3 Restructuring firm and household debt

The COVID-19–induced economic crisis and the temporary government measures intended to protect firms and households from bankruptcy have created unprecedented opacity about the financial health of households and businesses. Some borrowers are temporarily short on liquid assets, while others are facing longer-term structural difficulties and should exit the market. The challenge, then, is sorting the illiquid from the insolvent. Historically, court-led bankruptcy systems have performed this sorting function, and so these systems are scrutinized in times of financial crisis. Effective insolvency systems can help to quickly resolve high levels of debt distress to prevent collapse of the financial sector without relying on costlier forms of policy intervention. Reforms to strengthen bankruptcy systems also improve the underlying economic conditions and so are critical to an equitable recovery. This chapter lays out a blueprint for bankruptcy reforms that will help governments manage high levels of debt distress while laying the groundwork for economic recovery.

Policy Priorities

Countries can mitigate the risk of an onslaught of insolvent households and businesses by investing in four policy reforms:

- **Strengthening formal insolvency mechanisms** so that the rules that define the rights and behaviors of debtors and creditors are in place, giving each an incentive to negotiate and come to an agreement, whether in court or out of court.
- **Facilitating alternative dispute resolution systems such as conciliation and mediation** to enable faster and cheaper resolution of disputes than in the formal court system, but with some of the rigor that courts provide.
- **Establishing accessible and inexpensive in-court and out-of-court debt resolution procedures for micro-, small, and medium enterprises** to facilitate the recapitalization of viable but illiquid firms and the swift, efficient market exit of nonviable firms. Rules designed for small entities can help resolve their debts more quickly and cheaply with less burden on the judicial system than requiring the same rules regardless of firm size.
- **Promoting debt forgiveness and discharge of natural person debtors** so that solo entrepreneurs and individuals unable to pay their debts—through no fault of their own—can be discharged of those debts and more quickly move on from them, avoiding the stigma and loss of productivity that come from long-term debt distress.

Introduction

Building on chapter 2 on financial institutions, this chapter looks at the consumers of finance—households and firms—and especially at the insolvency systems countries can use in facilitating an equitable recovery from the COVID-19 (coronavirus) economic crisis. Those systems—debt enforcement laws and their institutional framework—are essential to achieving recovery. The reforms highlighted in this chapter, informed by the World Bank's "Principles for Effective Insolvency and Creditor/Debtor Regimes" and the "Legislative Guide on Insolvency Law" issued by the United Nations Commission on International Trade Law (UNCITRAL),[1] focus on mechanisms for restructuring or discharging debt.

Effective debt resolution, which these reforms facilitate, can contribute to economic growth and contain the wider economic impact of business distress. In addition to establishing fairness for debtors by providing a pathway out of perpetual indebtedness, well-functioning insolvency systems can spur future innovation and economic growth by freeing up capital for lending to new and productive enterprises. To deliver on this potential, insolvency systems have to find an effective balance between the need, on the one hand, to address individual instances of overindebtedness and, on the other, to discourage borrowers from engaging in unnecessary risk-taking.

Why should anyone care about insolvency systems?

Financial crises typically draw attention to insolvency systems because they are an effective way to manage and reduce high rates of nonperforming loans (NPLs).[2] However, this ex post argument for strong insolvency systems is accompanied by an ex ante justification for pursuing insolvency reforms as well.[3] Improvements in insolvency systems are associated with greater access to credit,[4] improved creditor recovery, strengthened job preservation,[5] higher productivity,[6] and lower failure rates for small businesses.[7] Cost-reducing reforms can also create the right conditions for nonviable firms to file for liquidation,[8] which can help resolve the problem of so-called zombie firms, discussed shortly. In short, the rationale for reforms to strengthen insolvency frameworks in the COVID-19 era is a mix of crisis management and recovery planning.

This chapter highlights the positive benefits of insolvency systems (a primer on those systems appears in box 3.1). But it is also important to recognize the risks of maintaining the status quo for those countries lacking sound insolvency systems. One characteristic of inadequate insolvency frameworks is the lengthy processes that can reduce the returns to creditors because of the costs of recovery proceedings

Box 3.1 A short primer on the insolvency process

Despite differences in insolvency frameworks across countries, most involve a contractual relationship between a firm or individual (the debtor) and one or more creditors. This relationship can be for the provision of goods and services (such as utilities or suppliers), labor (such as employees), or debt financing (such as lenders). In most jurisdictions, a debtor will be insolvent under the law if it is unable to meet one or more of its contractual obligations in the ordinary course of business or if the total of the debtor's assets is less than the total of its liabilities. If a debtor company becomes insolvent under the law, the debtor or the creditor (in some jurisdictions) can seek a court order declaring that the company is to cease operations and its assets are to be sold to repay, to the extent

(Box continues next page)

Box 3.1 A short primer on the insolvency process *(continued)*

possible, what creditors are owed (also known as liquidation).

An alternative to liquidation is restructuring a company's affairs so it can continue to operate and meet its debt obligations (or meet altered obligations to which the creditors agree or are required to accept). Restructuring typically occurs in circumstances in which the alternative is liquidation, and it can occur either before or after court liquidation is sought. Identification of the assets and obligations of the debtor is required for both liquidation and restructuring to determine how to proceed.

Liquidation and restructuring are collective processes. They are designed to address a situation in which a debtor is no longer able to pay its creditors. Both liquidation and restructuring provide a mechanism for the equitable treatment of all creditors—that is, they avoid a race to the bottom in which individual creditors seek to enforce their own contractual rights.[a]

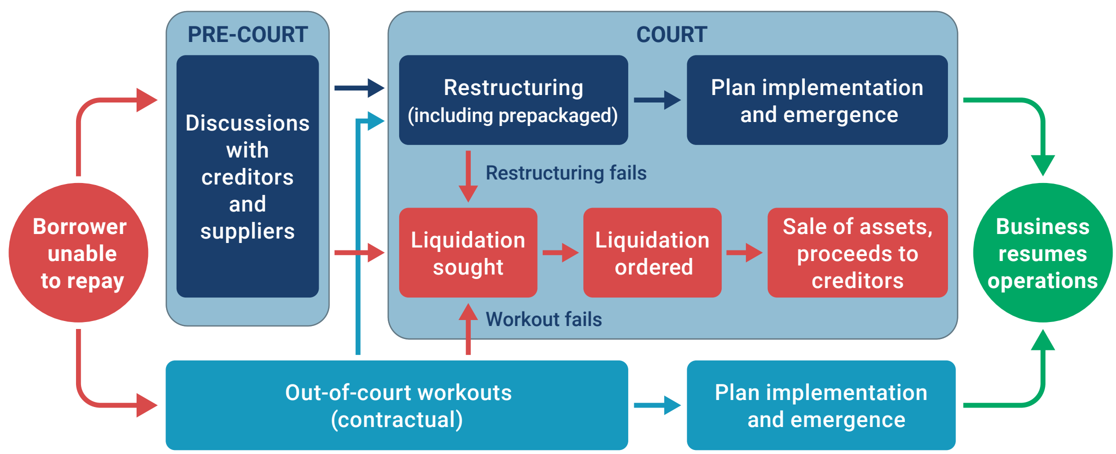
These processes vary across countries. They may be implemented by an insolvency practitioner, who is tasked with administering such formal insolvency procedures. Depending on the jurisdiction, the insolvency practitioner may operate under a license granted by their country's insolvency authority.

