

Debt Resolution and Business Exit

Insolvency Reform for Credit, Entrepreneurship, and Growth

The willingness of banks and investors to support new businesses depends a great deal on the rules that govern failing businesses. Effective insolvency regimes save struggling firms when possible, or reallocate assets of failing firms more productively. These procedures—focused on the end of the business life cycle—have a profound impact on the beginning. Banks and investors are more willing to lend when they know they can recover at least some of their investment. Entrepreneurs are more willing to enter the market when they are not putting their entire personal fortunes at risk. This Viewpoint examines literature that quantifies the impact of effective insolvency regimes.

Need for insolvency reform

The World Bank Group Enterprise Survey of businesses in 135 emerging markets shows that almost 60 percent of businesses require a loan at some point, while only just over one-third of businesses have a loan or line of credit. Well-designed insolvency laws are one of the factors that can help businesses access these crucial loans. A number of published studies associate effective insolvency reform with a lower cost of credit, increased access to credit, improved creditor recovery, strengthened job preservation, promotion of entrepreneurship, and other benefits for small businesses. Countries that implement sound insolvency regimes reduce the cost of credit and increase overall economic stability. In contrast, in countries with

weak insolvency regimes, struggling companies and their assets often languish unproductively, limiting creditor recovery. In countries where unincorporated businesses such as sole traders are subject to personal bankruptcy regimes, owners of struggling small businesses often face the threat of a lifetime of debt. Banks worried about their ability to recover loans may limit their lending to those borrowers that present the least risk, or they may impose extensive collateral requirements that small entrepreneurs cannot meet.

Given that market exit is an integral part of the business life cycle, particularly in times of crisis, even developed economies with more efficient insolvency regimes are faced with addressing business failure. More than five

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years from the onset of the global financial crisis, many wealthier countries continue to flounder, with weak financial markets and many indebted firms. The Credit Reform Economic Research Unit reported that between 2010 and 2011 corporate insolvencies increased by 6.4 percent in Belgium, 18.7 percent in Spain, and 7 percent in Ireland.² Reorganizations of multinationals such as U.S.-based General Motors,³ where at least 1.2 million jobs in the automotive supply chain were at stake, and Eurotunnel⁴ with 2,300 employees and 800,000 shareholders, emphasize the far-reaching and cascading effects of business distress and subsequent business rescue on jobs, business supply chains, and bank reserves. The financial crisis has shown that even countries with more established and orderly insolvency procedures are looking at ways to make their economies more resilient through improvements in their debt resolution systems.

Benefits of effective insolvency frameworks

The World Bank Development Report 2014 states that “Bankruptcy law and the depth of resale markets are particularly important to liberate productive resources from an unproductive enterprise and to ensure that creditors and potential investors in other enterprises are protected if a business fails.” Insolvency law provides an orderly process for the reorganization or liquidation of insolvent entities in a collective manner. It serves as an important safety net for business activity, ensuring that when businesses face financial difficulties, mechanisms are available to either rescue them or maximize the value realized from their assets through their deployment to more productive firms. It also

ensures an orderly payment process, avoiding a chaotic race by creditors to collect. Unlike bilateral debt enforcement, all creditors participate in insolvency proceedings, and effective insolvency regimes aim to provide a balance of both debtor protection⁵ and creditor recovery. Finding this balance is one of the main challenges that policy-makers face when designing an insolvency law. The best approaches will be tailored to meet the particular needs, characteristics, and economic and social goals of a given country. The literature shows that effective insolvency regimes preserve jobs by facilitating the survival of distressed but viable businesses, reduce credit risk, and attract venture capital and associated high-quality innovation, particularly vis-à-vis smaller firms.⁶

I. Effective insolvency regimes are associated with a lower cost of credit

Credit opens markets to entrepreneurs and promotes expansion of successful businesses. Credit lines help to ease liquidity shortfalls inevitable to business. Constrained credit supplies, on the other hand, limit growth as liquidity concerns reduce lenders’ willingness to take risk. A 2007 study in China showed that after the enactment of credit and property rights reforms, firms could more readily invest in growth opportunities, with less sensitivity to cash flow.⁷

The World Bank Group World Development Indicators have shown that access to credit is a constraint in many parts of the world. Table 1 shows that in many countries, domestic credit provided by banks as a percentage of GDP is below 50 percent.

