



Insolvency Law and Crisis Preparedness

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IBA CONFERENCE

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Overview

- Introduction: the IMF and the International Financial System
- Economic crises and insolvency
- The Economic Context
- The Response to the Current Crises
- Crisis Preparedness and Recovery
- Conclusion



Introduction: The IMF and the International Financial System

- The mandate of the IMF
- The IMF's functions
 - Surveillance
 - Capacity Development
 - Financial Support
- The relationship between insolvency law and the Fund's mandate and functions: macro-economic importance of insolvency regimes



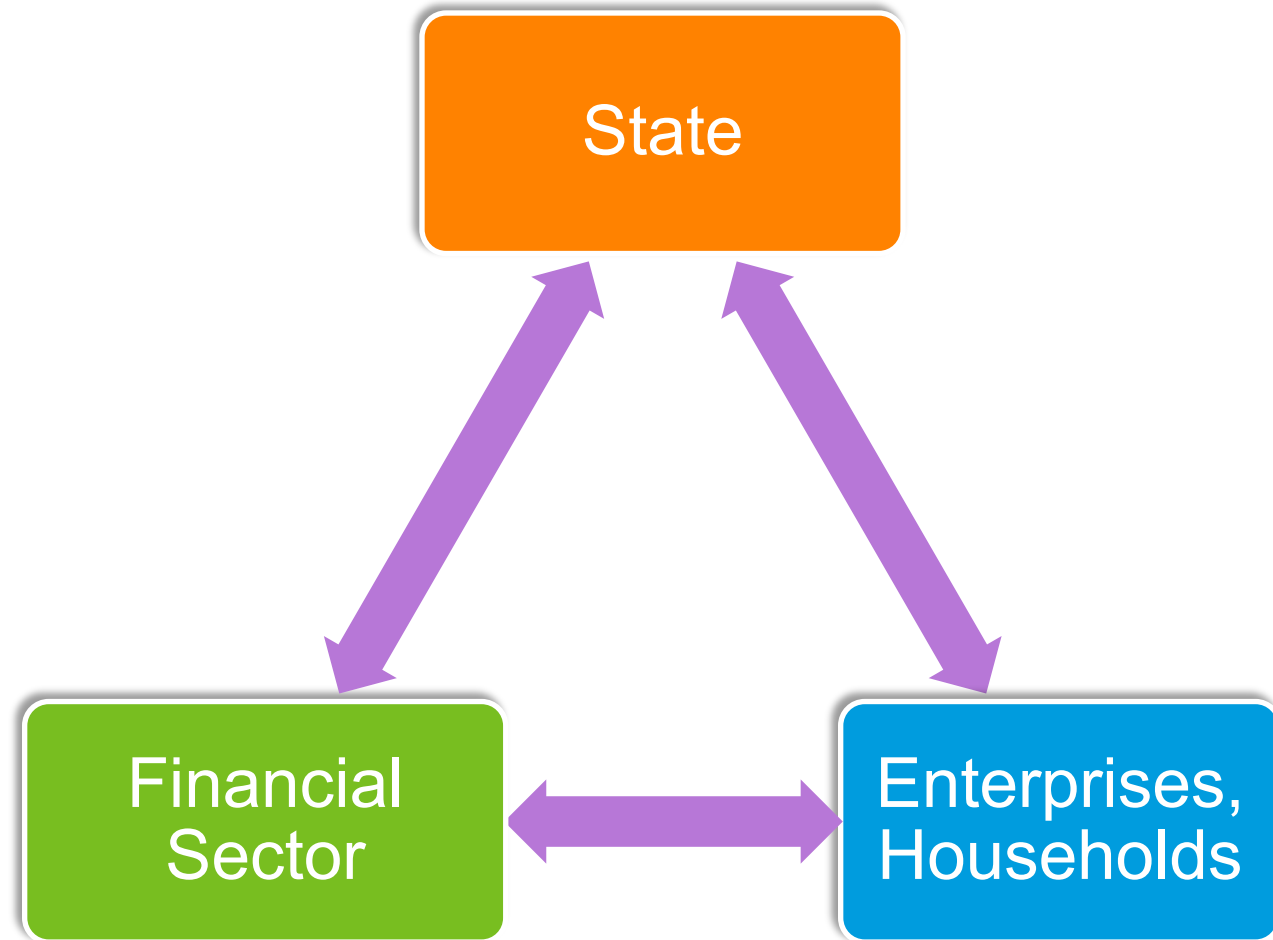
Macroeconomic effects of insolvency regimes

- Support to credit system, maximization of value of claims
- Preservation of going concern value
- Predictability of allocation of losses in an equitable fashion
- Discipline in creditor/debtor relationships
- Market exit to preserve efficiency and competitiveness
- Connection with privatization of SOEs



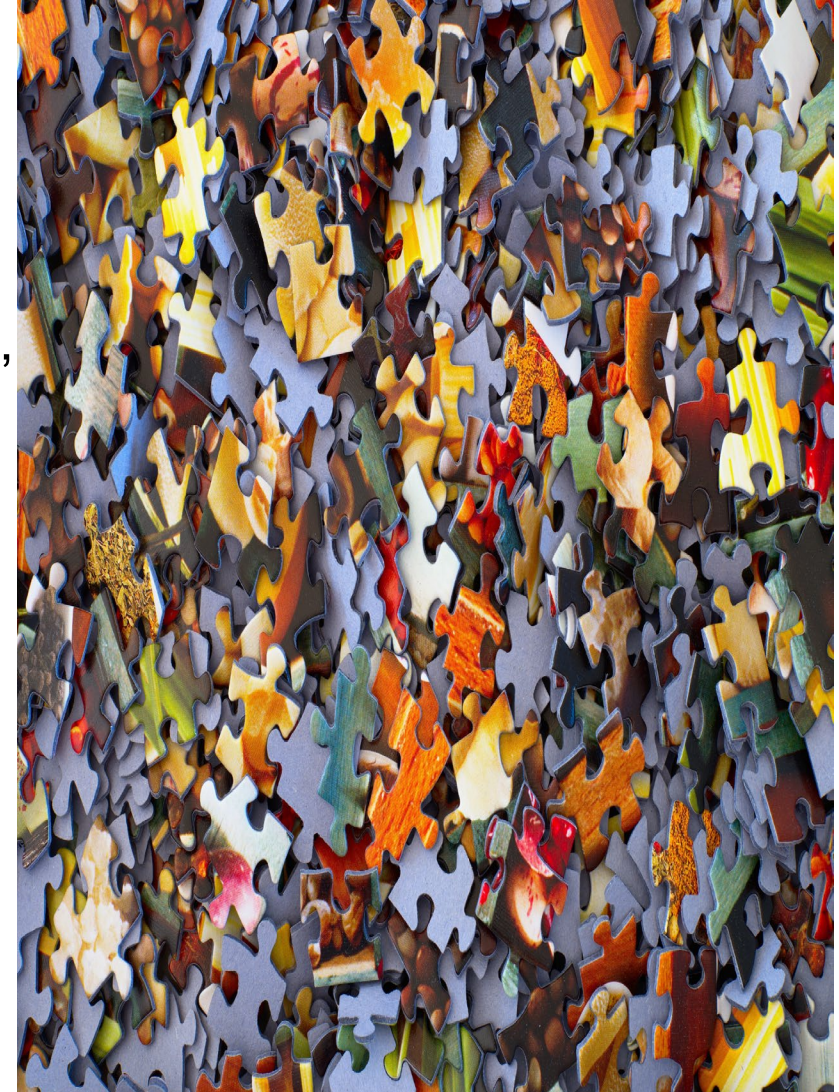
Economic Crises and Insolvency

- Crises start and develop in multiple ways
- Fiscal Crisis
- Financial Crises (currency crises, balance of payments crises, debt crises, and banking crises)
- Crisis in the real economy: enterprises and households