The outcomes of liquidation and restructuring are different. In liquidation, the business is eventually deregistered. In restructuring, the ultimate aim is for the business to resume normal operations. Components of restructuring can include debt forgiveness, debt rescheduling, debt equity conversions, or sale of the business (or parts of it) as a going concern. Failed restructuring can ultimately result in liquidation.

Three additional mechanisms can augment a typical insolvency framework. First, early warning tools can detect or predict a borrower's inability to repay its debts before that inability arises. Second, credit reporting frameworks serve as a classification system for borrowers' inability to meet their debt obligations. They are most relevant in the period after default, but before engaging the court. Third, out-of-court workout options can prevent liquidation using varying degrees of court or noncourt supervision. They can be instituted at any time between failure to pay and liquidation, with some technical limitations on what can be negotiated once the court is involved.

Figure B3.1.1 depicts the key elements of the insolvency process in a timeline format.

Figure B3.1.1 Insolvency process timeline



Source: WDR 2022 team.

a. IMF (1999).

and deterioration of the value of underlying assets. Long processes also delay the redeployment of capital tied up in nonviable firms to viable businesses and productive sectors.

Nonviable zombie firms[9] generate enough income to repay interest on outstanding debts but not enough to repay the outstanding debt balance. They drain productivity from the economy by absorbing resources that would produce better returns if they were used to finance healthier businesses.[10] The relationship between insolvency systems and zombie firms is supported by empirical findings that higher barriers to restructuring are associated with "zombie congestion" in high-turnover industries and with a lower ability to attract capital.[11] Effective insolvency systems reduce such barriers.

Restructuring and forcing the market exit of zombie firms have significant political economy dimensions. Most important are the jobs lost by the employees of restructured or liquidated companies. Complicating matters further, in the present crisis it is very difficult to distinguish between liquid and illiquid firms because even healthy firms have experienced a temporary collapse in liquidity.[12] The COVID-19 emergency government measures aimed at preventing widespread business collapse have made this identification process even murkier.

This difficulty was of little consequence in the short term because propping up both zombie firms and viable firms likely produced economic benefits in the form of continued employment for workers at zombie firms at a time when new job opportunities were severely limited. However, over the longer term government measures that inhibit the exit of zombie firms should be removed, while recognizing that these actions may create other challenges. For example, simplifying the liquidation or restructuring process for nonviable companies may produce rapid job losses in certain sectors, even as it creates higher returns for creditors and releases more value into the economy. At scale, however, delaying liquidation or restructuring of zombie firms because of fears of job losses may be counterproductive. Actual job losses may also be less than feared: empirical evidence suggests that zombie firms tend to use loans to build up cash reserves instead of contributing to economic activity through hiring or spending.[13]

The absence of effective insolvency frameworks especially hurts small businesses and individuals. Without a working framework for restructuring debts, businesses experiencing a temporary inability to repay their loans are more likely to have to exit the market.[14] Sole proprietors in countries that subject the proprietors to personal bankruptcy regimes may face the threat of a lifetime of debt because of the unavailability of discharge (cancellation of debt).[15] Small and medium enterprises (SMEs), particularly unincorporated enterprises where the line between individual and business is blurred,[16] are inherently more vulnerable to insolvency because of their informality, low operating margins, and constrained access to credit (see spotlight 3.1 for a discussion of the microfinance institutions overcoming this constraint). SMEs are widespread in emerging economies, where the challenges of inadequate insolvency regimes are more pronounced.[17]

Countries that lack effective bankruptcy frameworks have limited options for dealing with high NPL levels other than blunt public intervention. Governments may be forced to turn to borrower bailouts (in which the cost is borne by the taxpayer, insulating creditors) or bail-ins (in which the cost is borne by the creditor, insulating debtors and the taxpayer).[18] For some industries or in some circumstances, these approaches may be desirable,[19] but they come with substantial risks.

Studies of borrower bailouts suggest that the short-term benefits of debt relief come with long-term costs. In particular, future borrowers may be more likely to engage in a strategic default in the belief that they will not have to repay, and creditors may, in turn, respond by restricting access to credit. Although some studies have found that debt relief programs can have positive welfare effects and lead to positive outcomes in certain cases,[20] research indicates that, overall, the risk of future strategic loan default rises, especially among previously "good" borrowers, and there are no improvements in real outcomes.[21]

A study of debt relief in India in the wake of the global financial crisis found a subsequent increase in strategic default and a decrease in new lending to the sectors that were bailed out.[22] Another study of a mortgage modification program for delinquent borrowers in the United States revealed that announcement of the program was followed immediately by a 10 percent relative increase in delinquencies, predominantly attributable to new delinquencies among borrowers otherwise deemed least likely to default.[23] Other studies showed the same—that previously "good," or nondistressed, borrowers were more likely to strategically default or take longer to repay their loans after a bailout.[24] Risks emerge for the political economy of credit as well. In India, defaults were found to be sensitive to the electoral cycle, and the pattern was magnified after the bailout.[25] Furthermore, borrowers who are angrier about the economic situation, who trust banks less, and who want to see more banking regulation are more likely to default strategically. Borrowers are more willing to default as knowledge of others defaulting and media coverage of the same become more widespread.[26]

Ad hoc bailouts, as opposed to those conducted systematically, put governments in the position of picking winners—a skill they usually lack. The problems are compounded for emerging economies because there is less budget flexibility for bailouts.[27] The moral hazard risk may be exacerbated in jurisdictions in which declaring bankruptcy is not a viable alternative or even an option in the current legal framework.[28] Bail-ins, by contrast, are likely to increase the risk of financial sector collapse and may result in reduced future lending.[29]

International best practice, empirical research, and lessons from previous high-profile financial crises point to four critical areas for legal reform of insolvency: (1) strengthen formal insolvency mechanisms; (2) facilitate alternative dispute resolution systems such as conciliation and mediation; (3) establish accessible, inexpensive liquidation, in-court, and out-of-court procedures for micro-, small, and medium enterprises (MSMEs);[30] and (4) promote debt forgiveness and discharge of natural person debtors. The remaining sections of this chapter address these four areas and elaborate on how to manage the expected increases in nonperforming loans in a way that enables an efficient and effective recovery.

Strengthening formal insolvency mechanisms

A strong formal insolvency law regime is critical to the successful functioning of an insolvency system with both formal and informal options. Strong formal regimes have default rules and boundaries within which creditors and debtors can mediate or otherwise negotiate debt outside, but "in the shadow" of, formal insolvency law.[31] Participants in out-of-court processes know how their case would be treated in the in-court system and behave accordingly. Furthermore, if out-of-court bargaining fails, participants have recourse to the formal system. A strong formal system thus creates the right incentives and defines the rights and behaviors needed to make both in-court and out-of-court workouts orderly, which, in turn, spurs innovation and economic growth, as articulated in the introduction to this chapter.