Indeed, the World Bank Group Enterprise Surveys⁸ of more than 130,000 firms in 135

Table Domestic credit provided by banking sector (% of GDP)

Region	Domestic credit as a percentage of GDP for 2012
Least developed countries: UN classification	29.9%
Middle East & North Africa	37.4%
Europe & Central Asia	62.6%
South Asia	71.1%
Latin America & Caribbean	73.6%
East Asia & Pacific	141.5%
European Union	156.0%
OECD members	205.8%

Source: World Bank Development Indicators (Financial Indicators)

countries documents that access to a bank loan or line of credit is restricted in developing regions—particularly Africa—in relation to the number of firms requiring such financing. Table 2 shows that more than half of firms in developing regions need a loan, but in none of these regions are more than half the firms able to access credit, with access acutely tight in the Middle East.

Insolvency laws directly affect the willingness of lenders to extend credit, and the terms on which they are prepared to lend. A study across France, Germany, and the United Kingdom showed that banks price loans based on their rights in case of default, and price them higher to mitigate creditor-unfriendly aspects of the bankruptcy law. The study sampled similar small and medium enterprises (SMEs) that had defaulted on bank loans. The authors examined whether differences in the level of creditor rights in bankruptcy in the different jurisdictions had an impact on lending terms. After adjusting for other factors, they found that French banks required more collateral, and specific forms of collateral, than in the other two countries because of provisions in the French bankruptcy code, which were unfavorable to creditors. The study also found that France, the least ‘creditor friendly’ country among the three, had a significantly lower rate of business recovery than in Germany or the United Kingdom. Limiting the availability of credit enabled French banks to mitigate, but not fully avoid, the costs of “unfriendly” bankruptcy laws.

Reforming an insolvency regime can help lower interest rates, making credit more affordable. A 2012 study examined Italy’s 2005 reform of its reorganization and liquidation procedures under the bankruptcy law. The study separately analyzed the impacts on the cost of

credit to SMEs of reorganization and liquidation reforms. Supplementing their analysis of loan-level data with firm-level data on borrowers, the authors found that the liquidation reform led to a decrease in interest rates, although the reorganization reform had the opposite effect.⁹ In particular, firms with higher numbers of bank creditors saw the most pronounced reduction in interest rates due to the enhanced coordination provided by the bankruptcy law.

II. Effective insolvency regimes are associated with increased availability of credit

Effective insolvency systems enhance predictability and thus lender confidence in loan recovery upon default, which encourages more lending and leads to financial inclusion for more businesses.

A 2012 study of Brazil’s 2005 bankruptcy law reform compared accounting data pre- and post-reform from 698 publicly traded firms¹⁰ in Brazil, Mexico, Argentina, and Chile to evaluate the impact of the reform on loan terms and levels of debt. The authors put their firm-level data in context by considering aggregate data on credit market development in Brazil as compared with the other countries. The authors reported a statistically significant increase in the Brazilian private credit market after the 2005 reform, an increase not replicated in the other jurisdictions that had not implemented insolvency reform. At the firm level, the authors reported a 10- to 17-percent increase in total debt and a 23- to 74-percent increase in long-term debt, although with no evidence of change in short-term debt. The authors attributed a significant fall in trade credit to the increased availability of other forms of debt financing. They also reported a

Table Enterprise Survey data reporting firms’ access to credit

2 Economy	Percentage of firms with a bank loan/line of credit	Percentage of firms not needing a loan
East Asia and Pacific	37.7	44.9
Eastern Europe and Central Asia	41.2	46.4
Latin America and Caribbean	47.6	42.1
Middle East and North Africa	6.0	38.1
South Asia	34.8	40.3
Sub-Saharan Africa	23.8	34.1

7.8- to 16.8-percent reduction in the cost of debt financing for the Brazilian firms.¹¹ In short, the study found that the reform helped make credit more available, and on better terms.¹²

