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Economic Systems

RESOLVING INSOLVENCY MANAGEMENT: COMPETITIVENESS OF NATIONAL BUSINESS ENVIRONMENTS[1]

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Abstract

The problem of insolvency and over-indebtedness has long been present in most of the world economies. Number of insolvent businesses, as well as the value of unsettled obligations has been steadily rising in the past decade. On the other hand legal business environment framework is considered to have an important facilitating/limiting role in treating the problems, arising from the situations of insolvency and over-indebtedness of businesses. The insolvency legislation and monitoring as an essential part of such framework belongs to the most dynamic fields of contemporary research interest.

The goal of this paper is to detect the most reformative national economies of the European Union in business insolvency management dealing with speediness and cost management of the resolution process. That should reveal the features of a business environment as a platform for finding better indebtedness management possibilities.

The methodology entails using World Bank data on efficiency in resolving insolvency across all EU national economies in the period of 12 years. Scoring system is developed and applied to the data.

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As a result, the countries are ranked according to the intensity of their reformative efforts in the field of insolvency management in the researched period. The features of the highest ranking countries will be analyzed, as the best practices of facilitating role of such frameworks.

Keywords: *insolvency, business environment, resolving insolvency indicators*

JEL Classification: P47, P52, G33

1. INTRODUCTION

Economic and social outcomes in each national economy are largely influenced by the conditions, which form the business environment within which companies operate. Political-legal business environment sector concerns shifts and changes in regulation and institutions that governments set as a framework for a business activity. Today entrepreneurial economy is regarded as means of solving both, growth and unemployment issues in modern societies. Therefore an attractive political-legal business environment sector is the one that enhances and not constrains entrepreneurial activity. This research applies such business environments approach to the part of its political legal segment concerning ever-growing problem of insolvency and over indebtedness of business entities. This is done by elaborating possible synergy of different government-driven reforms with resolving insolvency management improvements.

This paper focuses on the comparative analysis of the resolving insolvency indicators of EU countries in last decade (2003-2014). The goal of the paper is to investigate whether the resolving insolvency conditions in researched economies evolve from regulating to stimulating conditions. Methodology used in the paper is based on interpretation of secondary data collected by World Bank in their Doing Business project. The results for 28 EU countries are gathered, presented and reinterpreted in search of most reformative practices of insolvency treatment in Europe.

2. BACKGROUND

The most important part of the aggregate indebtedness of the economy is that of non-financial enterprises (Yankov; 2014, 40). At moderate levels debt improves welfare and enhances growth. The levels of corporate debt above 90% of the GDP are generally considered as the point when indebtedness impact to economic

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growth turns from neutral to negative (Cecchetti et al.; 2001). Over-indebtedness is not the only cause of insolvency but it is certainly the most important one. At the same time, without an exception, over-indebtedness is permanent companion phenomenon to insolvency. Dealing with insolvency and over-indebtedness has become an important task of regulators for several reasons. There is evidence that efficient national insolvency management solutions give incentive to entrepreneurship (Cirmizi et al.; 2010). Further, evidence supports strong relationship between insolvency framework that enables failing firms to efficiently exit with improved business success of renascent entrepreneurs (Stam et al.; 2008, 502).

Different studies have shown positive effects of efficient insolvency treatment to several growth boosting phenomena: credit market development, probability of timely repayment, lower cost of debt, reduction of the business failure rate, better loan terms, higher bank recovery rates (Araujo et al.; 2012, Klapper; 2011, Cirmizi et al.; 2010, Visaria; 2009). The features of the well-functioning public insolvency management framework are: speediness, low costs (different fees: court, insolvency administrators, lawyers, assessors, auctioneers etc.), higher recovery rate for creditors, and higher rate of the most favorable outcome (continuation of operation). Gradual shift in the focus of national resolving insolvency methods from dealing with bankruptcy and liquidation proceedings towards restructuring and reorganization proceedings is an attempt to save viable businesses as going concerns (Vuković & Bodul; 2014b, 50). This shift reflects social sensitivity of European regulators with preservation of jobs in mind (Vuković & Bodul; 2014a, 34).

Many of the national insolvency regimes in the world including EU countries are far from the described desired level of efficiency. The need to reform existing insolvency practices can be further argued by the fact that in some of the EU countries (Croatia) bankruptcy proceedings can last up to 10 years and can cost up to 90% of the debtor's estate value (Tomas Žiković et al.; 2014a, 318). Given this, resolving insolvency management framework must be continuously molded and reshaped in every aspect that affects the ease of solving over-indebtedness problem in a modern economy which then in turn enhances economic growth and employment creation as major goals of every national economy.