Both debtors and creditors should have incentives to engage with the insolvency system and participate in good-faith negotiations. For creditors, the key incentives of a strong insolvency system include the possibility of negotiating an out-of-court debt restructuring plan that may yield a greater return than a forced liquidation. Effective insolvency systems also enable creditors to feel secure in their rights. Thus rather than resort to a unilateral approach, they are willing to coordinate with other creditors in the expectation that coordination will maximize returns.

A strong insolvency regime creates incentives to negotiate a debt restructuring plan in good faith. Creditors may make concessions, and the plan may open a path to the continued operation and turnaround of the indebted business. In regimes in which management loses control of the business once the company enters administration, debtor companies may prefer to negotiate out of court to avoid losing control of their business. If the court system provides an avenue for creditor recourse, debtors are also less likely to misbehave by using out-of-court processes to stall or defer repayment.

For these reasons, functioning insolvency laws underpin the reforms recommended in this chapter. No one-size-fits-all model will work in all jurisdictions and all circumstances. However, strong formal insolvency systems exhibit the following characteristics: (1) predictable creditor priority rules; (2) timely resolution of insolvency proceedings; and (3) strong, accessible bankruptcy expertise among private practitioners and government officials.

These three characteristics warrant particular attention because they are versatile—they can be implemented or improved within the multitude of extant frameworks worldwide—and there is empirical support to suggest they can improve the efficiency of insolvency regimes. These characteristics are generally achieved by writing formal legal requirements into legislation, combined with the ongoing efforts of adequately resourced institutions. For example, strict court deadlines written into an insolvency law to speed up the insolvency process may not work if there are not enough judges to hear cases within the specified time frame. These characteristics are an important part of the World Bank's "Principles for Effective Insolvency and Creditor/Debtor Regimes" and will be especially important in navigating the post–COVID-19 recovery.

Role of the judiciary in the insolvency process

A country typically relies on its judicial system to play a critical role in the insolvency process because of the legal and procedural complexity of the issues and the need to balance the interests of debtors, creditors (including employees), and the public at large. Even in well-functioning judicial systems, the time between an application for liquidation and the final distribution of funds to creditors can take years, particularly for large companies with complex affairs. For example, in Australia insolvency proceedings launched in 1991 for one set of companies were finally resolved in 2020. The main trial was held between July 2003 and September 2006, consuming 404 days of court time. The 26,430-page judgment was drafted over two years.[32]

Clearly, then, insolvencies can place heavy demands on court resources and time. Improving the legal capacity to manage insolvency is therefore critical to economic recovery. A sudden rise in NPLs is likely to strain even the most sophisticated, well-resourced, and well-structured judiciary[33] because insolvency court cases require technical specialization and expertise.[34] Without reforms to simplify and scale the process, judiciaries are likely to experience a case backlog, resulting in further delays.

Countries cannot afford the delay. Longer court cases can reduce the value of assets and the ultimate recovery rate for creditors. Systemically, low recovery rates for creditors reduce the availability of credit within an economy and raise its cost.[35] Weak enforcement, or the perception of weak enforcement, that may arise from backlogs can lead to late payments. They, in turn, can create further insolvencies for businesses connected within supply chains.[36]

Characteristics of strong insolvency frameworks

1. Predictable creditor priority rules

Insolvency systems should provide clear, predictable rules of priority when there are competing claims for or interests in the same assets.[37] Such rules facilitate an orderly process if a debtor is unable to repay its debts, and they increase the appeal of a jurisdiction where investors have greater certainty about what will happen if the debtor fails to repay. Clear priority rules also benefit other aspects of insolvency frameworks. In particular, for out-of-court resolution to work effectively in the shadow of the law, parties must know their rights and how their claims would be treated if they go to court.

Jurisdictions differ widely in their priority rules, in the balance between debtor and creditor rights, and in the domestic policy choices and frameworks that underpin different approaches. For example, some jurisdictions treat employee entitlements as having no priority in the order of repayment, whereas others give employees the highest priority. These matters are important policy and political choices for governments that may be influenced by other factors such as the existence of social safety nets for particular groups. Some frameworks give secured creditors absolute priority, while others give creditors that provide an illiquid business with fresh financing higher priority than preexisting creditors.[38]

Notwithstanding these variations, predictability can play an important stabilizing role in credit markets. A clear priority order that remains the same before and after the onset of insolvency proceedings increases predictability and fairness, which can, in turn, increase the availability and lower the cost of credit. On the other hand, the absence of clarity and predictability decreases the availability and increases the cost of credit because creditors factor the uncertainty into their decision-making or restrict their lending within a jurisdiction. If the law is not clear and predictable (such as on the relative position of creditors), parties may also exploit the court system. For example, creditors may unilaterally seek liquidation of a viable business, and debtors may seek to delay debt repayment or stall on relinquishing control of their business. In the 1994 Mexican tequila crisis, systemic financial sector weaknesses, including those in the bankruptcy law, prolonged and frustrated repeated government efforts to stabilize and reduce NPLs. Ultimately, from a high of 30–45 percent in 2002, NPL rates only began to decline meaningfully one year after comprehensive insolvency reforms were adopted. Around the same time, domestic credit began to rise again as a share of the gross domestic product (GDP) after having bottomed out at 12 percent in 2001 (see online annex 3A).[39]

2. Timely resolution

Reducing the amount of time needed to satisfy creditors after the filing for insolvency in court is a common target for reform because of the benefits of moving faster.[40] Timely resolution of insolvency proceedings correlates strongly with higher returns to all creditors[41] and allows the rapid redeployment of capital from unproductive to productive enterprises.[42] In this way, timely resolution creates a positive feedback loop that motivates all actors to engage in out-of-court workouts, confident that, should the situation escalate, in-court options are available and efficient.

One method commonly used by governments to resolve insolvency proceedings is the imposition of time limits for some stages in the process. Many jurisdictions temporarily extended these time limits in the context of COVID-19 either through legislation or through a more lenient approach in the courts. For example, Australia extended the response time to a bankruptcy notice from 21 days to six months.[43] In Mauritius in November 2020, the Supreme Court granted the administrators of Air Mauritius a long extension (seven months) to hold a watershed meeting.[44] Extensions like these should be phased out as the recovery continues to prevent the perpetuation of zombie firms and facilitate the reallocation of capital from nonviable to viable firms (see chapter 1).

Divergent views among creditors are another source of delay. These can be managed with measures that (with a court order) allow restructuring agreements to proceed without the support of all creditors. In a “cramdown,” the majority of a creditor class binds the minority in that class. In a “cross-class cramdown,” a majority in a creditor class binds a minority in other creditor classes. The United States has cramdown mechanisms in place,[45] and they were recently introduced in the United Kingdom.[46] Momentum is growing for their introduction in other jurisdictions as well[47]—in some cases unrelated to the COVID-19 pandemic.