Just as an effective insolvency system promotes access to credit, a weak system inhibits it. A 2008 study comparing 88 countries found that failure to enforce debt contracts, including inefficient bankruptcy proceedings, reduced the amount and quality of available credit at the macro level.¹³

The World Bank Group *Doing Business* report for 2014 uses a resolving insolvency indicator to measure the time, cost, and outcome of insolvency proceedings involving a financially distressed small domestic company.¹⁴ The methodology for measuring the recovery rate for creditors—the percentage of their original investment they recover in a liquidation or reorganization proceeding—depends on these three variables. If a distressed company emerges from the proceedings as a going concern, the recovery rate tends to be higher than when a failed company's assets are sold piecemeal. Figure 1 shows a strong correlation between the indicator's recovery rate and the availability of domestic credit from a country's banking sector (measured as a percentage of GDP). The correlation coefficient between the *Doing Business 2014* recovery rate and

the percentage of domestic credit by the banking sector is 0.70. The correlation is significant even at the 1 percent level. More developed insolvency systems that have a variety of tools to address financial distress are positively associated with higher levels of credit and, conversely, less developed systems with lower aggregate credit levels have lower recovery rates.

It is interesting to note that a 2014 study tested the effect of 38 selected indicators on seven measures of the regulatory and institutional environment. Among the 38 indicators, the study identifies the recovery rate of the resolving insolvency indicator of the *Doing Business* report as the single most valuable measure.¹⁵

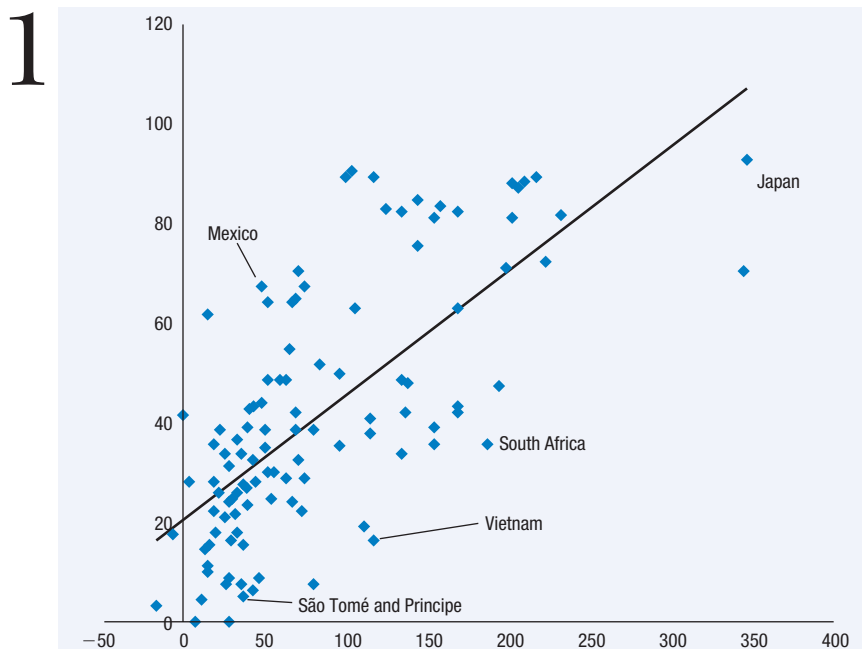
III. Effective insolvency reforms are associated with increased returns to creditors

Studies have shown that insolvency reforms improve creditor returns in cases of loan default. A 2007 study in Mexico showed that the enactment of a new corporate insolvency law, which was designed to reduce delay and ensure better filtering of non-viable from viable debtors, increased the average recovery rate for secured creditors from 19 cents on the dollar to 32 cents on the dollar, and shortened the duration of proceedings from an average of 7.8 years to 2.3 years.¹⁶