3. METHODOLOGY

Widely accepted measures of the outcomes of insolvency proceedings are those developed by World Bank in their Doing Business reports. The project started with the report in 2004 and is issued since then on a yearly basis. It expanded in both number of indicators followed (from 24 in 2004 to 36 in 2015) and number of economies covered (from 132 in 2004 to 189 in 2015). One of the fields covered since its inception is Resolving insolvency, until 2011 named Closing a business. Change in name reflects the above mentioned transition in focus that accentuates survival rather than piecemeal sale of business. Three measures are present since 2005 and they represent three different desired features of resolving insolvency outcomes. These are: time required to recover debt measured in calendar years (speediness), cost required to recover debt measured as percentage of debtor's estate value, and recovery rate for creditors measured as percentage of their claims recouped through reorganization, liquidation or debt enforcement (foreclosure) proceedings. Methodological scope of the WB indicators reaches out into various features of resolving the creditor/ debtor regimes (including restructuring, bankruptcy, liquidations, and foreclosures) (Tomas Žiković, et al.; 2014b, 569). For the purpose of this paper, which is to study the dynamics of the reforms of resolving insolvency management in EU countries, the mentioned three indicators will be taken into consideration.

Scoring methodology is developed which evaluates the rate and direction of change in the studied indicators. Relative change is scored from 0-5, 0 meaning no change in indicator in comparison to the previous year's results. Scores from 1-5 are assigned as follows: 1– change in range from +0 – 20%; 2 – 21 – 40%; 3 – 41 – 60%; 4 – 61 – 80% and score 5 – for change in range from 81 –100% and more. Positive or negative score denotes the direction of change, which can be either in sense of more stimulating or more constraining resolving insolvency management changes. Indicators are aggregated and final reform score is obtained by adding up single indicator scores.

There are two main limitations of this approach. First, the scoring scale is discrete and therefore does not allow for fine-tune differences, for example between results such as 20% change which has score 1 and 21% which has score 2. Second, all single indicators are given the same importance that also limits the in-depth understanding of the researched topic, especially bearing in mind that the third indicator entails (to a certain extent) the effect of the second indicator.

4. RESULTS AND DISCUSSION

The results that follow try to capture both quantitative and qualitative dimension of reforms being implemented on resolving insolvency in EU countries. Quantitative measure takes in account number of years (times) a country introduced reform(s) in field of national insolvency management in the period of nine consecutive years (only those reforms making it easier to do business are taken into account). Reformative efforts of EU countries are compared to the total number of reformative efforts worldwide each year in question. The countries that reformed in a particular year are listed.

Table 1 Reformative efforts in resolving insolvency

Year	No.of reformed countries (world)	No.of reformed countries (EU)	Reformed countries (EU)
2006	12	5	France, Italy, Latvia, Romania, Slovak Republic
2007	10	5	Croatia, Denmark, Hungary, Italy, Portugal
2008	16	8	Bulgaria, Czech Republic, Finland, Germany, Greece, Latvia, Poland, Portugal
2009	18	5	Estonia, France, Germany, Lithuania, Poland
2010	16	9	Belgium, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Romania, Spain, United Kingdom
2011	29	10	Austria, Bulgaria, Denmark, France, Italy, Latvia, Lithuania, Poland, Romania, Slovenia
2012	17	8	Germany, Greece, Lithuania, Poland, Portugal, Slovak Republic, Slovenia, Spain
2013	13	2	Croatia, Italy
2014	10	2	Slovenia, Spain
Total	141	54	

Source: Author's calculations, based on World Bank (2007-2014)

The data presented in Table 1 indicates that reforms that take place in EU countries are a significant share of all reforms in the world, ranging from 15% (2013) to 56% (2010), in average 38%. The largest number of reformative efforts both: worldwide (29) and EU (10) are detected in 2011. Common features of solvency reforms in the past decade include passing new bankruptcy laws, promoting reorganization proceedings, eliminating formalities and tightening time limits of insolvency proceedings, regulating the qualifications of insolvency administrators and strengthening the rights of secured creditors (WB; 2013, 94, WB; 2014, 114). In the past nine years four countries have introduced reforms four times (Italy, Latvia, Lithuania and Poland), six countries three times (France, Romania, Slovenia, Germany, Portugal and Spain). Six EU countries have not introduced any resolving insolvency reforms in this period: leaders in resolving insolvency management with excellent starting values of indicators in