Institutional capacity reforms can also speed up the insolvency process by clearing backlogs and increasing efficiency within the courts. For example, in Indonesia a judicial reform program enacted in the aftermath of the Asian financial crisis helped to reduce the time needed to conclude SME insolvency from 72 months in 2004 to 13 months in 2012.[48] Among other reforms, responsibility for administration of the courts was transferred from the executive to the judicial branch; a centralized unit was established for judicial training and development; and commercial court judges with jurisdiction over insolvency cases received insolvency-specific training. Similarly, reforms to Chile's insolvency law in 2014 included a requirement for insolvency law training for civil judges dealing with insolvency proceedings. As a result, the time to resolve insolvency dropped from 3.2 years in 2014 to 2 years in 2018. The improvements in various metrics in India also demonstrate the value of institutional reforms like these, which are especially important to address the anticipated increase in judicial caseloads described earlier in this chapter. Ongoing research and experimentation by the World Bank's Data and Evidence for Justice Reform (DE JURE) project have pointed to the potential for improving the efficiency of judicial decision-making through the use of data-based performance metrics (see online annex 3B).[49]

3. Expertise in bankruptcy

Expert practitioners, judges, and regulators are key to the success of well-designed insolvency legislation. Insolvency is a technical field at the intersection of law, finance, and policy. The availability of workable valuation estimates of a business and its property is fundamental for avoiding a sell-off, if reorganization is intended. For judges, insolvency presents complex legal and factual matrixes. Countries attempting to develop these sorts of capacities should strive to develop sustainable institutional capacity, including through ongoing training. Also critical are systems to oversee and regulate private bankruptcy professionals, particularly in a crisis, when the opportunities for bankruptcy fraud and abuse of power are greater.

With this in mind, many economies have embarked on reforms to bolster the capacity of their judiciaries. Some have sought insolvency-specific reforms, while others have aimed to boost capacity generically (which will nonetheless have benefits in the insolvency space). In Brazil, the National Justice Council introduced standardized procedures for judicial reorganization proceedings during the COVID-19 pandemic.[50] Spain announced its intention to create 100 additional judicial units within three years.[51] Similarly, many countries have pursued or are pursuing judicial capacity-building programs in collaboration with the World Bank Group. These training programs educate judges about insolvency law, as well as about practical aspects of their work such as case management and drafting judgments. Digitalization is also increasing. For example, Nigeria has announced measures to deploy digital facilities to enable taking evidence and alternative dispute-resolution filing.[52]

Beyond technical capacity, an effective insolvency regime requires stakeholder commitment. In the aftermath of the 1997 Asian financial crisis, the impact of insolvency reforms was limited by a "culture of non-payment" that, according to a report by the Organisation for Economic Co-operation and Development (OECD), prevailed in the affected countries.[53] That culture emerged because borrowers rarely faced consequences when they failed to repay their loans. To prevent this type of situation, countries must embed specific rules in their broader legal, economic, political, and social contexts, and insolvency judges and practitioners must have access to the training needed to abide by and enforce the rules correctly.

The institutional framework for insolvency includes courts and enforcement agencies, collateral registry and credit reporting systems, insolvency regulators, and insolvency practitioners. It requires judges able to interpret the law and manage caseloads. It also requires professionals (liquidators, administrators, receivers, conservators, and legal advisers) who have the technical ability to discharge their obligations to the court effectively.[54] In many cases, these bankruptcy professionals play a critical role in an efficient bankruptcy system. In many countries, they can be a key determinant of the speed of a reorganization. The presence of professionals with skills in these areas will increase the efficacy of the reforms discussed in the balance of this chapter because they will provide the solid formal legal foundation needed to facilitate out-of-court resolution of creditor-debtor disputes. Box 3.2 describes the comprehensive efforts in India to strengthen its institutional insolvency framework.

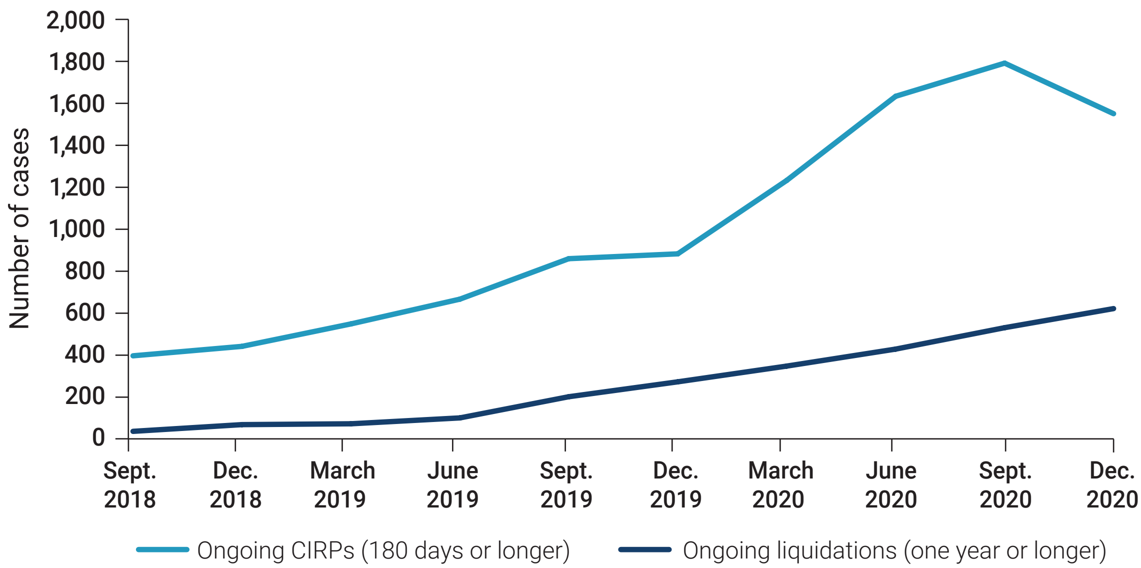
Box 3.2 Comprehensive and ongoing institutional insolvency reforms in India, 2016–20

In 2016, India overhauled its business and personal insolvency law framework, the Insolvency and Bankruptcy Code 2016 (IBC). It was then updated in 2018, 2019, 2020, and 2021.[a] The consolidated national law is designed to address the fragmentation of the previous regime, which made it difficult for firms and individuals to understand their rights. Prior to the overhaul, there were different rules for the rescue or rehabilitation of industrial companies and other businesses,[b] different recovery powers for financial institutions and other creditors,[c] and different rules for personal insolvency that varied by region.[d] As a result of this patchwork of arrangements, many different court jurisdictions heard insolvency proceedings. And the time needed to conclude insolvency was, on average, 4.3 years,[e] which allowed debtors to avoid repaying or restructuring debts for long periods without consequences.[f]

In addition to the changes in the legal framework,[g] the 2016 reforms took significant steps toward establishing insolvency expertise and specialization within the judiciary and the insolvency profession and redressing the issues just described. The IBC established the Insolvency and Bankruptcy Board of India (IBBI) to administer the law as well as to accredit and supervise insolvency professionals. The National Company Law Tribunal was designated the sole court with jurisdiction over first-instance corporate insolvency proceedings.[h] Meanwhile, the number of registered insolvency professionals steadily expanded, from 1,812 at the end of 2018 to 3,309 at the end of 2020.[i]

Early evidence suggests that the reforms have had numerous positive effects. The overall recovery rate for creditors increased from $.27 on the dollar before reforms to $.72 on the dollar in 2020, and the time needed to settle insolvency more than halved in that period, from 4.3 years to 1.6 years. Case backlog remains an issue (figure B3.2.1) and is the subject of an ongoing reform effort.[j]

Figure B3.2.1 Insolvency backlog in India, 2018–20



Source: Insolvency and Bankruptcy Board of India, *Quarterly Newsletter*, various, https://www.ibbi.gov.in/publication?title=quarterly&date=.