A 2012 study of 348 formal insolvencies in the United Kingdom showed that giving unsecured creditors more control in insolvency through the new administration procedure increased gross levels of returns. The study examined the effects of abolishing the use of receivership, whereby, a creditor with security over the whole of a company's assets could appoint a receiver to assume control over the debtor and conduct a "private liquidation." Administration, introduced greater accountability to unsecured creditors through a combination of improved voting rights and fiduciary duties. In addition to increasing the gross level of returns, administration also reduced the duration of cases from a median of 602 days¹⁷ under the receivership procedure to 358 days¹⁸ for the administration procedure. The study showed that the financial gains in returns from using the administration procedure were partially offset by an increase in the costs, because

4

Figure 1 Credit, debt recovery correlation



of more court appearances and procedural requirements.¹⁹

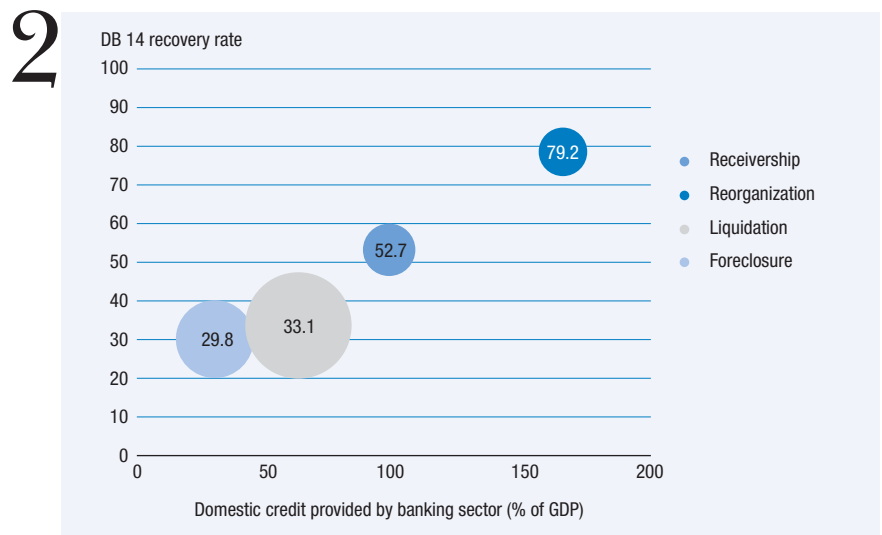
The *Doing Business* report's resolving insolvency indicator for 2014 illustrates that economies that combine developed insolvency systems with effective reorganization frameworks produce higher recovery rates for creditors compared to countries that have not updated their insolvency procedures (see Figure 2).

IV. Effective insolvency reforms are associated with job preservation through reorganization and business rescue

Businesses in severe financial distress, such as a cash-flow crisis, sometimes have no option but to liquidate and close. If well managed, this can result in the redeployment of assets to more productive firms and improved economic efficiency. However, it can also lead to significant job losses and diminished value for owners and creditors. A business that can overcome financial difficulties will be able to preserve jobs, keep supply chains intact, and retain asset value. Formal insolvency tools have been shown to be effective in encouraging the healthy recovery and rehabilitation of financially distressed firms. A corporate reorganization code in Colombia enacted in 1999 dramatically improved the efficiency of reorganization proceedings. The duration of the proceedings fell from an average of 34 months to 12 months. The authors of a study of the code found that, post-reform, liquidating firms were unhealthier than before and reorganizing firms were healthier. They concluded that the reform allowed for self-selection of healthy firms to opt for reorganization rather than liquidation, and to do so sooner. After controlling for macroeconomic conditions, the authors found that reorganized firms were able to recover faster under the new law, and achieved greater equity value.²⁰

Effective reorganization in countries such as Colombia and Belgium can allow a company's workforce to remain employed and productive. This outcome can also be achieved through formal procedures that facilitate the sale of the company's business on a going concern basis. Recent studies in the United Kingdom²¹ showed that of all the sales of businesses as going concerns during receivership or administration

Figure Reorganization proceedings present the best outcomes



Note: Size of the bubble shows the number of economies. Number inside the bubble shows average recovery rate.

proceedings, 65 percent concluded with the new owner preserving the entire work force. For pre-packaged sales, full retention of the work force was achieved in 92 percent of the cases.²² Even where some job loss occurred, job retention was still significant. In 73 percent of the cases where business sales resulted in some job loss, the new owner was able to retain at least three-quarters of the work force. For prepackaged sales involving some job loss, 95 percent concluded with at least three-quarters of the work force still on the job.²³ These numbers demonstrate the ability of a well-functioning insolvency regime to preserve jobs on a meaningful scale.