2003: Ireland, Netherlands and Sweden, and Luxembourg, Cyprus, and Malta that were later included in data set (2008, 2010, and 2013 respectively). The reforms typically work out. Recovery rates for bankruptcy claimants (creditors, workers and government) are significantly higher for the reformers, even controlling for country income levels. Rationale behind this relationship is that reformed bankruptcy regimes allow viable businesses to solve a short-term liquidity crisis, and insolvent businesses are rapidly liquidated (WB; 2006, 67).

In the table that follows starting and ending values of indicators in the time series are presented. Positive and negative changes are highlighted.

Table 2 Resolving insolvency indicators (time in years; cost and recovery in %)

Country	Time first	Time last	Cost first	Cost last	Recovery first	Recovery last
Austria	1,3	1,1	18	10	72,5	82,6
Belgium	0,9	0,9	4	4	86,2	89,1
Bulgaria	3,8	3,3	18	9	34,2	33,2
Croatia	3,1	3,1	18	15	26,1	30,5
Cyprus*	1,5	1,5	15	15	70,7	70,5
Czech Republic	9,2	2,1	38	17	16,8	65,6
Denmark	4,2	1	8	4	59,8	87,5
Estonia**	3	3	8	9	40	39,3
Finland	0,9	0,9	1	4	90,2	90,2
France	2,4	1,9	18	9	46,6	77,2
Germany	1,2	1,2	8	8	50,3	83,4
Greece	2,2	3,5	8	9	45,6	34,3
Hungary	2	2	38	15	30,8	40,2
Ireland	0,4	0,4	8	9	88,9	87,7
Italy	1,3	1,8	18	22	43,5	62,8
Latvia	1,2	1,5	4	10	85	48,2
Lithuania	1,2	2,3	18	10	52,4	43,6
Luxembourg***	2	2	15	15	41,6	44
Malta****	3	3	10	10	39,2	39,6
Netherlands	2,6	1,1	1	4	86,2	88,9
Poland	1,5	3	18	15	68,2	57
Portugal	2,6	2	8	9	69,9	72,2
Romania	3,2	3,3	8	11	6,9	30,7
Slovak Republic	4,8	4	18	18	39,6	54,4
Slovenia	3,7	2	18	4	23,6	50,1
Spain	1,5	1,5	8	11	83,4	71,3
Sweden	2	2	8	9	73,2	76,1
United Kingdom	1	1	8	6	85,8	88,6
Average	2,4	2,0	13,1	10,4	55,6	62,1

Last = 2015; First = 2004 (time, cost); 2005 (recovery) for all countries except *, **, ***, ****
First observation * 2010; ** 2005; *** 2008; **** 2013

Source: World Bank (2004-2014)

The data presented in previous table gives evidence that EU countries have improved framework of resolving insolvency (time shortened from 2,4 to 2 years, cost lowered from 13,1% to 10,4% of debtor's estate, and recovery rate increased from 55,6% to 62,1% of creditor's claims, in average). Significant discrepancies are evident among countries. Seven countries have not improved any of the indicators, and five have improved all of them. Looking at each indicator separately, nine countries improved and six countries worsened in time required to recover debt. Eleven countries lowered and the same number raised cost to recover debt. The most number (18) of positive changes are evident in higher recovery rate for creditors, where nine countries worsened in that indicator.

Scoring methodology was applied to data available in 12 years time series. Therefore scores capture the dynamics of reformative outcomes in the observed period (Table 3).

