, 1984) that noted the need to “rescue” corporate debtors and to distinguish between the dishonest and the unlucky.

The CVA is a private contract for the satisfaction of debts. As such it can be influenced by the quality of the relationships between lenders and debtors. In this court-supervised procedure the debtor company proposes how the debts are to be satisfied, under the guidance of a licensed insolvency practitioner (IP) and

under the protection of a “moratorium” on creditor action either directly through the Insolvency Act 2000 or via an Administration Order, also ushered in by the 1986 Act. The creditors are given the opportunity of amending and accepting or rejecting the proposal. A 75% majority of creditors (by value) accepting the proposed CVA binds them and any dissenters.

The choice faced by SMEs in financial trouble is between CVA, and the finality of liquidation (liquidation of available assets). The choice faced by the creditor is limited by the predisposition of the debtor towards survival in the first instance and by the existence of “moral hazard” which makes the CVA riskier for the creditor. However, a successful CVA can improve creditor recoveries (Cook et al, 2003) and increase customer retention, since income from continued employment or trade is often included as a benefit.

Moral hazard exists in the CVA situation because the creditor is forced by the Insolvency Act 1986 to make a choice between either CVA acceptance or liquidation. If the creditors choose CVA, debtors can take actions, unobservable by creditors, which transfer greater risk to creditors. This is compounded by the lack of a formal investigation of the debtor’s affairs in a CVA and the debtor’s retention and possession of assets. Creditors must be aware that over-ambitious repayment proposals made by debtors may look attractive initially but may fail to materialise as debtors fail to co-operate with the IP or market conditions change once the CVA has been accepted.

Creditor experience of liquidation is rarely good as official costs and the preferential treatment of some Crown debts (up to September 2003) deplete available assets and average returns from this procedure (R3, 2003). This contrasts with the overall experience of CVAs (Cook et al, 2003).

The asymmetric bargaining power of larger creditors, a result of their corporate experience, centralisation and specialisation, security position and size of debt also helps banks, in particular, to influence the acceptance of CVAs more readily.

Generally, banks are able to use their experience and select only CVAs that have a realistic chance of returning better dividends than liquidation. In these cases, their recoveries will be greater and, arguably, their retention of customers more marked.

Economic considerations

The fact that banks, as lenders, should be able to pursue profitable lending opportunities is not in question. What is questioned, however, is the time-scale over which such profits are measured.

In the short-term it appears that banks have profited enormously from the SME market (Competition Commission, 2002). Profits, however, are cyclical as macroeconomic factors play a significant part in bad debt experience (Pain, 2003). Figure 1 reports the profit margins and associated provisioning for bad debt of the major UK banks (dominated by the four key lenders to the SME sector).

TAKE IN FIGURE 1 ABOUT HERE

The Insolvency Act has, however, shown a preventive effect on business failure (Liu and Wilson, 2002) despite the fact that only small numbers of rescues (including small numbers of CVAs) have been recorded. Figure 2 reports the incidence of insolvent liquidations and rescue procedures under the Insolvency Act 1986 since 1986. The recession of 1990 – 1994 is shown in a marked way.

TAKE IN FIGURE 2 ABOUT HERE

Where banks hold unsecured debt the tendency in corporate insolvency has been towards liquidation rather than rescue or rehabilitation. Smaller businesses appear not to warrant bank involvement in workouts (Gladstone and Lane Lee, 1995. Gopinath, 1995) and the same policy appears to be adopted for unincorporated businesses and personal debtors. This approach is typically

justified by banks on the basis that there is no point “putting good money after bad” (sic).

The financial argument for this is clear: the amount of debt written off (debt less recoveries) can influence specific provisions for bad and doubtful debt, net profits and tax charges. Transaction costs incurred in account intervention will merely add to losses in the short-term.

The longer-term economic argument is less clear but sees write-offs as “sunk costs”. Normal costs of extending credit must take potential losses into consideration and be discounted in the risk related interest rate charged. The decision to invest in relationships with debtors should not, therefore, take the bad debt loss into account. Instead, the decision should compare the risk weighted “lifetime value” of the debtor against the cost of a more detailed investment in customer rehabilitation. Companies taking a longer-term, strategic, view of recovery also show tendencies to deliver more successful rescues than firms that “fire fight” (Sudarsanam & Lai, 2001).

In the SME market such a policy may be more commercially viable in the longer term, especially where both legislation and social values want to encourage development of “the rescue culture” (DTI, 2000) and where large numbers of liquidated companies are repaying nothing to their lenders. Taking a slightly different perspective, customer information relating to crisis and rehabilitation could eventually lead to danger signals being recognised much earlier in the day, allowing banks to take preventative action and, perhaps, even avoid the need for formal insolvency procedures.