The Role of Insolvency Law in Crises

- More controversial than general macroeconomic effects
 - Legal framework designed for the failure of single enterprises or individuals
 - Situations of widespread corporate or household debt distress?
- Legal reforms to address crises take time (design, implementation, full effects). Institutional reforms take even longer.
- Crises raise distinct issues:
 - Speed is of the essence
 - But formal insolvency system can become overwhelmed
 - Lack of confidence in competence or integrity of the formal system
 - Disruption by potential changes of ownership in enterprises
 - Cooperation of the state
 - Legal and regulatory obstacles become apparent (debt/equity conversions, tax treatment, limits to foreign investment, competition law, banking regulation)



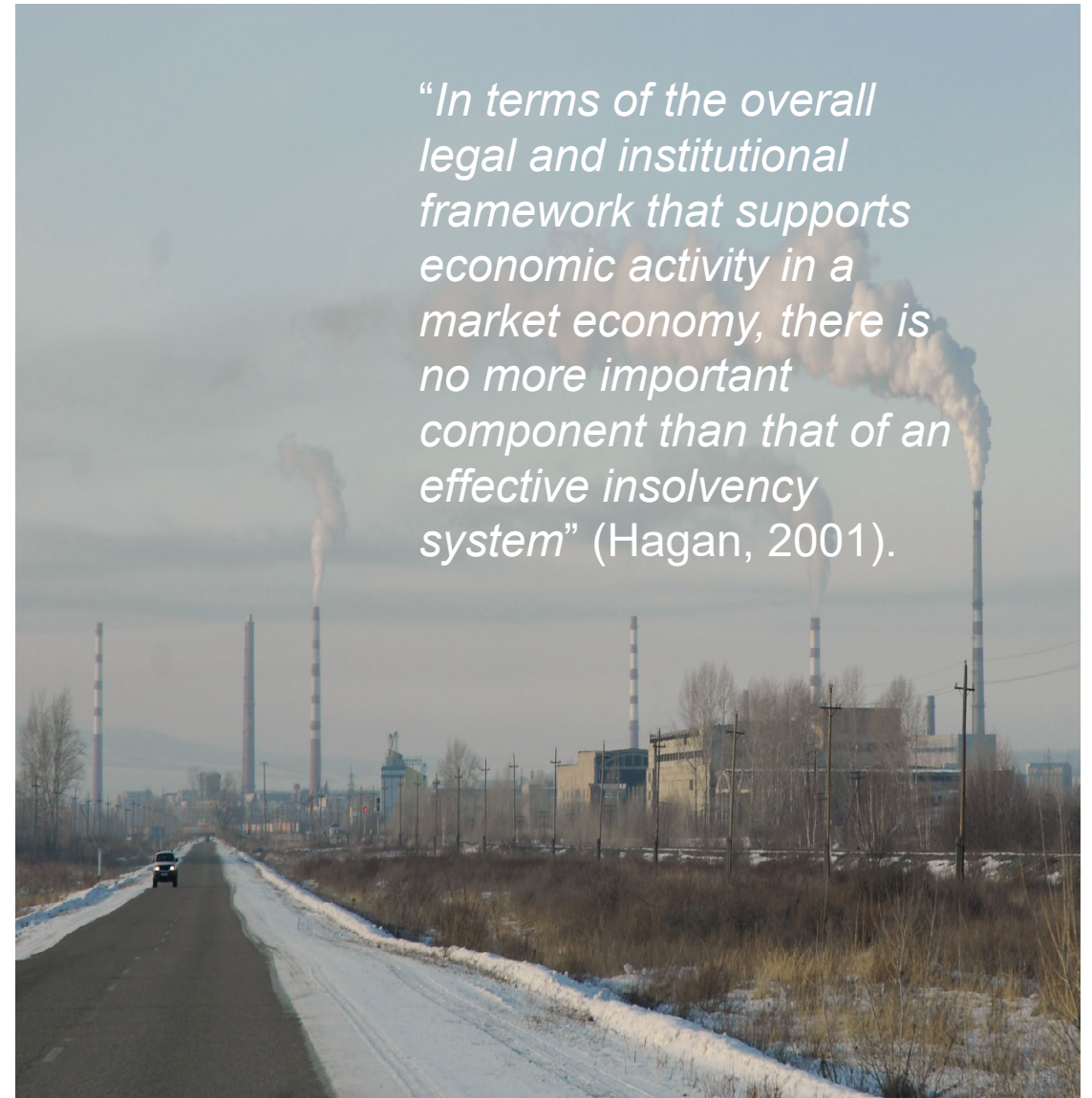
An Overview of Modern Crises (I)

Asian Financial Crisis

Currency crisis, evolved into a banking crisis: immediate effect on financial sector; spillover on the corporate sector (debts in foreign currency, lower revenue because of depressed demand, lack of credit)

Policy response:

- Remove problem loans from banks
- Restore corporate sector by facilitating restructuring
- Establish insolvency regimes
- Avoid bailouts



An Overview of Modern Crises (II)

Global Financial Crisis and Euro Area Crises

Financial crisis: financial sector meltdown; downward spiral of problem loans, insolvencies and unemployment, and loss of access to credit. Evolved into fiscal crisis in some countries.

- Connection with mortgages and personal insolvency

Policy response:

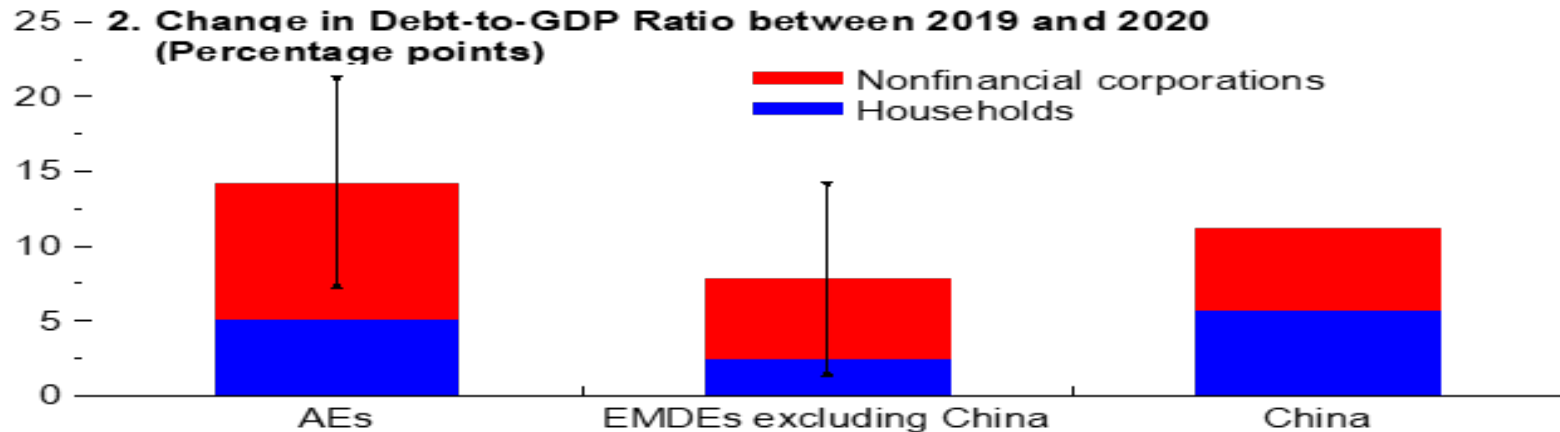
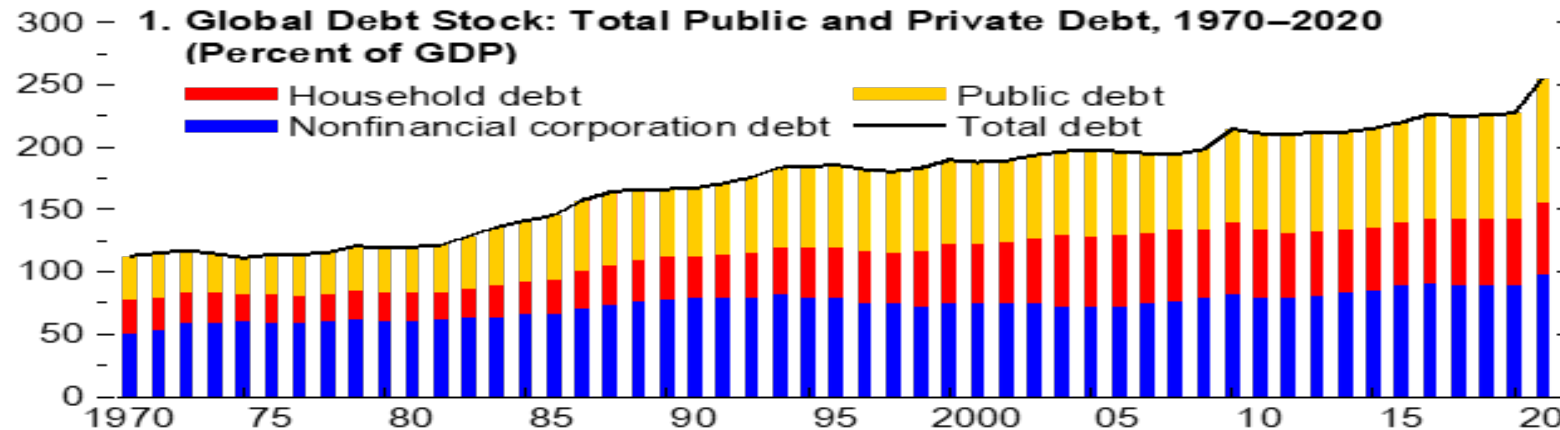
- In Europe, policy solutions moved from purely out-of-court restructuring to the use of hybrid restructuring
- Introduction of personal insolvency regimes and the issue of primary residences.
- Comprehensive strategies to bring down problem loans

“There is an increasing recognition that leaving high private sector debt unresolved helps neither debtors nor creditors. Private sector debt restructuring works best if it is part of a comprehensive approach” (Liu and Rosenberg, 2013)



The Economic Context: Rapidly Increasing Private Debt

(source: WEO, Spring 2022)



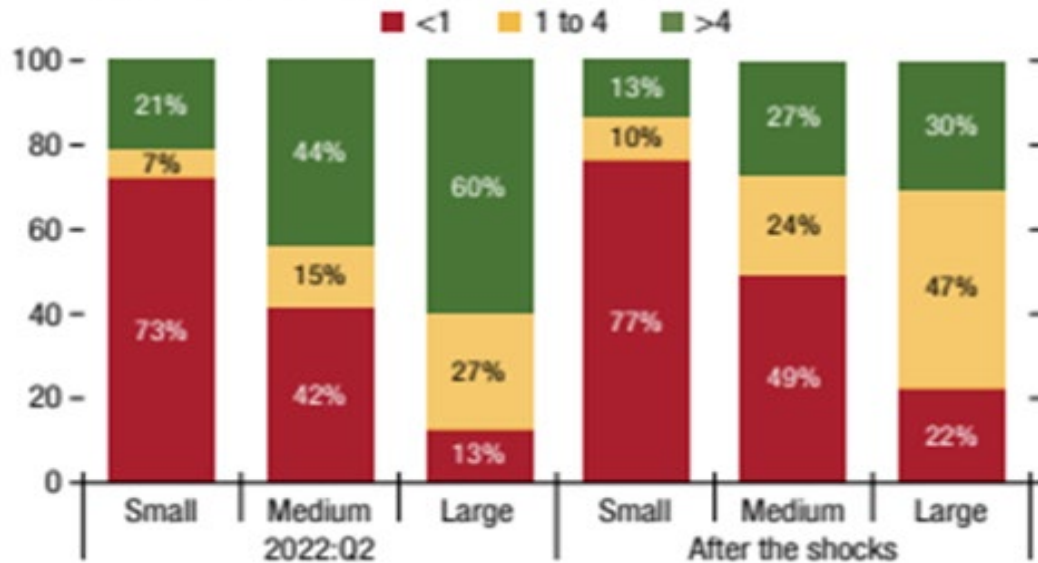
Debt is concentrated in the industries hard-hit by the economic shocks

Debt at Risk in the Corporate Sector

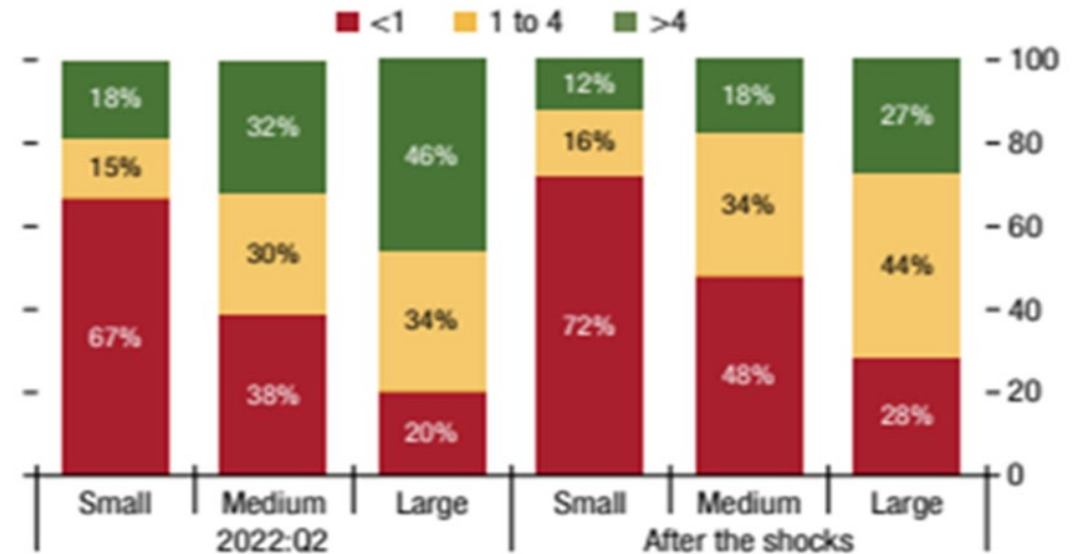
(source: GFSR, Spring 2023)

- Lower earnings and higher funding costs further worsen leverage metrics
- In emerging markets, highly rated companies are more sensitive to changes in interest rates