Table 3 Resolving insolvency reformative scores

Country	Time	Cost	Recovery	Total	Country	Time	Cost	Recovery	Total
Czech Republic	7	2	11	20	Malta	0	0	1	1
Slovenia	4	6	7	17	Poland	-4	1	4	1
Denmark	8	2	2	12	Estonia	0	-1	1	0
France	2	2	5	9	Netherlands	4	-5	1	0
Germany	0	0	9	9	United Kingdom	0	2	-2	0
Romania	-1	-3	12	8	Italy	-2	-2	3	-1
Croatia	0	0	7	7	Cyprus	0	0	-2	-2
Austria	1	3	1	5	Ireland	0	-1	-1	-2
Bulgaria	1	2	1	4	Lithuania	-6	1	0	-5
Belgium	0	0	3	3	Finland	0	-6	0	-6
Hungary	0	3	0	3	Greece	-3	-1	-2	-6
Luxembourg	0	0	3	3	Latvia	-1	-3	-2	-6
Slovak Republic	1	0	2	3	Spain	-1	-4	-5	-10
Portugal	2	-1	1	2	**Total**	12	-4	63	71
Sweden	0	-1	3	2					

Source: Author's calculations, based on World Bank (2004-2014)

Czech Republic has the highest total reformative score. There are two reasons for that. First, in 2004 Czech Republic bankruptcy procedures ranked among ten slowest and most expensive in the world. Such low starting position made it possible that two Czech reforms (2008, 2010) had an outcome of 20 score points (all three indicators improved significantly). Second reflects the positive effects of the two implemented, comprehensive reforms. In the beginning of 2008 the Czech Insolvency Act took effect. The law introduced reorganization as the preferred method for resolving insolvency, mandated stricter deadlines, established an electronic insolvency register and set new qualification standards for trustees (WB; 2009, 55). In its second reform in 2010 the Czech Republic made it easier to deal with insolvency by introducing further legal amendments to restrict setoffs in insolvency cases and suspending for some insolvent debtors the obligation to file for bankruptcy (WB; 2011, 136).

Second most reformative country is Slovenia with three implemented reforms (2011, 2012, and 2014). In 2011 Slovenia simplified and streamlined the insolvency process and strengthened professional requirements for insolvency administrators. Next Slovenian reform involved strengthening its insolvency process by: (1) requiring that the debtor offers creditors payment of at least 50% of the claims within four years; (2) giving greater power to the creditors' committee in a bankruptcy proceeding; (3) prohibiting insolvency administrators from allowing relatives to render services associated with the bankruptcy proceeding; and (4) establishing fines for members of management that violate certain obligations or prohibitions (WB; 2013, 142). In 2014 Slovenia introduced a simplified reorganization procedure for small companies and preventive restructuring procedure for medium-size and large ones. It also allowed creditors greater participation in the management of the debtor. The last novelty was establishing provisions for an increase in share capital through debt-equity swaps (WB; 2015, 163).

Denmark took the third position with its two implemented reforms (2007 and 2011). Through first reform Denmark granted the courts more power to oversee trustees and make sure they act efficiently. This resulted in shortened bankruptcy proceedings (WB; 2008, 56). In 2011 Denmark introduced new rules on company reorganization which led to elimination of the suspension-of-payments regime. (WB; 2012, 68).

At the other end of the reformative spectrum are those countries that experienced either moderate negative changes in the value of all three indicators (Greece and Latvia), or countries with several stagnant indicators and several worsened ones (Spain and Finland). Finland deserves special attention. Its indicator of recovery (that did not change) has the highest value in EU (90,2%) and its time value is second best (0,9 years) in the whole period. Only the cost changed, but it changed from the lowest level (1%) at the beginning of observed period to 4%, which is also the lowest level of indicator in the last observed year. Therefore in case of Finland scoring results are not representative.

5. CONCLUSIONS

Efficiency in resolving insolvency as a feature of national business environments is observed by using three indicators: time to resolve insolvency proceeding, cost to recover debt as percentage of debtor's estate value, and recovery rate for creditors as percentage of their claims. Observations of 28 EU countries during the period from 2003 to 2014 are subjected to the scoring methodology based on dynamics of change in order to form partial and total reformative scores for particular countries and other derived insights.

Reformative efforts in resolving insolvency can be labeled as very strong because all observed indicators are improved at the EU level, the total reformative score is also positive, the most of the countries have introduced some insolvency reforms and the number of European reforms exceeds one third of the reforms in the world. Still, all reformative scores do not record total positive outcome, namely cost to recover debt records negative total result. Recovery rate records the highest reformative score.

Belgium, Finland and Ireland are leaders in resolving insolvency indicators and Czech Republic, Slovenia and, initially best positioned Denmark are detected as the most reformative countries. Analysis of the practices in the most reformative countries reveals the most important directions in improving insolvency proceedings: simplification of the procedure, introduction of provisions to facilitate the restructuring of the company and to prevent abuse of the bankruptcy proceedings, and encouraging the active role of creditors.

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