Debtors and Levy Risk Guide

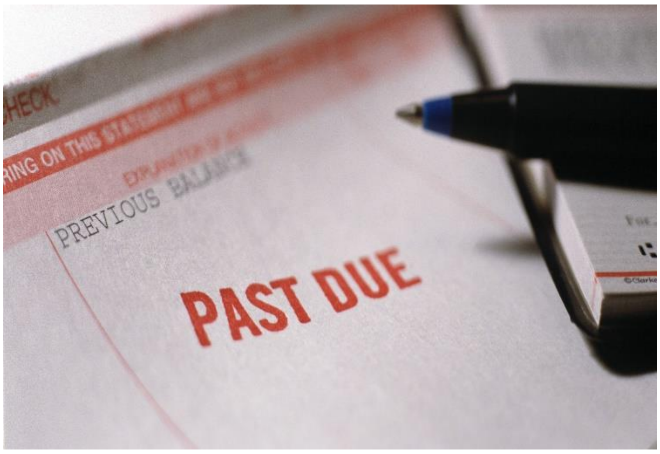
Contents

What are Debtors and Levy Risk?

Debtor/Levy Management risks are risks arising from the extension of payment terms relative to the provision of services by the Community Scheme. The extension of payment terms may trigger other risks (e.g. operational risks) and restrict or limit the use of resources by a Community Scheme.

Community Schemes can fail because of poor debtor management, especially where they are highly reliant on cash flow for the funding of their operations.

The Community Scheme needs to appreciate the implications of carrying levy debtors and other dues books. It then needs to establish the size of the debtor's book and the extent to which it can carry any non-performing or late payments without disrupting the operational running of the Community Scheme and its ability to meet its obligations.



As the expenditure of the Community Scheme requires continual funding, the up-front or advance collection of levies or amounts due needs to be proactively managed. Managing liquidity is integral to the successful management of a Community Scheme. Levies must also be set at realistic levels to ensure that budgeted and expected expenditure is comfortably met, taking into cognisance payment delays, arrears, and non-payment. It is no use trying to keep levies low just to improve collectability/affordability if the core expenditure is not being covered. This situation will quickly catch up and require special levies to be raised to resolve or result in the material deterioration of the Community Scheme's finances.

With budgets being largely balanced along with the need to build up reserves, there is very limited scope to be able to accommodate a large debtor's book of outstanding levies, long outstanding debtors, or bad debts. The collection of debtors requires that robust billing and collection processes and support systems are in place. As soon as extended payment terms are availed, you have effectively extended credit and need to manage your debtor's book accordingly. It needs to be remembered that bad or irrecoverable debt is not just a loss of income, but a loss of reserves and cash.

Debtors Policy

Before setting a debtor's policy it is important to understand the broader environment and arena into which the Community Scheme is extending payment terms and to set your Community Scheme's policies around this.

A debtor's policy should incorporate the following key elements:

- Terms and conditions surrounding the payment of levies, other dues, and special levies
- Compliance with relevant regulatory and reporting requirements including consumer protection and disaster management regulations e.g. level of allowable annual increases in normal levies (10%), raising of special levies, interest on arrears, level of interest rates, recovery of admin and legal fees, actions for non-payment, eviction, attachment of assets, sales in execution, withholding of services.
- Processes – monthly billing, payment monitoring, collections, use of debit orders
- Monthly level of levies and acceptable percentage of arrears
- Likely level of outstanding levies/arrears per name/owner – liquidity needs.
- Identification of concentration risk e.g., common debtors, high level of single ownership
- Payment terms
- Leniency period/arrangements
- Arrear's policy
- Collection policy
- Recovery of admin/legal and collection fees
- Bad debts – treatment/handling
- Risk mitigation e.g. insurance, collateral, security
- Use of legal resources, tracing and collecting agents – budget/cost of this

- It may also be beneficial for a Community Scheme to consider offering early settlement discounts to incentivise early payment of levies and dues.
- Consideration of selling/factoring the arrears debtor's book or the outright sale of the debtor's/levy book in situations where liquidity is stretched.