1. Share of Debt at Firms by Interest Coverage Ratio by Firm Size in Advanced Economies
(Percent of total debt, average across countries)



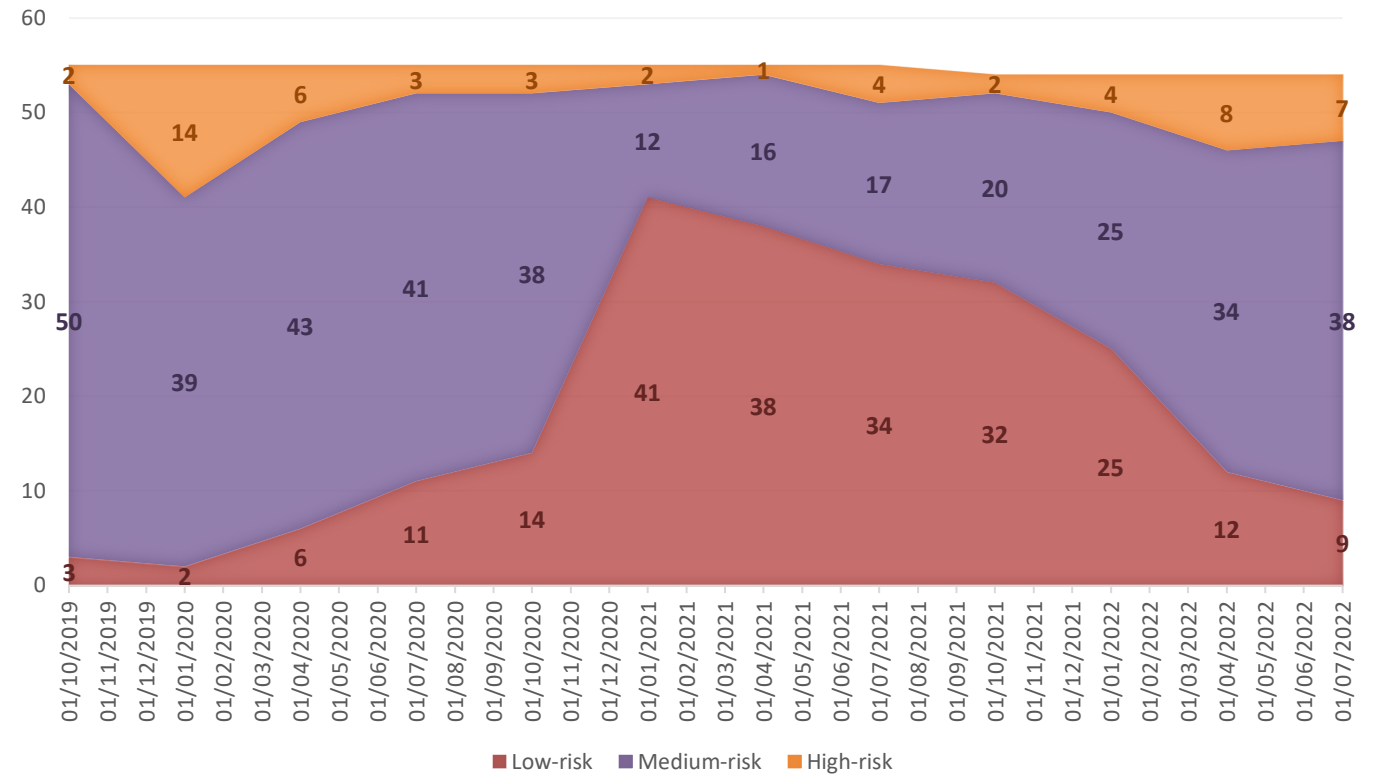
2. Share of Debt at Firms by Interest Coverage Ratio by Firm Size in Emerging Markets Excluding China
(Percent of total debt, average across countries)



Rising Risks of Corporate Debt Distress

- 55 advanced and emerging economies
 - Build-up of risk in the corporate sector +
 - Doubling of funding costs =
 - Increased risk of widespread corporate debt distress
- Debt problems existed before the pandemic (-but interest rates were extremely low)

CORPORATE SECTOR AT RISK

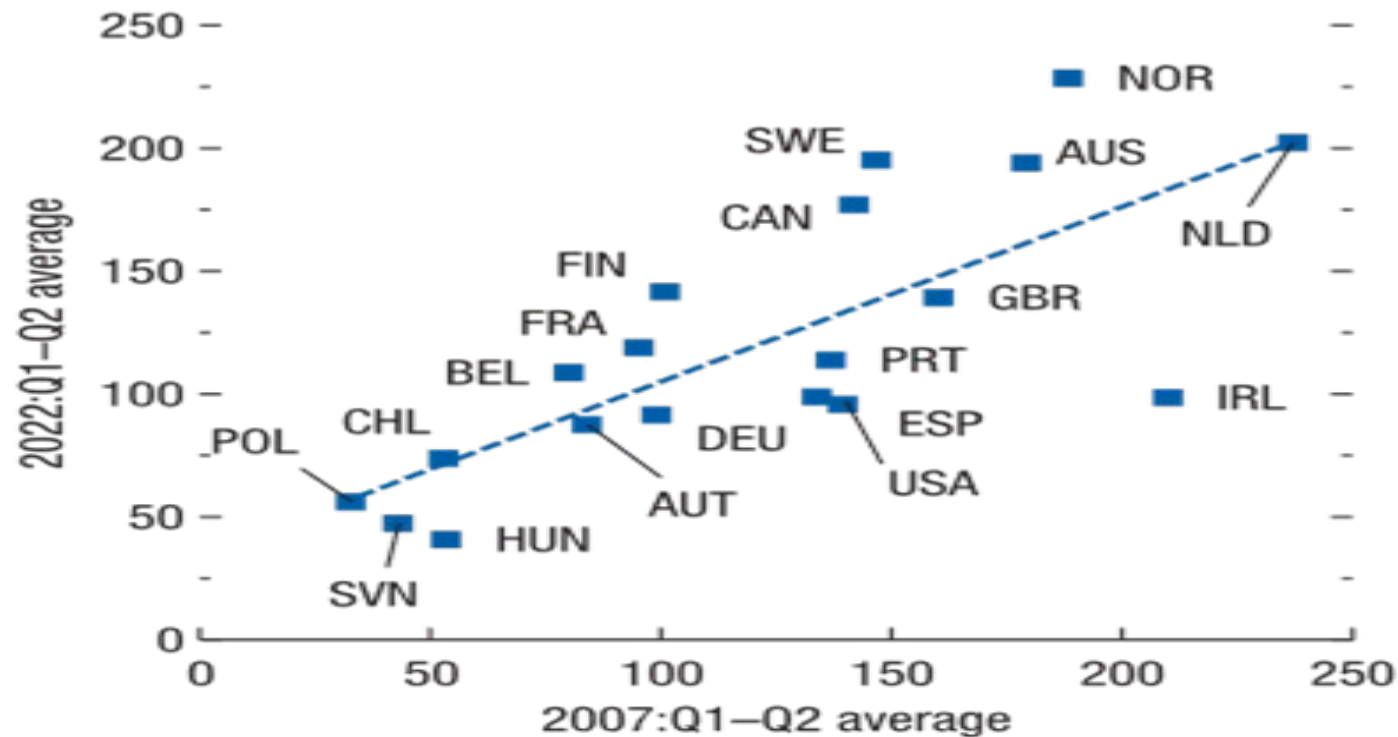


(Source: Hacibedel and Qu, IMF (2023))