The ethical dimension

The Cork committee (Cork, 1982) recognised that changes in commercial life and society since passage of the Bankruptcy Act 1883 necessitated a review and refashioning of insolvency law. The 1986 reforms that Cork influenced recognised that there needed to be a balance between two separate views of

liquidation: as a sanction against deviancy and consumer laxness (deterrence) and as a form of consumer protection (Ramsay, 1997). Creditors' maintenance of a failure "stigma" is under pressure from government and society in general. A society based on credit generally has a greater acceptance of debt and a more permissive attitude to default (Lea et al, 1993).

In a society based on credit, liquidation will provide a "safety valve", recognising that credit providers share responsibility for over-commitment. The key task in achieving this balance is to distinguish between the dishonest insolvent and the merely unlucky.

The main actors in achieving this balance, apart from individual debtor companies and creditors themselves, are Insolvency Practitioners and their public sector counterparts the Official Receivers. Cork's recommendation of a licensing system for IPs and the professionalisation of the industry coincided with the government's wish to reduce public sector involvement in the administration of insolvency. After 1986 The Insolvency Service, an Executive Agency of the DTI, concentrated on fraud and malpractice investigations. In pursuing this strategy the Insolvency Service was heavily reliant on IPs who were obliged to investigate and report on director misfeasance and malpractice in liquidations. Delinquent directors face disqualification, criminal proceedings and may have to contribute to company assets.

No compulsory investigations are undertaken in CVAs, a feature that helps to encourage company directors to choose this insolvency procedure. In addition, directors maintain control over assets in rescue regimes, although this requires high levels of creditor approval (Cook and Pond, 2004).

Banks' also find themselves in a privileged position in insolvency procedures through their taking of direct and indirect security and guarantees – a privilege maintained by the priority given to types of creditor in the Insolvency Act 1986. An unpopular view put forward in 1992 was the outlawing of collateral that would:

"....force banks into relationship banking, rather than simply paying lip service to it in hard times." (Harris, 1992).

This view ignores the increased cost of credit that unsecured lending would bring but does address the fundamental relationship between banker and customer.

A more accessible feature of the equation, for UK creditors is the institutional credit-trust relationship between lender and borrower. Initial lending relationships between banks and new customers are likely to be deterrence based but will develop into knowledge-based relationships where personal contact and repeated interaction are prevalent (Erfat, 1998).

When the value of the deterrence diminishes, however, as society's view changes and as insolvency law favours rehabilitation, the deterrent effect breaks down. In addition the deterrence-based relationship is unlikely to engender any emotional or moral input by the borrower.

6. A case study

This paper concludes with a short case study of a major UK bank (Bank A). Whilst not unique in its approach the strategy described for managing potential bad debt is an excellent illustration of the “relationship” vs. transactional switch seen during the last decade.

Bank A is a large retail bank with branch outlets throughout England and Wales. The bank derived over half of its 2002 net income from lending activity and is a major player in the SME market. Along with competitors Bank A suffered losses and high net provisions in 1990 – 1994 but resolved to learn from this and take a longer-term view to bad debt problems.

Bank A endeavours to support SME clients using specialist “Business Support” offices located in major centres. These offices deal with clients where exposure to the bank is between £1m and £20m. Around 80 experienced managers look after an average of 20 cases each, taking referrals from front-line managers in the branch network. Symptoms of financial problems are used as a trigger for

action by Business Support managers who take over the relationship from the branch once certain criteria are met.

There is no set pattern to dealing with cases but independent review by accountants and close supervision by bankers will form parts of the mix. On average clients remain with the Unit for 15 – 18 months with a successful return to branch management or re-banking in 75% of cases. This high success rate is quite normal for closely supervised “workouts” and reconstructions (Franks and Sussman, 2000). As well as averting loss in most cases Business Support generates £30m. in additional fee income to the bank by virtue of arranging appropriate financing for clients.

Business Support “branding” is vital to the success of the operation. Commitment by a major bank is important in encouraging wider creditor support, especially where a CVA is envisaged. In most cases creditor support is needed simply to continue to trade during the period of crisis.

Bank A supports appropriate CVAs and in many cases will have encouraged SME customers to consider this route. The bank also considers that it will reap longer-term reputational rewards ahead of its rivals and will counter the *self-defeating prophecy* of former times.

7. Conclusions

This paper presents a dilemma for bankers. It is a common dilemma as short-term profits are often prioritised ahead of long-term gains. It also presents a key option for the bank when customer default presages formal insolvency.

Traditionally “short termism”, driven by the need to satisfy shareholders, has taken overwhelming precedence over the need to develop long term relationships with customers. Competitive pressures have, however, focused attention on the importance of customer retention and the active management of the banker-customer relationship.

