Best practice insolvency and creditor rights systems: key for financial stability

Prepared by F. Montes-Negret [1]

When the World Bank in 2001 approved Insolvency and Creditors' Rights (ICRs) "Principles", this was an important milestone as the first internationally recognized benchmark to assess the effectiveness of domestic creditor/debtor rights and insolvency systems. Many stakeholders participated since 1999 in the development of these "Principles" - including the EBRD, other regional development banks, the IMF, the OECD, UNCITRAL, INSOL International, the International Bar Association, and 70 leading legal experts from around the world. The "Principles" provide a flexible benchmark and are regularly updated, most recently in 2015.

Why are ICRs so Important?

- ICRs that meet international best practice criteria reduce legal uncertainty and spell out what to expect in worst-case scenarios. They provide transparency, accountability and predictability. This allows credit institutions to price credit risks, reduce losses once default has occurred and reduce moral hazard and contamination of the banks' loan book, while protecting the interests of all parties (creditors, as well as debtors).
- Sound ICRs facilitate the normal flow of credit and investments to the real sector of the economy or its restoration following a systemic financial crisis.
- ICRs contribute to reduce interest rate spreads, as losses are minimized and allocated to the relevant parties, reducing cross-subsidies from less to more risky borrowers.
- ICRs facilitate the faster recovery of borrowers, preventing the unnecessary destruction of wealth, and the quick redeployment of productive resources in the economy following corporate failures.
- Sound ICRs assist in preventing graft and abuse of legal rights, while building the trust among lenders and investors, as incentives are properly aligned among different parties.
- Lower costs and timely enforceability are also key components of the ICRs.

[1] The author wants to thank Alejandro Espinosa-Wang (World Bank), Jose M. Garrido (IMF Legal Dept.), and A. Rouillon (Legal Consultant), for helpful data, references, and constructive comments.

Best international practice in designing ICRs

ICRs are embedded into a country's legal, institutional and regulatory fabric, but all insolvency systems and creditor/debtor rights address certain key features of debt distress and insolvency. The World Bank Principles, and assessments done on the basis of this document, cover four key areas:

1. **Credit environment**. Collateral arrangements, credit registry, and enforcement issues.
2. **Risk management.** This area comprises credit information systems, directors' obligations, and informal workout procedures.
3. **Legal framework**, comprising the insolvency law and its administration and application in corporate reorganisation and cross-border insolvency.
4. **Implementation arrangements** that ideally set out trustworthy and efficient institutional and regulatory frameworks.

These "building blocks" are detailed in thirty eight principles, which are used as flexible benchmarks to assess and rate compliance with best international practices in FSAPs and other technical assistance provided. [2]

Following the development of the "Principles", UNCITRAL developed a detailed *Legislative Guide on Insolvency* with hundreds of recommendations, a *Model Law on Cross-Border Insolvency* and a *Guide to Enactment*, which were approved by the UN in June 2004.[3] These efforts were complemented with a 2012 set of guidelines for the *Treatment of enterprise groups in insolvency* and a 2013 guidelines for *Directors' obligations in the period approaching insolvency*. These detailed set of recommendations and the *Model Law* are largely addressed to country authorities and, in particular, to legislatures which seek to adopt an efficient and effective insolvency framework, explaining in detail the underlying motivation for these reforms.

Evolution of ICRs in the CESEE region

Countries would be well advised to undertake a full ICR assessment against the best practice standards set out in the *Principles*, which provide a thorough and in-depth diagnostic tool. Still, such exercises are time-consuming and costly and rarely comparable across countries. The World Bank's page with Reports on the Observance of Standards and Codes (ROSCs) in fact shows few CESEE countries with recent assessments.[4]

[2] Financial Sector Assessment Programs conducted jointly by the World Bank and the IMF, for a list of recently concluded assessments see: https://www.imf.org/external/np/fsap/fsap.aspx.
[3] United Nations Commission on International Trade Law (UNCITRAL).
[4] https://www.worldbank.org/ifa/rosc_aa.html

A second-best approach that is better suited to assess progress achieved in improving insolvency proceedings, is to measure changes in selected standardized indicators. This allows a measurement of outcomes, based on case studies of corporate insolvencies that have gone through the legal and court proceedings.

The World Bank's Doing Business Indicators (DBI) annually measure the the distance from best international practices in resolving insolvencies.