Rising Household Debt

Household Indebtedness rates in selected economies (percentage)

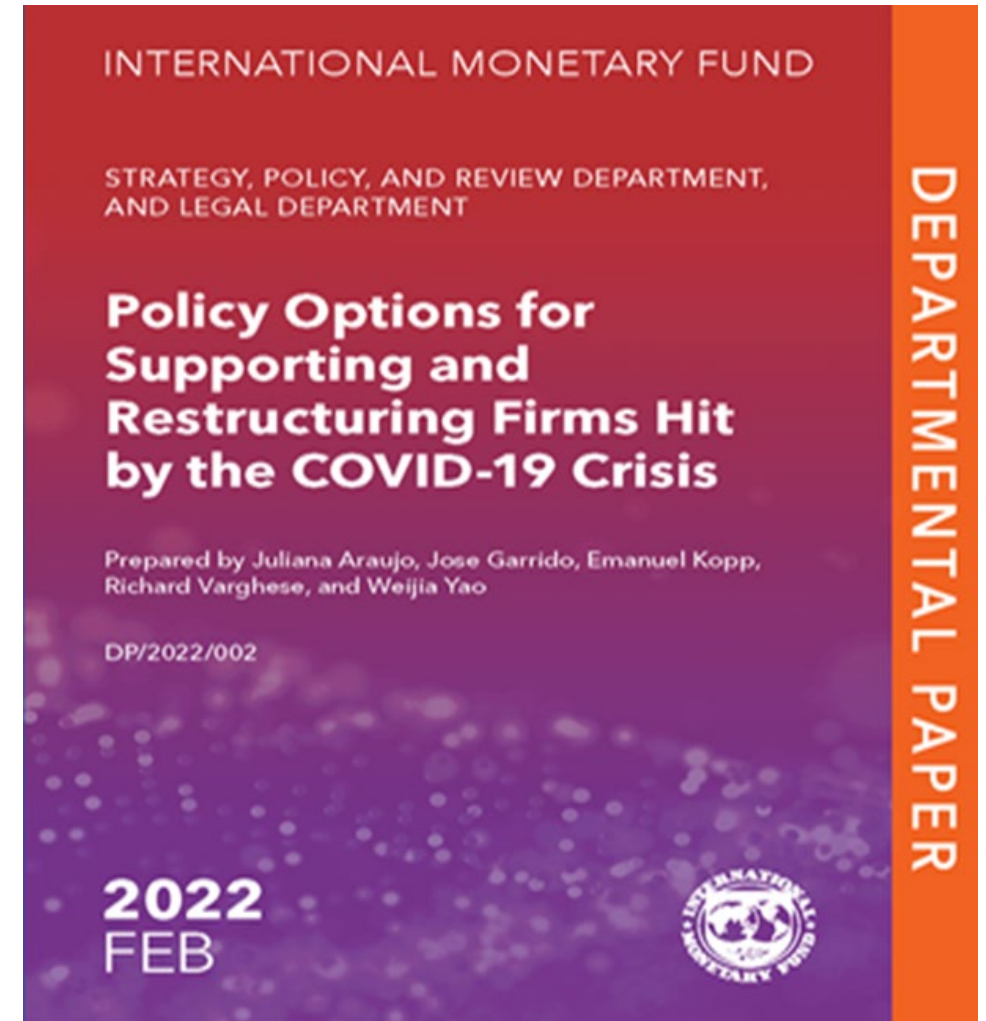
(source: WEO, Spring 2023)



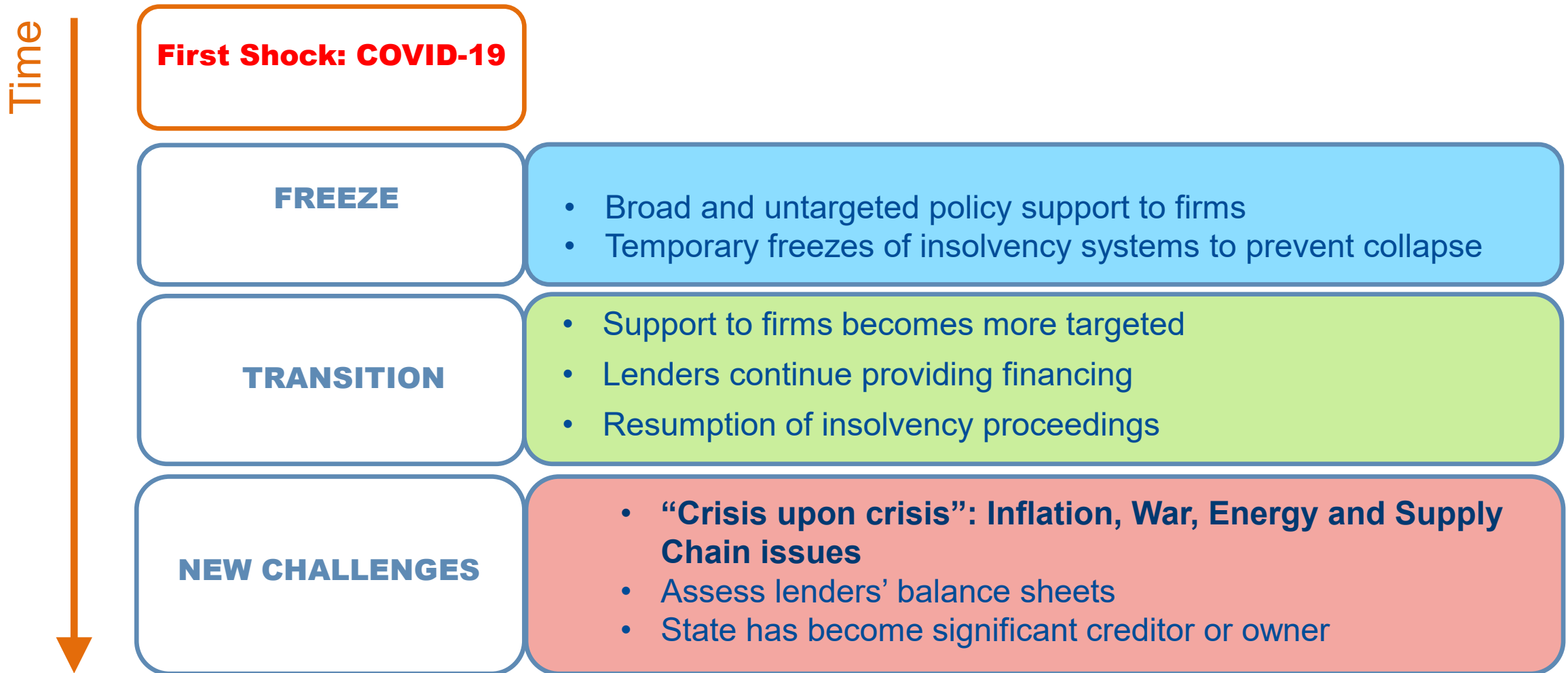
Sources: Organisation for Economic Co-operation and Development; and IMF staff calculations.