Consequently, banks that were traditionally transaction oriented, with an emphasis on standardisation and centralisation, in an endeavour to reduce costs, are emerging as relationship oriented organisations. The value and importance of relationship strategies in reducing moral hazard in the provision of credit to SME customers has been discussed. The paper also recognises the impact of moral hazard on the administration of insolvency law, which, since 1986 has embraced the concepts of rescue and survival.

Insolvency law has, in this respect, been ahead of the “thinking” within many banks and, significantly, has reflected the changing ethical attitudes of society to debt. In beginning to emerge as relationship-oriented organisations, therefore, the banks are adopting the values of society and the legal system but still have a long way to go in taking full advantage of rescue mechanisms. In a competitive environment banks need to embrace the importance of business rescue and survival in order to benefit from customer retention and continuing relationships with their debtor customers.

References

Beckett-Camarata EJ, Camarata MR and Barker RT, (1998), Integrating Internal and External Customer relationships through Relationship Management: A Strategic Response to a Changing Global Environment, *Journal of Business Research*, Vol 41, Part 1

British Bankers' Association, (2002), *Banks and Businesses: Working Together When You Borrow*, BBA Enterprises Ltd., London.

Competition Commission, (2002), *The supply of banking services by clearing banks to small and medium-sized enterprises Volume 1: Summary and Conclusions*, HMSO, London.

Cook GA and Pond K, (2004), *Explaining the Choice between Alternative Insolvency Regimes for Troubled Companies in the UK and Sweden*, Loughborough University banking Centre Research Paper series, forthcoming.

Cook GA, Pandit N, Milman D and Mason C, (2003), *Small firm rescue: a multi-method empirical study of company voluntary arrangements*, ICA (E&W), September, ISBN 1-84152-157-4

Cork Committee, (1982), *Insolvency Law & Practice – Report of the Review Committee*, HMSO, Cmnd. 8558, London

Cruickshank D., (2000), *Competition in UK banking - A report to the Chancellor of the Exchequer*, HMSO, London.

Department of Trade and Industry, (1984), *A Revised Framework for Insolvency Law White Paper*, HMSO, Cmnd. 9175, London

Department of Trade and Industry, (2000), *A Review of Company Rescue and Business Reconstruction Mechanisms: Report by the Review Group*, The Insolvency Service, London.

Erfat R, (1998), *The moral appeal of personal bankruptcy*, *Whittier Law Review*, Vol. 20.

Franks J and Sussman O, (2000), *The Cycle of Corporate Distress, Rescue and Dissolution: A Study of Small and Medium Size UK Companies*, Institute of Finance and Accounting Working Paper, No 306, London

Gladstone B and Lane Lee J, (1995), *The Operation of the Insolvency System in the UK: Some Implications for Entrepreneurialism*, *Small Business Economics*, Vol 7, Part 1

Gopinath C, (1995), *Bank Strategies towards Firms in Decline*, *Journal of Business Venturing*, Vol 10, Part 1

Harris A, (1992), Financial Times cited in Prindl AR and Prodhan B (Ed.), (1994), The ACT Guide to Ethical Conflicts in Finance, Blackwells.

Lea S E G, Webley P and Levine R M, (1993), The economic psychology of consumer debt, Journal of Economic Psychology, Vol: 14.

Leyshon A & Thrift N., (1999), Lists come alive: electronic scoring systems of knowledge and the rise of credit-scoring in retail banking, Economy & Society, Vol. 28, No. 3

Liu J and Wilson N, (2002), Corporate Failure rates and the Impact of the 1986 Insolvency Act: An Econometric Analysis, Managerial Finance, Vol 28, No. 6

Pain D, (2003), The provisioning experience of major UK banks: a small panel investigation, Bank of England Working Paper series, No. 177, ISSN 1368-5562

R3, (2003), 11th survey of company insolvency, Association of Business Recovery Professionals, London.

Ramsay I, (1997), Models of Consumer Bankruptcy: Implications for Research and Policy, Journal of Consumer Policy, Vol 20.

Roberts G., (2003), Law Relating to Financial Services 5edn., Institute of Financial Services, Canterbury, ISBN 0-85297-688-7

Smith JB, (1998), Buyer-Seller relationships: Similarity, Relationship Management and Quality, Psychology and Marketing, Vol 15, No. 1

Stone M, Woodcock N and Wilson M., (1996), Managing the Change from Marketing Planning to Customer Relationship Management, Long Range Planning, Vol 29, No. 5

Sudarsanam S and Lai J, (2001), Corporate financial distress and turnaround strategies: an empirical analysis, British Journal of Management, Vol 12, No. 3

Figure 1 Major British Banking Groups² Profitability and Provisions 1987 - 2001

Source: British Bankers Association, 2002.

² MBBG figures exclude long-term assurance funds.

Figure 2 UK insolvencies 1986 – 2003 (est.)