DBI studies evaluating the ICRs, focus on four key measurable features: the time, cost, outcome and recovery rate of insolvency proceedings involving domestic entities, as well as the strength of the legal framework applicable to the liquidation and reorganization proceedings.[5]

The main advantages of this assessment are: *(i)* comparability across time, for the same jurisdiction; *(ii)* cross-border comparability (relative ranking), among different countries, resulting in a standardized DTF Index; and *(iii)* focus on results rather than the legal basis in measuring the efficiency of the insolvency proceedings. The main drawbacks are that this does not offer a comprehensive and precise diagnostic of the shortcomings in each area covered by the Principles, nor which reforms are required, as it is derived from a survey and case study focused on the four sub-indices mentioned above for secured loans.

The DTF indices are shown in Table 1 below, for 5 years, broken in three periods (pre-crisis, crisis, and the post crisis latest year), including countries that are the focus of the Vienna Initiative in Central, Eastern and South Eastern Europe (PART I: CESEE & Baltics). For reference, Table 1 also includes the DTFs for some crises countries in Europe (PART II), as well as the DTFs of some advanced EU countries.

Prior to the European recession or 2008-09, most countries in Part I of Table 1 scored low DTFs, in the mid-30s range, with a few exceptions (Albania, Macedonia, Baltic countries and Hungary). Not much progress was achieved during the crisis years (2008-2009), with only Lithuania and Montenegro moving to an Index of around 50. In the latest DTF measurement (2016) things have dramatically improved, with the notable exception of Kosovo, with most countries moving to a DTF in the mid 60s, with Poland reaching a score of 70. It should be pointed that there is a high correlation between poor DTF indices and high NPLs.

Table 1 reveals that there has been very significant progress in all countries in improving the mechanism for resolving insolvencies (DTF index), as countries moved closer to the frontier from 2004 to 2016. The second observation is that progress through time, according to this DTF Index, has not been linear. In fact there are a few cases where the DTF worsened slightly between 2004 and 2008 (ex. Albania, Bulgaria, Hungary, Latvia, Netherlands, Austria, Germany, and Ireland).

[5] See the Doing Business webpage of the World Bank for a complete methodology.

Finally, with the exceptions of Poland and the Czech Republic, the DTF indices for 2016 still reveal very significant gaps to the more advanced EU countries. A lot of progress is yet to come to reach best international insolvency practices, which is essential in defining more efficient NPL resolution systems.

Table 1: DTF Index - Progress made, but still more to do

Country	Pre-Crisis		Crisis		Post-Crisis
	2004	2006	2008	2009	2016
PART I: CESEE+ Baltics					
Albania	40.49	43.09	39.59	41.67	63.42
Bosnia & Herzegovina	35.22	35.05	38.21	38.21	66.42
Bulgaria	36.35	36.05	34.88	34.48	58.93
Croatia	31.05	30.64	32.56	32.81	53.92
Czech Republic	16.58	19.20	22.93	22.48	77.73
Estonia	39.35	41.98	42.10	40.32	65.28
Hungary	41.78	38.48	41.34	41.35	50.58
Kosovo	n.a.	n.a.	n.a.	36.63(2010)	20.30
Latvia	38.48	36.44	37.24	31.23	63.39
Lithuania	36.87	53.61	52.98	51.67	48.06
Macedonia	38.90	42.57	43.14	44.53	67.73
Moldova	29.22	29.42	31.02	30.79	53.85
Montenegro	n.a.	n.a.	46.07	47.03	68.21
Poland	33.83	34.60	36.25	36.71	70.43
Romania	7.39	18.83	31.12	31.72	59.77
Serbia	22.09	21.81	24.92	27.35	58.52
PART II: Crises EU Countries					
Greece	47.86	49.41	48.18	47.53	56.28
Ireland	94.40	94.71	93.80	93.18	78.44
Portugal	78.81	80.40	79.63	74.75	84.79
Cyprus	n.a.	n.a.	n.a.	76.14	79.04
Part III. Advanced EU Countries					
Netherlands	94.46	95.20	93.72	89.56	83.77
Austria	78.70	78.91	77.97	76.95	78.89
Germany	90.04	87.49	88.11	86.66	91.93
Italy	37.61	68.45	66.52	60.89	76.14
Spain	79.16	79.78	78.42	72.73	75.83
France	48.97	51.10	50.80	47.92	76.09

Source: World Bank, Doing Business Indicators, World Bank, several years. n.a. = not available.

Table 2 examines the components of the DTF for 2016 under a new methodology, which also assesses the quality of the legal insolvency framework. This underlines that a number of countries (such as Croatia, Hungary, Latvia, Lithuania and Moldova) still need to undertake significant legal reforms to their insolvency legal framework in order to converge to best international practices. The table also shows

that the DTF Indices on the strength of the insolvency framework are quite high in general, except for Hungary and Lithuania (col.4), but more work is required to enhance recovery rates, possibly reflecting the remaining inefficiencies in the court system and enforcement frameworks.