Note: Corporate Insolvency Resolution Process (CIRP) arrangements are meant to be finalized within 180 days.

(Box continues next page)

Box 3.2 Comprehensive and ongoing institutional insolvency reforms in India, 2016–20 *(continued)*

In response to COVID-19, India temporarily amended the business and personal insolvency law. Most significantly, it suspended creditors' ability to initiate insolvency proceedings on the basis of defaults arising between March 25, 2020, and March 24, 2021.[k] It also raised the minimum default requirement for the purposes of corporate insolvency to ₹1 crore (10 million rupees) from Rs 1 lakh (to about $130,000 from about $1,300).[l] In April 2021, the government permanently amended the IBC to include a framework for insolvency for MSMEs, which may help prevent a further backlog and delays by easing the demand for the Corporate Insolvency Resolution Process (CIRP), a restructuring framework.[m]

a. Insolvency and Bankruptcy Code (Amendment) Ordinance(s), 2018, 2019, 2020, and 2021.
b. The Sick Industrial Companies (Special Provisions) Act (SICA) 1985 governed industrial companies.
c. Recovery of Debt Due to Banks and Financial Institutions Act (RDDBFI) 1993.
d. The two laws were the Presidency Towns Insolvency Act 1909 and the Provincial Insolvency Act 1920.
e. World Bank (2014a).
f. BLRC (2015).
g. For further analysis of these changes, see World Bank (2020, 54).
h. And for appeals, the National Company Law Appellate Tribunal and subsequently the Supreme Court of India.
i. IBBI (2020).
j. Shikha and Shahi (2021).
k. Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021.
l. PIB (2020).
m. Amendments are carried out through the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021. See PIB (2021).

Early warning tools

Systems for detecting and responding to potential insolvencies before they arise are important to strengthen insolvency frameworks. The earlier a debtor perceives financial difficulties, the higher is the probability of avoiding insolvency.[55] Similarly, if the viability of a business is permanently impaired, the liquidation process will be more orderly and efficient the earlier it begins. For these reasons, policy makers are increasingly aware of the importance of alerting businesses to upcoming troubles, especially in the European Union after the introduction of the Restructuring Directive in 2019.[56]

An early warning tool (EWT) is a means of helping businesses detect financial difficulties so they can be addressed proactively. Within this broad definition, EWTs may take many different forms, ranging from purely internal control systems involving corporate bodies to external control systems that rely on the intervention of third-party experts.

The French alert procedure,[57] which relies on the workers' council and corporate auditors to alert the debtor's managers of upcoming difficulties, is a well-known example of an internal control system. Of external systems, the Danish approach is among the most developed, leveraging an algorithm run by the Danish Business Authority that detects companies potentially at risk. At-risk companies are then referred to a network of restructuring consultants who advise the debtor.

Until recently, EWTs were typically designed to alert creditors and public authorities about the upcoming distress of corporate and special debtors. However, EWTs now focus on debtors to enable them to take early action. Although this tool is aimed at serving all debtors that engage in economic activities, EWTs are likely to be particularly useful for SMEs because those facing financial difficulties often do not have the resources they need to cope with high restructuring costs, such as advisers who can prevent or mitigate the effects of insolvency.

Strong insolvency frameworks in the context of COVID-19 recovery

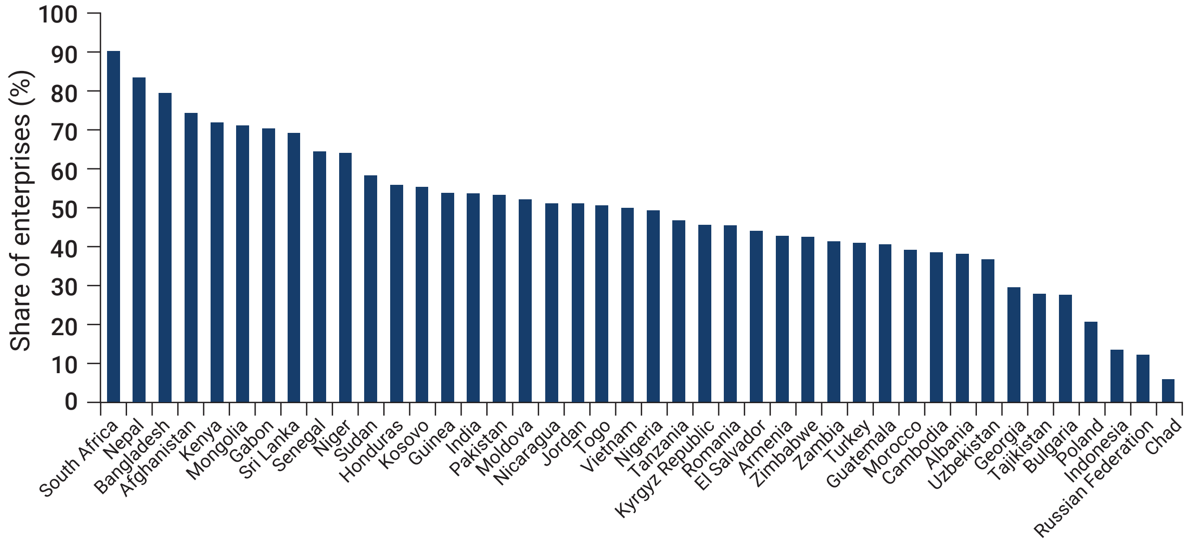
In addition to the financial measures adopted to staunch the worst of the damage from the COVID-19 economic crisis, many governments undertook temporary legal changes in their insolvency frameworks. According to a joint World Bank/INSOL International survey spanning both advanced and emerging economies, 67 of the 69 surveyed economies enacted some insolvency reforms in 2020.[58] The purpose of the reforms was to "flatten the curve" of insolvencies by creating breathing room for businesses, individuals, and financial institutions and preventing widespread economic collapse.

The most common reforms were relaxing debt repayment requirements (80 percent); placing moratoria on the initiation of insolvency proceedings by creditors (43 percent); and altering or temporarily suspending the obligations of directors and firm managers to enter insolvency proceedings in circumstances in which they ordinarily would be required to do so (30 percent). Relaxed debt repayment requirements included measures addressing borrowers' diminished ability to make payments, such as moratoria on or extensions of loan repayment terms (about 34 percent); measures addressing the effects of nonpayment, such as prohibiting the acceleration of contractual terms (about 55 percent); suspension of judicial proceedings (about 28 percent); and suspension of the execution of certain debtor-owned assets (about 4 percent).