The regulatory and compliance requirements for the recovery of outstanding amounts are onerous and complex and need to be established to ensure compliance where applicable. This includes the electronic communications act, prescription, maximum permissible interest rates, permissible associated administration charge recoveries, recovery of insurance excesses, and the level of disclosure required in monthly debtor statements.

Where the debtors/levy book of a Community Scheme is financed whether by factoring or outright sale, the terms and conditions, nature of recourse, and cost of this, need to be clearly understood.

The ability of the Community Scheme to carry finance charges or operate on the reduced cash flow from the discounted face value of the levy/debtor's book needs to be carefully evaluated.

Managing Debtors – Processes, People, and Supporting Systems

The extension of payment terms requires the establishment and implementation of four core elements – namely policies, processes, resourcing, and support systems.

Before any payment terms are allowed or extended, the people, processes, and systems to support the extension of payment terms and the management and collection of debtors must be in place.

Processes

Processes that need to be in place to support the payment policy and the ability to enforce terms and conditions, the ongoing monitoring and review of the debtor's book, and the following of laid down disciplined collections steps. Processes and controls must be detailed and tested to ensure that they are comprehensive, robust, repeatable, and secure.

Some key processes are the production of accurate invoices and the sending out of these well in advance of the required payment date. This requires a good accounting system, and a mailing system (postal/personal delivery/e-mail or another form of electronic delivery or online access).

Payment/collection options for levies or dues need to be flexible and robust with a focus on critical payment reference fields e.g. web/app-enabled, EFTs, debit orders, and pre-formatted credits. The acceptance of cash payments should be resisted.

The "owner" database needs to have accurate and up-to-date information and contact details, for not just monthly statements and invoices, but for other critical notices and interactions.

People

Staff or Office bearers/Third Parties with appropriate credit and collection experience/skill sets need to be employed and trained further where necessary. The supervisory structures and executive time need to be established to support the management of payments and debtors. A clear separation/segregation of duties is required in respect of invoicing, the application of payments, and the collection follow-up process. Any potential conflicts of interest or relationships with connected parties should be disclosed and avoided.

Systems

Only tried and tested reputable integrated debtor packages should be deployed. These need to provide integrated reporting, comprehensive information on the debtor's book as a whole and individual debtor, control limits, detailed age analysis, flagging of arrears, arrangements, legal proceedings, recoveries, etc.

Collection Policies and Processes

Collection policies and processes are an integral part of debtor management as they have a direct bearing on the cash flow of the Community Scheme. If policies are not strictly enforced, it becomes impossible to manage payments due or debtors.

Skilled and experienced parties dedicated to the management and collection of outstanding/debtors need to be deployed/contracted. It is no use trying to manage a debtor's book on an ad-hoc or part-time basis. It requires a continuing, consistent, and proactive focus.

It is important that collection processes take cognisance of the risk of long outstanding dues becoming prescribed and that processes ensure that acknowledgment of debt and default judgments are obtained timeously where necessary. Judgments need to be placed on record with the respective credit bureaux.

You need to establish exactly which/what percentage of your debtors the Community Scheme is most likely to be vulnerable to as well as the Community Schemes concentration risk to any one name. This can result where a single owner owning multiple units in a Community Scheme whether directly or indirectly through trusts. It can also arise where a developer still owns several unsold units or undeveloped properties in a Community Scheme.

The one hold that Community Schemes have on owners is the withholding of levy clearance certificates upon the sale of units. The situation can however get messy where levies are up to date, and council rates and taxes are in arrears or vice versa. There are several complexities around the termination of the provision of utility services due to non-payment, notably water. Attorneys should be consulted before utility services are suspended/withdrawn from defaulting units/properties. Arrears levies and/or municipal fees and/or utilities are a good indication of pending problems in the ongoing collection of levies.

In some instances, the level of levy and related arrears can have grown to be substantial relative to the market value of the property in question, the amounts owing on bonds and arrears in respect of utility and municipal rates and taxes. The impact of major arrears on the cash flow of a Community Scheme can be severe. The selling of properties, interest, or shares in execution can become essential to bring these situations to a head. Taking action timeously under legal advice becomes a critical component of managing these scenarios.