Responding to the Covid-19 Crisis and Recent Shocks

- A crisis without insolvencies - Is it possible?
- The role of support programs
- Keeping the financial system intact
- Insolvency not very useful at the lower end of the enterprise spectrum: comparing small business reorganizations and business closures in the US
- Insolvency is far more useful for large enterprises
- Comprehensive toolbox for enterprise debt distress



Sequence of Response to Current Crises



The Covid-19 Crisis and the “Bankruptcy Gap”

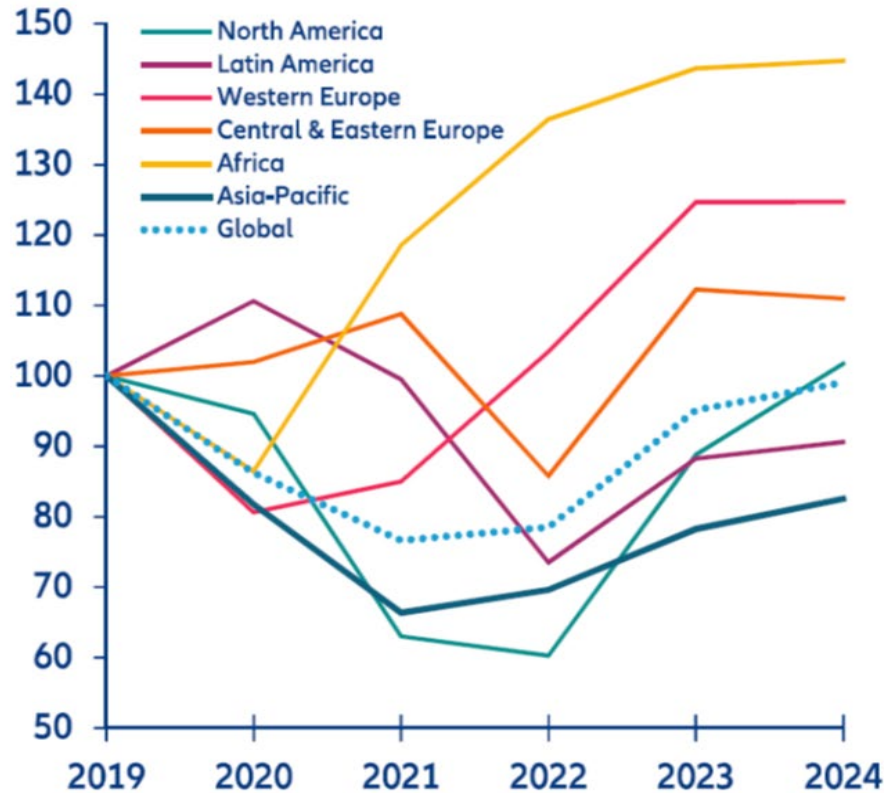
- Some commentators have expressed the preference for “bail-outs” and “bail-ins” to deal with this crisis, instead of using insolvency and restructuring tools (van Zwieten, Eidenmüller and Sussman, 2020).
- Support programs reduced insolvencies in all countries, particularly in advanced economies.

*“A gap has opened between previously reliable predictors of bankruptcy rates based on economic activity and actual realised bankruptcies.”
(Banerjee et al., 2021).*



Is There a Bankruptcy Gap?

Figure 1: Global and regional insolvency indices, yearly level, basis 100 in 2019



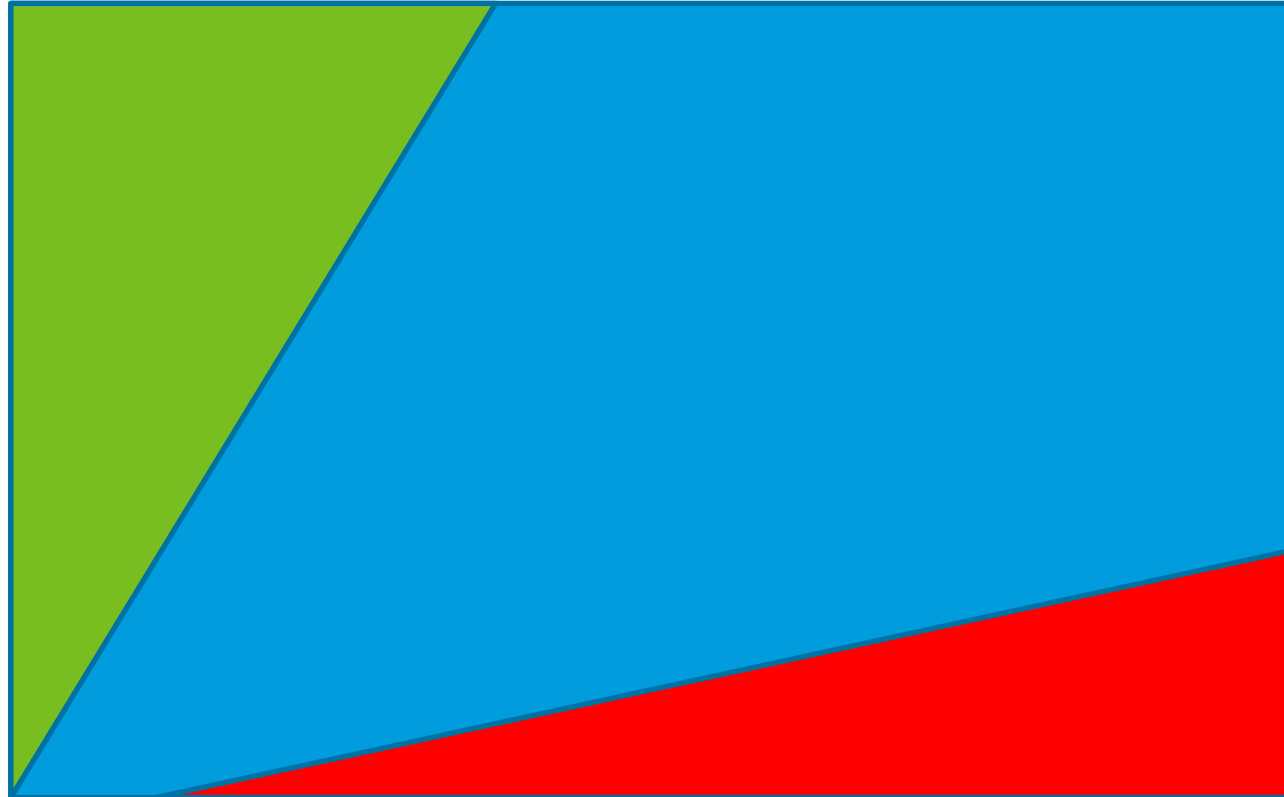
Source: Allianz Research

- Insolvencies did not increase during the pandemic, despite the fear of a “wave of insolvencies”
- Several factors explain the decline in insolvencies
- Small businesses disproportionately affected by the Covid crisis –mostly resulted in closures
- Financial system weathered the crisis so far.

Insolvency/Closure and Business Size

US: 1000 small business reorganizations in the first six months of operation in 2020.