In 2021, the World Bank designed a survey to identify the characteristics of corporate debt restructuring frameworks, as well as the types of insolvency-related COVID-19 emergency measures that jurisdictions had introduced.[59] The World Bank team worked with INSOL International and the International Association of Insolvency Regulators to distribute the survey.[60] Experienced insolvency professionals in 135 economies were contacted, and at least three independent contributors were contacted in 100 jurisdictions. Responses were forthcoming from 114 economies, including multiple responses from 71 percent of those economies. The survey found that OECD economies introduced measures to stymie debtor (57 percent) or creditor (54 percent) bankruptcy filings more frequently than non-OECD economies (24 percent and 17 percent, respectively). By contrast, debt repayment emergency measures (that is, those contract modification measures addressing either the prospects of repayment or the effects of nonpayment) as well as suspension of judicial procedures were more evenly distributed.[61] This finding is consistent with the fact that advanced economies tend to have more robust insolvency systems and insolvency usage.

Most of the insolvency-related emergency measures introduced after the onset of the pandemic included sunset clauses determining the timing for winding them down. Although many of these measures were extended (and they may be further extended or even reintroduced), a clear picture has emerged of their duration. Debt repayment measures, preventing the crystallization of insolvency, were estimated to have the longest duration—on average, 451 days or about 15 months.[62] Three-quarters of economies wound down debt repayment measures within 600 days, though in one country a measure was set to last 1,035 days. Suspension of judicial procedures measures was much shorter-lived—on average, 273 days. Three-quarters of the economies studied halted these measures in just over 400 days. As for measures to increase barriers to creditor-initiated insolvency filings, they lasted 384 days, on average, with three-quarters of the economies winding down these measures within 550 days. Finally, measures to avoid forcing debtors to file for bankruptcy lasted, on average, 324 days, with three-quarters of the economies drawing these measures to a close in just under 500 days. All in all, only a

Figure 3.1 Share of enterprises in arrears or expecting to fall into arrears within six months, selected countries, May–September 2020



Source: Apedo-Amah et al. 2020, based on World Bank, COVID-19 Business Pulse Survey Dashboard, 2020–21 data, https://www.worldbank.org/en/data/interactive/2021/01/19/covid-19-business-pulse-survey-dashboard.

Note: The figure presents percentages for countries surveyed by the World Bank.

few of the insolvency-related emergency measures introduced in the context of COVID-19 were expected to remain in place at the end of 2021.

As governments ease short-term support measures, experts expect to see an increase in COVID-19–related business and personal insolvencies stemming in no small part from widespread business distress (see figure 3.1). The International Monetary Fund (IMF), the Bank for International Settlements, and others predicted that beginning in 2020 business insolvencies would exceed pre–COVID-19 levels by 20–35 percent.[63]

Facilitating alternative dispute resolution systems such as conciliation and mediation

Alternative dispute resolution (ADR) systems will be an essential mechanism for economies seeking to emerge stronger after the COVID-19 pandemic. Effective ADR frameworks allow quicker and cheaper resolution of disputes than the formal court system, while retaining some of the rigor that courts provide.[64] ADR in the insolvency context involves direct engagement between debtor and creditors to come to a resolution about an outstanding debt. ADR is typically, but not necessarily, overseen by a third party, and any resolution is contractually binding. ADR can be initiated voluntarily by the parties or at the order of a court. Third-party mediators ideally facilitate, as opposed to actively participate in, the resolution of intercreditor differences.[65]

One of several structural obstacles to effective ADR deployment in the insolvency context is the challenge of convincing multiple parties with varied interests to agree on a resolution that is consistent with the obligations of the parties under the broader insolvency law. Before the pandemic, many countries had already introduced or were in the process of introducing schemes that sought to facilitate ADR systems that addressed these challenges (see online annex 3C). Ideally, this trend will continue in the near to medium term—a possibility that underlies the guidance offered in this section.

Aristotle would likely have found ADR preferable to in-court proceedings because "an arbitrator goes by the equity of a case, a judge by the strict law."[66] There is growing evidence that ADR can be cheaper, quicker, and more satisfactory than court proceedings.[67] In the insolvency context, out-of-court resolution of debt disputes has the added advantage of occurring confidentially, which allows participants to avoid harm from public knowledge of debt distress, including constraints on capital and supply chains.[68] Although the data on the efficacy of ADR in the context of insolvency are limited, a 2012 pilot program in the District Court of Amsterdam found that over 70 percent of cases resulted in successful solutions at greater speed and less cost when measured against the alternative—litigation.[69]

An oft-cited example of a jurisdiction with a successful insolvency ADR regime is the United Kingdom. The "London approach," a nonlegislative set of cultural norms and principles fostered by the Reserve Bank,[70] guides the manner in which creditors voluntarily and collectively approach debtor distress. It does not require a third-party mediator or a conciliator. The London approach has four key tenets: (1) creditors keep existing facilities in place and do not rush to appoint receivers; (2) reliable financial information about the debtor exists and is shared among creditors; (3) creditors work collectively to resolve the issue; and (4) the burden of debtor concessions is shared equally among creditors.[71]

Because of its informal, confidential nature, limited empirical evidence is available on the merits of the London approach. It requires significant creditor buy-in and cohesion. However, these may be lacking in jurisdictions without the requisite trust in debtors or the underlying system to enforce legal rights. For example, creditors from multiple jurisdictions may be unable or unwilling to attempt a coherent approach to the problem. Or they may be willing to make concessions only if other creditors make equivalent concessions. Thus creditors unwilling to make concessions can frustrate the process.[72]

The challenge of creditor cohesion has been addressed in some jurisdictions by mechanisms that allow, in certain circumstances, for the courts to approve (and bind creditors to) restructuring plans negotiated outside of court. The French conciliation approach consists of a two-part model toward this end. In the informal method (*mandat ad hoc*), the court appoints a representative to mediate a nonbinding resolution of the debt distress. In the semiformal method (*conciliation*), the court approves and makes binding the output of mediation.[73] In practice, debtors tend to begin within the *mandat ad hoc* framework and then proceed to *conciliation* to obtain court approval of the restructuring agreement.[74]

Several advanced economies have included variations on this model (court endorsement of out-of-court negotiations) in their COVID-19 reforms. Germany has introduced a new conciliation scheme (Stabilization and Restructuring Framework) in which the debtor can apply for a court-appointed mediator ("restructuring facilitator") to assist in negotiations with creditors for up to three months. After successful mediation, the court can confirm the agreement, which protects the participants from avoidance or liability claims.[75] The Netherlands has introduced reforms that enable debtors to offer their creditors restructuring plans outside of the formal bankruptcy procedure. If approved by a court, these plans can bind unwilling creditors (including secured creditors) to a restructuring arrangement in a cross-class cramdown.[76]

Another way of managing the problem of creditor cohesion is use of an intercreditor agreement—a contract among creditors—that sets the general rules for approaching restructuring, while allowing flexibility for individual restructuring. A recent example of this approach is Turkey's updated Framework Agreements on Financial Restructuring. Such an approach, which is in effect a co-regulatory model subject to the oversight of the regulator with a more limited role for the courts, may be attractive in jurisdictions with fewer court systems.