The recovery of any legal fees used to recover outstanding levies, interest on arrears and administration fees involved in arrears recoveries should be recouped from defaulting owners. The extent of these recoveries is restricted or limited in terms of regulations and the rules of the Community Scheme in question.

Management and On-going Review of the Debtor's Book

The management of debtors is not a static or once-off process and once you have monies owed to the Community Scheme, they need to be continually monitored and managed.

One of the key requirements of Community Scheme risk management is the ability to manage and be prepared to deal with the impact of socio-economic risks. All Community Schemes are indirectly exposed to the broader socio-economic environment and a volatile macro business environment in which they operate.

Socio-economic conditions can have an enormous direct impact on affordability and the ability of owners to pay levies due, and then on the overall state of levy collections. These can rapidly manifest themselves in several ways and can also be very localised in nature e.g., unemployment, economic downturns, business failures, closure, or failure of major employers in the area, immigration (loss of skills), regulatory and legislative changes, financial impacts (interest and exchange rate volatility). They can also be due to global socio-economic issues and factors such as recessionary conditions, global conflict, lockdowns, travel restrictions, disease outbreaks, pandemics, trade embargoes, border closures, sanctions, etc. which can also have a major impact. You need to try and establish to what extent your debtors are going to be vulnerable to a sudden risk event or adverse socio-economic circumstance and plan accordingly.

In some Community Schemes, a levy subsidisation scheme or fund is put in place to "smooth" the payment of levies by limiting the growth in annual levies to meet increasing and erratic levels of expenditure. While this might help the affordability and predictability of levies, it often doesn't work where major maintenance expenditure is required or where insufficient general reserves are in place. It also won't help deal with meeting unexpected expenditures unless the funds of the Community Scheme can carry this. The raising of special levies to accommodate arrears levies is an unacceptable/undesirable practice.

The tenant/owner resident mix in a Community Scheme is also an indicator of potential debtor risk. The buy/own-to-rent market is particularly vulnerable to prevailing socio-economic conditions and the ability of owners to find tenants and in turn, the tenant's ability to pay their rents. The knock-on impact of tenants' behaviour and general financial stress will flow through to owners and their ability to pay levies. The same applies where owners rely on Air B&B, sub-letting, swaps, or short-term rentals to pay levies.

The knock-on effect of business failure and employee retrenchment can have an impact on the ability of tenants to pay owners, and in turn the owner's ability to pay their levies. You need to try and identify and become aware of the general likely impact on your debtor's book, and the extent to which the Community Scheme will become vulnerable to a major downturn in the economy or adverse socio-economic event.

Budgets should factor in the impact of lower levy collections due to the inability of owners to pay and the accounts should have a provision for bad debts.

The risk profile of debtors can vary greatly. Debtor behaviour, and in particular changes in behaviour, need to be monitored. You must be aware of early warning signals of distress in your debtors. These might come about because of genuine personal circumstances or indirectly due to matters beyond the debtor's control. In most cases, however, payment default is a result of parties being generally over-extended, which drives this behaviour.

Delaying and non-payment tactics can range from niggly disputes around service delivery/Community Scheme issues, endless requests for duplicate invoices and statements, issuing of cheques knowing they will be dishonoured, stopping of payments, unpaid or cancelled debit orders or other general payment delaying tactics with levy payments being withheld for no material reason.

Collection rates and success must include all debtors and amounts due, and not be distorted by say one or two large arrear debtors suddenly paying.

While it is also possible to finance the debtor's/levy book of the Community Scheme by discounting or selling specific debtors outright or the entire book to generate liquidity/cash flow for the improvement of the Balance Sheet and running of the Community Scheme, this might not be a panacea for a cash strapped/illiquid Community Scheme, as it comes at a financial cost which needs to be clearly understood and evaluated by the Office bearers before being put forward to owners for approval at an AGM.

Poor historic collection processes and actions/efforts should not be allowed to drive this decision in isolation.

Arrangements

Where owners fall into arrears and/or are unable to pay their levies or dues for specific credible reasons, it may be in the interests of Community Schemes to enter acceptable payment arrangements to not only accommodate the situation but to then recoup arrears.