V. Effective personal insolvency reforms support entrepreneurship

Entrepreneurship creates jobs, increases productivity, and promotes innovation.²⁴ Recent studies show that start-ups and newly established firms produce multiplier effects that can increase long-term employment growth rates at companies throughout an entire region.²⁵

Venture capital funding provides valuable support to entrepreneurship and innovation. A 2004 study of the United States and 10 European countries found a correlation between debtor-friendly personal bankruptcy regimes and levels of venture capital funding. The authors speculated that greater protections for personal assets, with more "forgiving" bankruptcy regimes,

made entrepreneurs more willing to commit their own resources and better able to attract other venture capital.²⁶

At the level of bank lending to businesses, effective insolvency laws strengthen creditor rights and promote access to credit and growth. At the level of the individual entrepreneur or consumers, laws that are more debtor-friendly can also encourage growth. Entrepreneurs often have to commit personal assets to start a business, and personally guarantee loans to the new venture. A safety net provides a certain level of protection through personal insolvency laws, and appears to encourage the risk-taking necessary for entrepreneurship and innovation.²⁷

Several studies have shown a connection between a country's personal insolvency law and entrepreneurship. A 2003 survey compared asset exemptions during insolvency proceedings (for the residential home, personal effects, retirement accounts, and other personal assets) among U.S. states. The survey of 20,000 families found that there are more entrepreneurs in those states with higher asset exemptions.²⁸ A 2008 study that compared self-employment in 15 countries in Europe and North America between 1990 and 2005 found that more forgiving personal bankruptcy laws, measured particularly in reference to the time a bankrupt individual has to wait to be discharged from pre-bankruptcy debts, combined with ready access to limited liability protections, enhance entrepreneurial activity.²⁹ A 2009 study, again comparing U.S. states and their bankruptcy exemptions for personal property, found that the probability of starting a business is 25 percent higher in states with higher exemptions.³⁰

VI. Effective insolvency reforms are associated with benefits for small firms

Small and micro firms may be the primary beneficiaries from certain insolvency reforms. When increased availability of debt financing leads to businesses being able to pay suppliers on time, or allows a company to finance cash shortfalls through credit lines, small businesses are less susceptible to failure due to liquidity issues. A 2008 study examined the impact of a reform by Belgium in 1997 affecting small and

micro businesses. The reform involved three major changes:

- Introduction of a new court-supervised reorganization procedure.
- Implementation of an early warning system for financial distress by the establishment of special units in charge of monitoring firms' financial health.
- Amendments to the liquidation procedure to ensure the recognition of retention of title interests, thereby strengthening property rights.

The authors reported a lower failure rate in the post-reform period than in the period immediately preceding reform. After controlling for various factors, they found that the reduced failure rates occurred in small and micro businesses in two sectors in particular—manufacturing and trade.³¹ They attributed the improvement to the strengthened recognition of proprietary interests in liquidation.

Small and medium enterprises were most affected by Italy's 2006 insolvency reforms. In a study comparing interest rates pre- and post-reform, "riskier" SMEs, those more likely to default, were shown to have lower interest rates after the liquidation reform. The authors of the study used loan-level data on 202,964 SMEs and 1,097 banks to prove their assumption that improved creditor control during liquidation raised the liquidation value of firms, which led to lower interest rates for the SMEs in the riskier group.³² In China, a 2013 study of reforms that made it easier for secured creditors to foreclose on collateral and restricted expropriation of private property held by local government found that the changes enabled firms to respond to growth opportunities due to greater access to credit with less sensitivity to cash flow.³³

Conclusion

Effective insolvency regimes have a dual aim: to save viable businesses and to ensure that non-viable businesses can quickly exit the market, allowing the deployment of assets to more productive firms. In achieving these dual goals, strong insolvency regimes aim to balance creditor and debtor rights, maximizing recovery, providing a safety net for financially distressed debtors and impacting

numerous economic indicators including credit, job preservation, and entrepreneurship. Moreover, the quality of an insolvency regime affects the willingness of investors, banks, companies, and entrepreneurs to take risks and invest in growth. As the studies described here demonstrate, an effective insolvency system can enhance all of these measures and promote economic growth. Empirical evidence points to the importance of developing effective and efficient insolvency systems through thoughtful, targeted reform, and the results can be felt economy-wide, in improved investment climate, economic growth, and job creation.