Poland's experience demonstrates how the adoption of out-of-court restructuring can quickly take the heat out of widespread and rising NPL levels and lay the foundation for future economic health by putting banks on a firmer footing to extend new credit. As part of a larger effort in the early 1990s to establish a market-based economy, Poland adopted the Act on Financial Restructuring of Enterprises and Banks.[77] In effect until 1996, this legal framework for insolvency was intended to supplement formal bankruptcy and liquidation proceedings when the state-owned national bank was split into nine commercial banks—a step that revealed high levels of nonperforming loans in the banks' portfolios.[78] The act empowered financial institutions to design and implement a process for restructuring enterprises through which they brokered conciliation agreements with debtors and divested NPLs on the secondary market.[79] The banks received an influx of capital to facilitate the restructuring process.[80]

By mid-1995, about 85 percent of the conciliation agreements had been finalized.[81] Common features of the agreements included debt write-offs or extensions of the payment period, more favorable terms for small creditors, and debt-for-equity swaps (in about one-third of cases). Less than 1 percent of borrowers were required to make immediate partial payments. Meanwhile, the more viable firms (23 percent) went into conciliation, while the financially weaker firms went into liquidation or court bankruptcy.

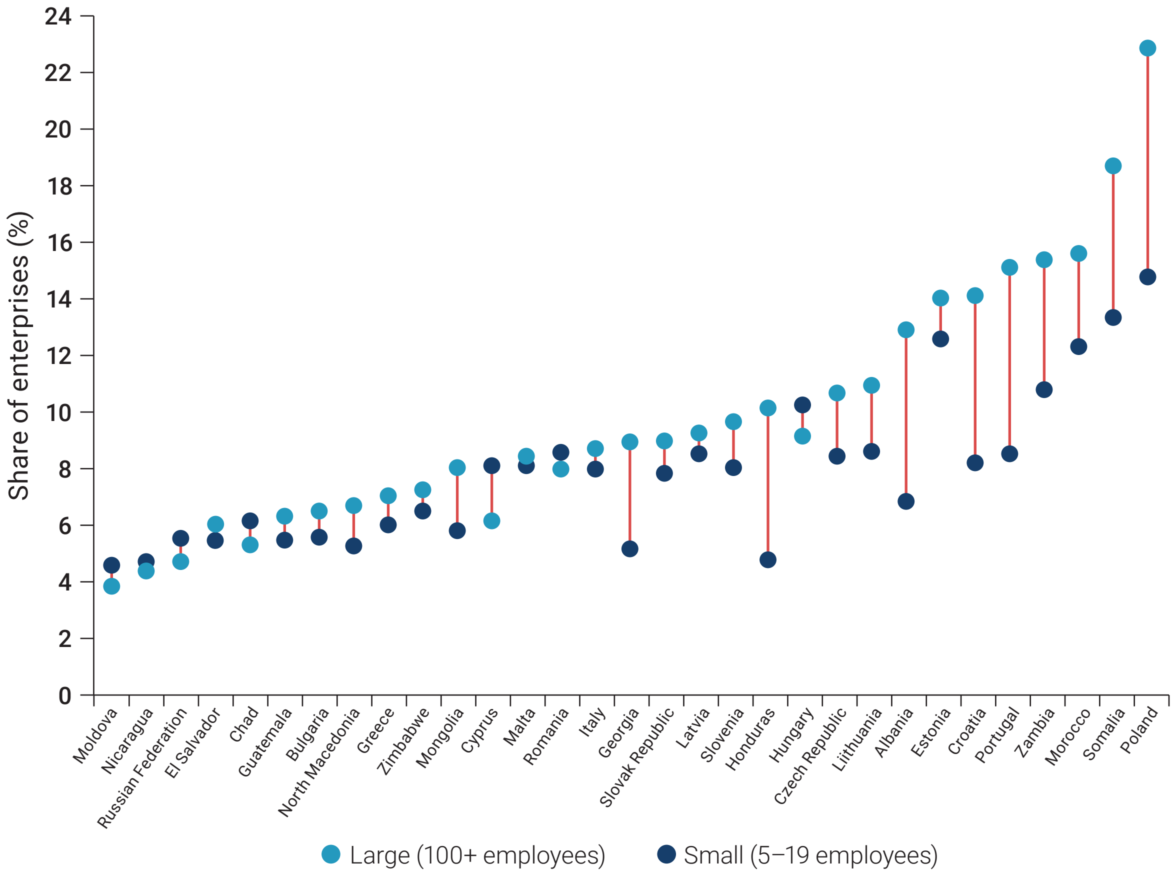
The firms that entered bank conciliation accounted for 46 percent of the debt owed at the end of 1991, reflecting the unequal distribution of debt within the economy. Overall, thanks to the Polish conciliation scheme the NPL rates of bank portfolios fell rapidly, from 31 percent in 1993 to 9 percent in 1996.[82] Loans were written down or swapped without widespread debt forgiveness,[83] leaving banks in a better position to extend new loans on market-oriented terms.

Despite these improvements, the increase in conciliation and restructuring alone failed to address the underlying problems of firm mismanagement and unprofitability. Restructuring plans did not require changes in management or operational restructuring, and less than half of firms committed to asset sales or reduction of staff. As a result, during the first two years of implementation businesses subject to conciliation saw their average operating profit decline, and few were privatized. Because MSMEs were excluded from the conciliation scheme (the threshold debt level was high, and the cost was substantial), they struggled to access credit over the course of the recovery.[84] Thus, although the adoption of legal frameworks to facilitate ADR can contribute significantly to the swift resolution of NPLs, regulators should push for workout agreements to include commitments that put businesses on a path to viability, lest they merely prolong or defer the underlying economic challenges.

Establishing accessible and inexpensive in-court and out-of-court debt resolution procedures for MSMEs

MSMEs play a critical role in economic growth and employment, particularly in emerging economies, but they have been the enterprises hardest-hit by the COVID-19 pandemic. They are more vulnerable than large enterprises to debt distress and less equipped to seek recourse in either the debt market or the legal system. It is therefore not surprising that they have shorter survival times (figure 3.2).[85] Post–COVID-19 insolvency reforms should therefore address the specific needs of MSMEs to facilitate the recapitalization of viable but illiquid firms and the swift but least painful market exit of nonviable firms. This is particularly important in emerging economies, where MSMEs represent a large proportion of total firms.[86]

Figure 3.2 Enterprise ability to survive a drop in sales, selected countries



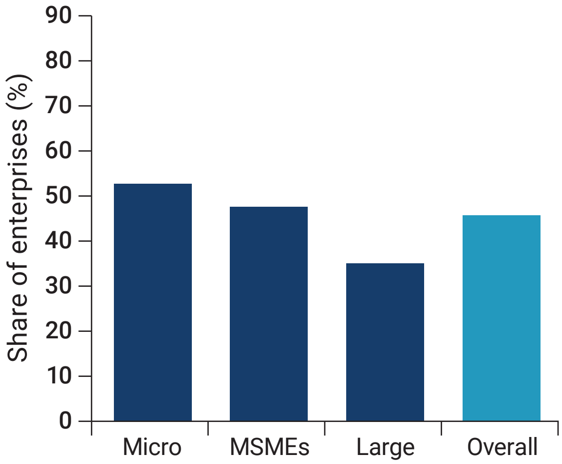
Source: World Bank, COVID-19 Business Pulse Survey Dashboard, 2020–21 data, https://www.worldbank.org/en/data/interactive/2021/01/19/covid-19-business-pulse-survey-dashboard.