These should consider the amount of the arrears, the owner's historic payment track record, outstanding bond/encumberment of the property, likelihood and timeframe of repayment, market value of the property/interest, and the current personal financial situation of the owner.

It might also be possible to get supporting security for the obligations of a debtor such as a guarantee from a partner, parent, or credible third party.

It is no use allowing an owner to defer the full payment of levies and amounts due as this sends out the wrong signals and allows the owner to prefer other creditors. It also becomes very hard for them to catch up and reverse the situation. While the monthly amount due could be reduced for a period, at the same time recovery of the arrears needs to be agreed upon and formalised.

Bad Debts

Debts need to be tracked and followed up on aggressively before being written off as bad.

While arrears levies can always be recovered upon the sale of a property/interest, this is cold comfort if the amount is significant or has built up over time at the expense of the Community Scheme and its cash flow. Obviously, the number of defaulting owners will have a compound effect. Where there is no change in ownership this becomes more complicated, particularly where the property is occupied by a tenant or where the owners do a skip/runner or just abandon the property/their interest. Invariably the property may be fully bonded with many other creditors waiting in the wings.

The level of arrears and bad debt trends need to be monitored/measured to ensure they are not deteriorating.

Bad debts in Community Schemes can't always be planned for and can arise unexpectedly. As such it is prudent to budget and provide for a level of bad debts against debtors.

It needs to be remembered that bad debt is not just the loss of profitability but is effectively a loss of Community Scheme funds/reserves and cash.

Collection Policies and Processes

Where the service offering is subject to a fixed recurring consistent monthly obligation such as levy payments, the use of debit orders should be made. The necessary mandate and authorisation for this must be obtained from the owner concerned. These instructions should be obtained in writing and must be signed by the party or authorised signatories of the obligant party. While a debit order doesn't guarantee payment, it does bring some discipline to collections and more certainty to cash flow. Debit orders can also be used where a payment arrangement has been made with a defaulting debtor.

To keep payment collections flowing smoothly, the use of a series of letters and phone calls to encourage owners to pay should be made. These communications should start as friends and progressively become more serious and insistent as payments become long overdue. How each Community Scheme or Managing Agent structures their collections approach is an individual matter and might depend on the nature and length of relationships with the various outstanding debtors. In some instances, the Community Scheme may wish to call up certain owners personally rather than sending them letters. The important thing is to have a system that works for the Community Scheme and to ensure that this is not deviated from.

At some stage, tough decisions need to be taken with irregular debtors as the actions required to collect long outstanding amounts which are likely to have a serious impact on the relationship and trust between the Community Scheme and the owners in question.

Relationships with reputable and competent attorneys who specialise in debt collections will need to be formalised. Relationships with tracing agents and reputable debt collectors should also be formed.

There are however a few steps in a robust collection process that should be put in place and followed. These are:

- Ensure that your collection processes follow legal requirements.
- Manage and enforce the payment terms as agreed.
- Regularly track and take note of changes in payment patterns, frequency, and amounts paid.
- Implement a strict process of collection management and debtor interaction.
- Try and ensure that debtors settle their outstanding amounts due before lengthy festive or holiday office breaks taken by The Community Scheme members or Managing Agent

- Consider offering settlement discounts to encourage earlier payment.
- Deal with irregular debtors, payment arrears, and agreed re-payment arrangements.
- Hand over long overdue debtors, who have not responded to final notices, or who are in default of arrangements to lawyers and/or debt collectors.
- Move to the sale of properties/interests/shares in execution for the recovery of significant arrears.

You need to understand the true cost of carrying delinquent and slow-paying debtors. The time spent chasing debtors and the costs of collection should also be factored in. Don't be scared to badger owners for payment, particularly where they are delinquent. You need to revisit your debtor's book constantly to know who your good debtors are from your slow- or consistently late-payers and flag them as such.

You might need to also investigate the viability of insuring single major/large debtors, whose potential failure could place the entire Community Scheme at risk.

In some instances, you might want to investigate the viability of outsourcing collections to a professional third-party organisation.