Conclusions

The World Bank's ICR *Principles* established for the first time an internationally accepted standard to assess individual countries' insolvency regimes. The DBIs DTF for resolving insolvency develop a benchmark to measure annual progress in each jurisdiction, establishing a standardized comparator and a mechanism for ranking the country's ICR systems.

In Greece, for instance, the efficiency of insolvency resolution has yet to catch up with the advanced-countries' in the EU in terms of efficiency and quality of the legal and judicial systems. Creditors can expect to recover less than 35 cents on the dollar of the estate value of an insolvent firm, and the process takes three and half years. By contrast, Poland has made remarkable progress in the DTF Index on resolving insolvency in the past decade.

As the DB publications emphasize, bankruptcy laws are critical "because they promote predictability for both creditors and entrepreneurs - by establishing the rules for the worst case scenario." In resolving insolvency, quality and efficiency are again linked: where there is a good legal framework for insolvency, creditors recover a larger share of their credits at the end of the insolvency process. Moreover, countries with better ICRs for secured loans deal more efficiently with high non-performing loans (particularly NPL corporate loans), as the example of the more advanced EU countries and Ireland shows.

ICRS inefficiencies have major direct and indirect costs for the economy. This includes lower investment and FDI, lost output, as well as inefficient credit allocation. This in turn may aggravate the accumulation of NPLs.

In the CESEE countries enforcement and execution delays lead to the depreciation of movable collateral and lower recovery rates on mortgages. World Bank Assessments also highlight the fact that multi-creditor negotiations are rare and difficult and that the out-of-court debt restructuring regimes are underdeveloped. In many cases there are no out-of-court restructuring guidelines endorsed and no procedure by which entities and their creditors can negotiate a restructuring, subject to court approval, as an alternative to bankruptcy. Bankruptcy regimes tend to be biased towards piecemeal asset liquidation, in terms of both the law and practice. Bankruptcy proceedings are slow and cumbersome, and often do not maximize the value of a firm's assets and recoveries by the creditors as a whole. Ambiguities regarding creditor rights and priorities remain, in particular in relation to the rights of secured creditors. The bankruptcy regime does not provide rules

regarding the treatment of enterprise groups in insolvency. In most countries the effectiveness of the judicial system needs improvement, including more resources, and more specialized capacity in the judiciary.

An efficient ICR regime is critical to foster growth and investment and a well-functioning market economy, relying on the rule of law and ability to enforce financial contracts – in a more predictable and timely way, and at low cost.

Table 2 – 2016: Resolving Insolvency DTF Decomposition

Country	Strength of Insolvency Framework (0-16)	Recovery Rate (Cents/Dollar)	DTF Strength of Insolvency Framework Index (A)	DTF Recovery Rate Index (B)	DTF (New Methodology) [(A+B) / 2]
PART I: CESEE+ Baltics					
Albania	13	42.34	81.25	45.58	63.42
Bosnia & Herzegovina	15	36.31	93.75	39.09	66.42
Bulgaria	13	34.01	81.25	36.61	58.93
Croatia	12	30.52	75.00	32.85	53.92
Czech Republic	13.5	66.04	84.38	71.09	77.73
Estonia	14	40.01	87.50	43.07	65.28
Hungary	9	41.71	56.25	44.90	50.58
Kosovo	0	37.71	0	40.59	20.30
Latvia	12	48.11	75.00	51.78	63.39
Lithuania	8	42.85	50.00	46.12	48.06
Macedonia	14	44.55	87.50	47.96	67.73
Moldova	12	30.37	75.00	32.69	53.85
Montenegro	13.5	48.35	84.38	52.04	68.21
Poland	12.5	58.28	78.13	62.73	70.43
Romania	13.5	32.67	84.38	35.16	59.77
Serbia	13.5	30.35	84.38	32.67	58.52
PART II: Crises EU Countries					
Greece	12.0	34.90	75.00	37.56	56.28
Ireland	10.0	87.69	62.50	94.39	78.44
Portugal	14.5	73.36	90.63	78.96	84.79
Cyprus	13.0	71.37	81.25	76.83	79.04
Part III. Advanced EU Countries					
Netherlands	11.5	88.87	71.88	95.66	83.77
Austria	11.0	82.70	68.75	89.02	78.89
Germany	15.0	83.72	93.75	90.12	91.93
Italy	13.5	63.09	84.38	67.91	76.14
Spain	12.0	71.22	75.00	76.67	75.83
France	11.0	77.51	68.75	83.43	76.09

Source: World Bank, Doing Business Indicators, World Bank, several years. n.a. = not available.