3.3 million small businesses exited the market in the same period (out of the existing 30 million)

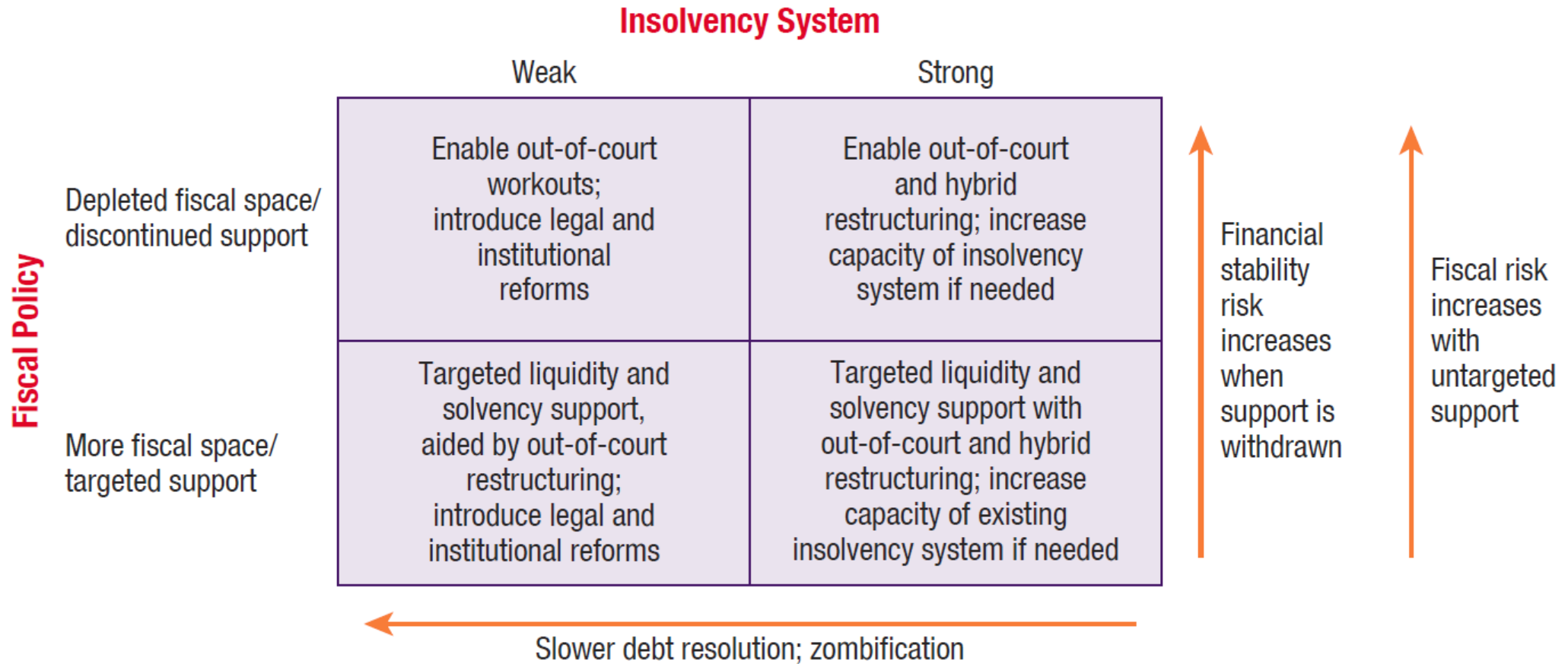


Large enterprises

Micro enterprises

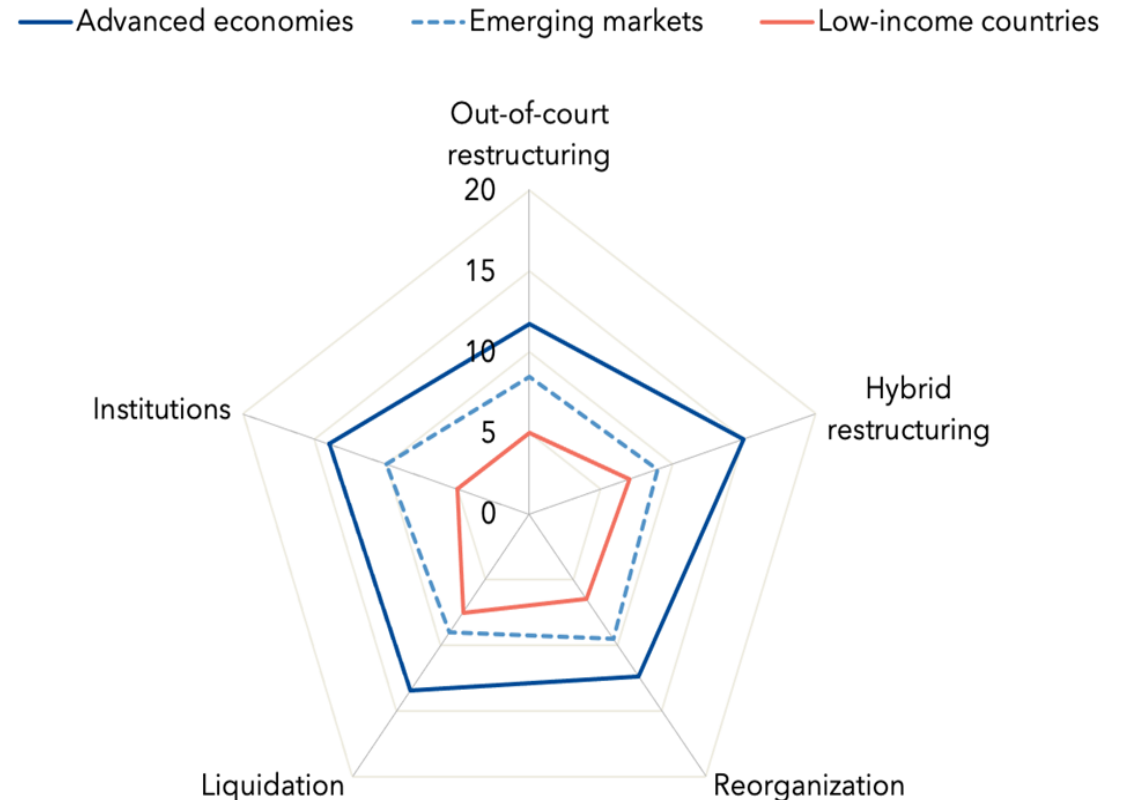
- Reorganization
- Liquidation
- Closure

Options and Trade-offs (IMF, 2022)



Crisis Preparedness Indicator

- Measures the preparedness to address a corporate debt crisis.
- The indicator has **5 sub-indicators** with equal weight: *out-of-court restructuring*, *hybrid restructuring*, *reorganization*, *liquidation*, and *the institutional framework*.
- Aspects of the **international standard** especially relevant in crises.
- Coverage includes **60 countries**, from all regions and income levels (91 percent of the world's GDP, 84 percent of population).
- Room for improvement in all areas.



Source: IMF staff calculations.

Note: The closer to the center, the lower the value of the sub-indicator, showing a lesser level of preparedness.