The debtor's book requires continual review and monitoring in respect of total amounts outstanding to the Community Scheme, individual arrears, adherence to terms, concentration if any, detailed age analysis, and discounts allowed. Potential bad debts need to be flagged as early as possible.

In some instances where the liquidity of the Community Scheme is severely stressed due to unexpected expenditure, poor budgeting, or large arrears debtors, it might be worthwhile considering the outright sale of or cession of the debtor's book to third parties or specialist finance organisations. This can only be undertaken subject to regulatory requirements being met, the constitution of the Scheme, and the approval of the Community Scheme members. This will effectively represent a debt obligation of The Community Scheme and have financing and administration fee costs. Such financing arrangements might only provide temporary relief if debtors and payment collections are not improved. They will also not eliminate the risk of bad debts having to be written off unless the arrangement of the sale or discounting of the debtors is on a non-recourse basis.

Unwinding or ceasing this type of financing arrangement is however not simple and can take time and require specific lump sum cash outflows to settle outstanding debt.

Basic Debtor Collection Process

The following is a recommended template of action steps in the debtor collection process.

Step 1: Customer satisfaction phone call

Dissatisfied or unhappy owners are more likely to withhold payment or pay late. These friendly calls let you inquire about issues they might have. These calls should be concluded by mentioning that the smooth functioning of the Community Scheme is totally dependent upon the owner's payments.

Timing: three days after payment is due.

Step 2: First overdue notice

This is a friendly reminder that the payment due date has passed. You are assuming that the owner has forgotten, neglected, or lost the invoice and will pay with some gentle prodding. One common method is to send a duplicate invoice with "past due" stamped on it.

Timing: ten days after the invoice due date.

Step 3: Second overdue notice

Another mild nudge reminds the owner that the account needs attention. This can be a short-form letter with a duplicate invoice attached. This should be kept friendly and non-threatening and re-enforce that the owner needs to keep payments current.

Timing: 10-15 days after the first overdue notice was sent/20+ days after the invoice due date.

Step 4: First collection phone call

Follow the overdue notices with a phone call to find out if there is a reason for non-payment. The owner may still be unclear or unhappy about something or may be experiencing cash flow problems. While you need to remain courteous, you should also get a commitment to pay.

You need to be prepared to handle excuses such as they are waiting for their tenant hasn't yet paid or the banking payment system has not been available.

Timing: 7-10 days after the second overdue notice is sent out/27 + days after the invoice due date.

Step 5: First collection letter

The tone of this letter should be kept consistent with the first phone call - courteous, but direct. Confirm in writing what was said in the call and remind the debtor of his or her promise to pay.

Timing: immediately after the first collection phone call/28+ days after the invoice due date.

Step 6: Second collection phone call

The account is now 30-40 days past due. Be polite yet firm and ask for full immediate payment. Work to resolve payment problems. If the debtor cannot pay immediately, get him or her to commit to a payment date.

Timing: ten days after the first collection letter has been sent/38+ days after the invoice due date.

Step 7: Second collection letter

This is the time to communicate the seriousness of delinquency. This letter should demand immediate payment within 7 days and discuss the short-term consequences of failure to pay such as possible legal action. This letter and any subsequent correspondence that follows should be sent via registered mail or courier to give you a record that it was received.

Timing: ten days after payment is expected from the previous collection phone call/50+ days after the invoice due date.

Step 8: Third collection phone call

While remaining polite and calm, you need to stress the seriousness of the situation. This phone call should be used to explain that this is the last opportunity for the owner to pay before you turn the matter over to a collection agency and possibly take further legal action. Be sure to communicate the benefits of resolving the issue - maintaining good relations and not getting an adverse credit record because of a judgment. As with the previous phone call, you need to get the debtor to promise to pay by a certain date.

Timing: 15 days after the second collection letter is sent out/65+ days after the invoice due date

Step 9: Final collection letter

The tone of this letter is now stern and demanding. This letter is used to confirm what was agreed upon in the last call and demand payment. It is important to state that if payment is not received by an agreed-upon date, you will hand the account over to a collection agency and institute legal action.