Notes

1. This Viewpoint was prepared under the World Bank Group Debt Resolution & Business Exit (DRBE) program, under the leadership of Mahesh Uttamchandani. The DRBE program is part of the World Bank Group's Trade & Competitiveness Global Practice Business Regulation work, led by Najy Benhassine. The author wishes to gratefully acknowledge the contributions to this viewpoint by Angana Shah, Andres Martinez and Fernando Dancausa.
2. Creditreform Economic Research Unit
3. Sean P. McAlinden, Debra Maranger Menk, "The Effect on the U.S. Economy of the Successful Restructuring of General Motors", CAR Research Memorandum, Center for Automotive Research, December 5, 2013, describing the effects of a scenario where General Motors was not rescued, and suppliers were bankrupted in a cascading effect, with estimated job losses of 1.2 million.
4. *New York Times*, January 15, 2007, "French court approves Eurotunnel restructuring – Business-International Herald Tribune" and "Insolvency warning at Eurotunnel", BBC News, July 13, 2006, news.bbc.co.uk/2/hi/business/5175188.stm describing the 2,300 employees and 800,000 shareholders who would be affected in addition to Eurotunnel riders if a reorganization deal could not be reached.
5. The nature of the 'protection' required will of course vary depending on whether the debtor is an individual person or a legal entity such as a limited liability corporation.

6. E. Cirmizi, L. Klapper and M. Uttamchandani, "The Challenges of Bankruptcy Reform," The World Bank Research Observer Advance Access (July 2011).
7. D. Berkowitz, C Lin & Yin Ma 2013
8. <http://www.enterprisesurveys.org/data/explore/topics/finance>
9. Rodano, Serrano-Velarde, Tarantino (2012)
10. 338 (around half) Brazilian firms, 108 Mexican, 82 Argentine and 170 Chilean.
11. Depending on which model was used: Araujo, Ferreira and Funchal 2012
12. Funchal 2009
13. Djankov, Hart, McLiesh and Shleifer 2008
14. Doing Business 2014 <www.doingbusiness.org>
15. Kray and Tawara (2014) – upcoming.
16. M. Gamboa-Cavazos and F Schneider, (2007)
17. Mean was 627 days
18. Mean was 357 days
19. Armour, Hsu and Walters 2012
20. Gine and Love 2010
21. Frisby 2007, Polo 2011
22. i.e. sales negotiated in anticipation of the commencement of the formal proceedings, and executed on entry into those proceedings.
23. *Ibid.*
24. Mirjam Van Praag, Peter H. Versloot, (University of Amsterdam), "The Economic Benefits and Costs of Entrepreneurship: A Review of the Research", Foundations and Trends in Entrepreneurship, Vol. 4, No. 2, pp. 65-154, 2008. Available at SSRN: <http://ssrn.com/abstract=1625828>.
25. Mirjam Van Praag, Peter H. Versloot, (University of Amsterdam), "The Economic Benefits and Costs of Entrepreneurship: A Review of the Research", Foundations and Trends in Entrepreneurship, Vol. 4, No. 2, pp. 65-154, 2008. Available at SSRN: <http://ssrn.com/abstract=1625828>.
26. Armour, J., "Personal Insolvency and the Demand for Venture Capital", European Business Organization Law Review (2004) at 87.
27. Uttamchandani and Menezes 2010
28. Fan and White 2003
29. Armour 2009
30. Mathur 2009
31. N Dewaelheyns and C van Hulle 2008
32. Rodano, Serrano-Velarde, Tarantino (2012)
33. Part II, Berkowitz, C Lin & Y Ma 2013

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