Crisis Preparedness – Key Elements

Out-of-court restructuring

- *Guidelines*
- *Master Restructuring Agreements*
- *Enabling environment*

Hybrid restructuring

- *Prepackaged plans*
- *Pre-insolvency procedures*
- *Schemes*

Reorganization

- *Sophisticated mechanism*
- *Reserve key judicial resources*

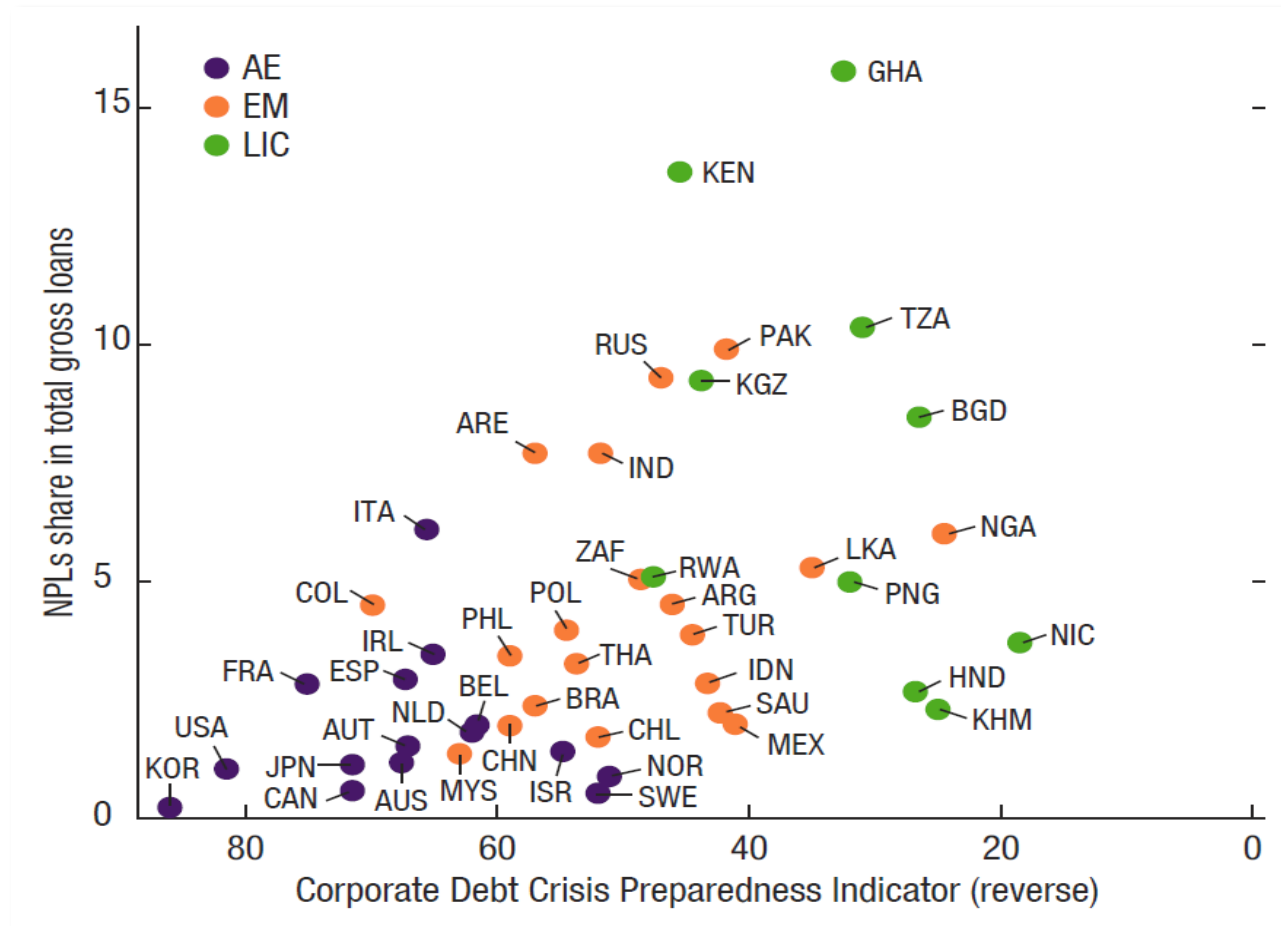
Liquidation

- *Avoid unnecessary restrictions on sale of collateral*
- *Sale as a going concern*
- *Use of technology*

Institutional framework

- *Specialized judiciary with adequate support*
- *Insolvency professionals*
- *Lawyers, accountants, valuers*

Are Systems Prepared to Tackle Corporate Debt Crises?

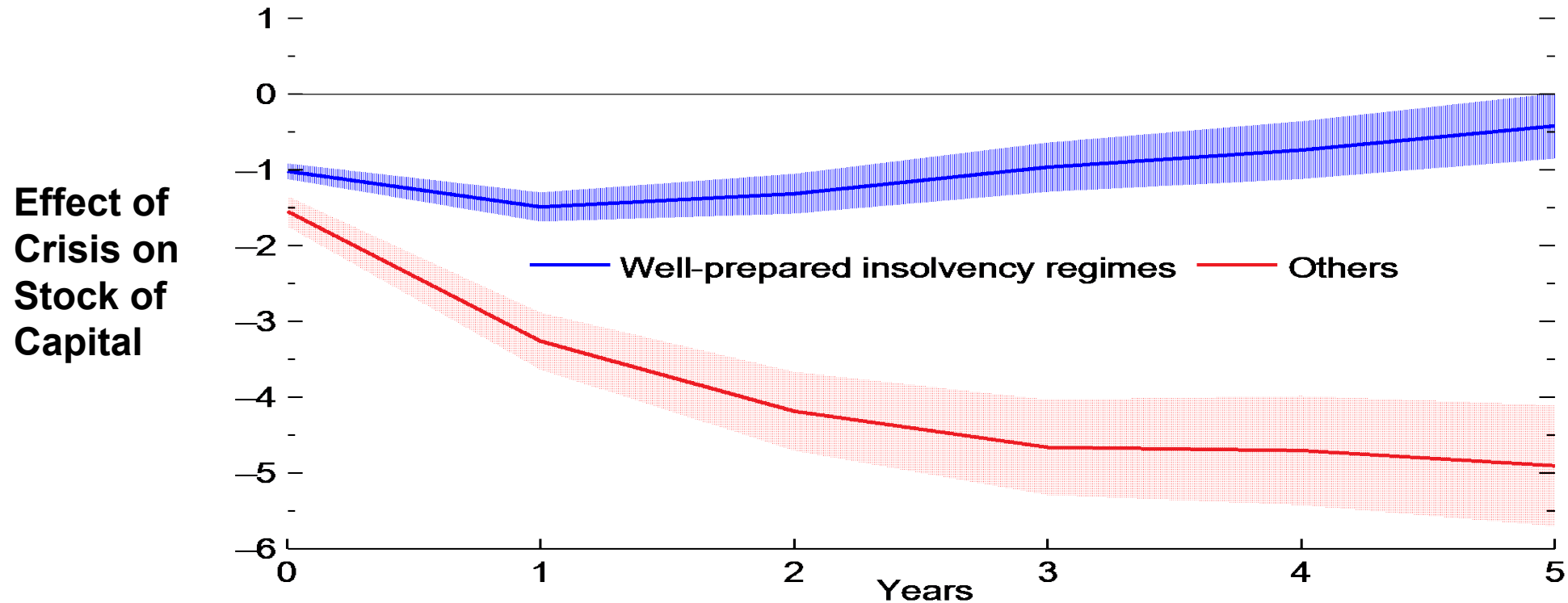


Source: IMF 2022

Crisis Recovery

The Role of Insolvency Regimes

(source WEO, 2022)



Sources: Bureau van Dijk Orbis; IMF, Crisis Preparedness Index; and IMF staff calculations.

Conclusion – and Policy Recommendations

- Successive economic shocks have increased debt and vulnerabilities, despite support programs.
- Role of the insolvency regime in crisis resolution
- Preparation for crisis events:
 - ▶ **Out-of-court restructuring** and **hybrid restructuring** as alternatives to full formal insolvency proceedings.
 - ▶ Preserve the **capacity of courts** to deal with complex cases.
 - ▶ Improve the **institutional framework** (specialized courts, insolvency representatives, other professionals).