Timing: seven days after the third collection phone call/72+ days after the invoice due date.

Step 10: Turn over to a collection agency/lawyer and/or attorney

The account is now 90+ days in arrears and will require professional assistance to resolve. Receiving a letter from a collection agency or lawyers often motivates a debtor to pay, but these services can be costly. Collection agencies typically take from a quarter to a half of what they collect. Instead of immediately turning the account over to a collection agency, you might want to enlist your attorney/lawyers to make a quick phone call or send a letter to the debtor - this can often motivate payment.

Timing: If payment has not been received by 10-15 days after the final collection letter is sent/90+ days after the invoice due date.

Given the legal and regulatory complexities, more substantial or long outstanding arrears that could require properties, legal interest, or shares needing to be attached or sold in execution, should be done under the advice of attorneys specialising in this area.

Legal Collections Process and the Sectional Title Schemes Act:

According to decisions taken at Office bearers/other meetings of Community Schemes/Bodies Corporate, the following legal process should as a matter of best practice be followed: (Decisions taken are concerning the time period, i.e. whether it should be handed over when an owner is in arrears with 3 months' payments or whether longer periods of non-payment should be allowed).

- Arrears accounts should be handed over to debt collectors/attorneys for collection, who should first interrogate every account and consider alternative methods of collection prior to selecting an attorney to hand over the accounts to for formal collection in a court of law if they don't themselves do this.

- Instructions should then be sent to the selected attorney to commence legal action, which instruction must be acknowledged by the attorney as having been received.
- The Attorney must contact the owner/s and inform them that their account/s is now with attorneys for legal action and a formal letter of demand must be sent to the unit owner/s by the attorney.
- The owners should be informed that continued default will lead to multiple judgments being sought:

The legal process now commences. This is normally a lengthy process as it is heavily regulated by legislation and is also subject to many external factors that can cause further delays. The legal process can also be suspended/stopped at any time if a payment arrangement is made with the owner, provided all the requirements for a valid payment arrangement have been met. During this period, it is important that there are still attempts to collect all the outstanding debt and dues owing to the Community Scheme/Body Corporate.

Once the legal process has commenced the Office bearers must ensure that the attorneys are acting in the best interest of the Community Scheme/Body Corporate and are doing so in the most cost-effective manner.

The Sectional Title Schemes Management Act stipulates that an owner is liable for all reasonable legal costs and disbursements – as taxed or agreed by the member – that the Community Scheme/Body Corporate incurred in collecting the arear levies or other amounts owing to the Community Scheme/Body Corporate, or in enforcing compliance with the Acts or Rules.

Actions by Office Bearers in respect of arrears

Many Community Schemes are seeing an increase in the level of arrears levies and as a result growing outstanding debtor's books. In many cases, owners keep up bond payments to keep the banks quiet but consistently default on the payment of levies and utility accounts. It is also common that where properties or units are rented or leased out, any default or non-payment of rentals/leases, results in a default in the payment of levies or utilities by the owner. In some instances, tenants are in good standing with their rental payments, but the levy or any utility dues collected by the owner, are not being paid over to the Community Scheme.

Non-payment is often done knowingly by owners as the Community Scheme and in turn, Office bearers, have limited ability to take immediate legal action without processes being followed. Notwithstanding this, it remains paramount that action be taken immediately where levies fall into arrears.

It should be noted however that Office bearers cannot deny access to or the provision of services to any tenant of a property, albeit if the owner is in arrears with levy payments.

This includes general access to the Community Scheme, access to the property/unit in question, access to designated parking or garages, the provision of security services, provision of water, and access to gyms or other facilities in the Community Scheme.

Where electricity is provided, this too can't be disconnected unless an application order has been obtained from the Court. Where pre-paid meters are in place, no arrears can be loaded onto electricity or other meters.

Conduct rules can be amended to give Trustees/Directors to be generally authorised to approach the Courts for disconnection orders.

Unfortunately, the required legal processes must be followed to recover outstanding amounts to the detriment of the Community Scheme. Obviously the higher the number of defaulting owners, the greater the financial risk to the Community Scheme.