Why MSME procedures matter

The World Bank's Business Pulse Survey, conducted on a rolling basis of enterprises in 50 countries, has revealed the outsize impact of the COVID-19 pandemic on MSMEs, especially microenterprises. From June to September 2020, of the firms reporting they were in arrears or expecting to be in arrears within six months, 48 percent were MSMEs (including 53 percent of microenterprises within that group), compared with only 36 percent of large enterprises (figure 3.3). Furthermore, 83 percent of MSMEs (including 84 percent of microenterprises within that group) reported lower monthly sales than in the previous year, compared with 73 percent of large enterprises (figure 3.4).

Most insolvency frameworks subject MSMEs and large companies to the same rules and processes.[87] Complexity, length, and cost are obstacles to the use of these frameworks by MSMEs.[88] In the circumstances, insolvency can be "a luxury that many MSMEs cannot afford."[89] This is a critical factor in why small enterprises are more likely than large enterprises to become zombie firms. Financially distressed small businesses with limited or no prospects for future rehabilitation continue to operate because the obstacles to liquidation are too high. Targeted insolvency frameworks could help them, while also facilitating access to credit for viable MSMEs.[90]

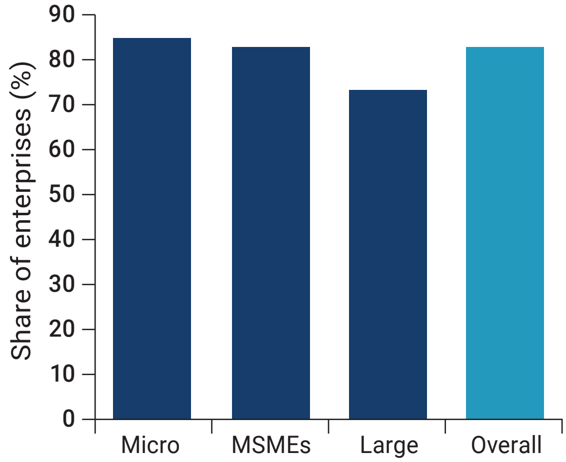
Figure 3.3 Share of enterprises in arrears or expecting to be in arrears within six months, June–September 2020



Source: World Bank, COVID-19 Business Pulse Survey Dashboard, https://www.worldbank.org/en/data/interactive/2021/01/19/covid-19-business-pulse-survey-dashboard.

Note: MSMEs = micro-, small, and medium enterprises.

Figure 3.4 Share of enterprises with lower monthly sales than in the previous year, June–September 2020



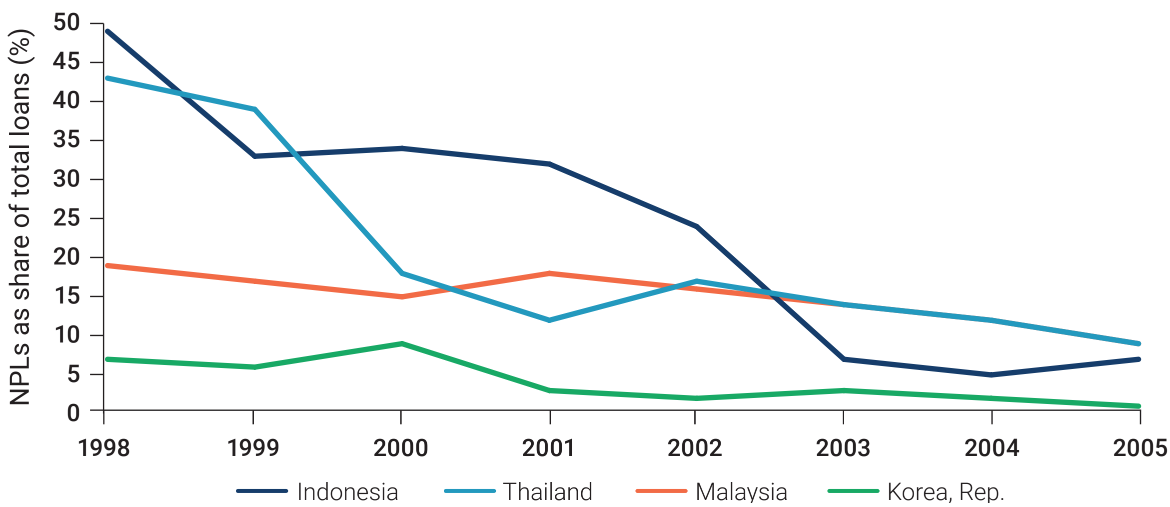
Source: World Bank, COVID-19 Business Pulse Survey Dashboard, https://www.worldbank.org/en/data/interactive/2021/01/19/covid-19-business-pulse-survey-dashboard.

Note: MSMEs = micro-, small, and medium enterprises.

Lessons learned from MSME insolvency reform during the Asian financial crisis

In the late 1990s and early 2000s, firms in Southeast Asia experienced widespread debt distress. In fact, NPL rates exceeded 40 percent in some jurisdictions (see figure 3.5). MSMEs were unable to obtain credit or were subjected to high interest rates. In Indonesia, the number of MSMEs fell by about 7 percent between 1997 and 1998 and did not return to their former level until 2000.[91] In Thailand, in 1998 a greater proportion of MSMEs (55 percent) than large enterprises (45 percent) experienced a reduction in employees.[92]

Figure 3.5 Nonperforming loans, selected Asian countries, 1998–2005



Source: Lee and Rosenkranz 2019.

Note: NPLs = nonperforming loans.

In response, countries adopted various reform measures (see online annex 3D). Of countries in Southeast Asia, Thailand's reforms resulted in the most rapid reduction in NPL rates, but there was a long tail: rates remained above 10 percent until 2005, and only 48 percent of NPLs in Thailand were resolved by mid-2003. By contrast, 77 percent of the debt referred to Malaysia's Corporate Debt Restructuring Committee was resolved by that time. In the Republic of Korea, by mid-2003 restructuring agreements were reached for about 80 percent of registered cases representing about 95 percent of total (corporate) debt. Thailand did the least to address restructuring, and it did not enforce any changes in management. Its approach can be attributed to deficiencies in the formal insolvency framework and the lack of political will to force change in large companies.[93] Echoing the experience in Poland, in Thailand the absence of substantive restructuring of large companies likely delayed resolution.

Reforms to facilitate MSME insolvency proceedings

As noted earlier, in 2017 the World Bank published a comprehensive review of MSMEs and insolvency frameworks, setting out the characteristics and requirements.[94] The 2021 "Principles for Effective Insolvency and Creditor/Debtor Regimes" and an updated version of the UNCITRAL "Legislative Guide on Insolvency Law" (see online annex 3E) together provide a series of principles and recommendations on insolvency frameworks aimed at assisting MSMEs with insolvency. Drawing on those sources, table 3.1 sets out some priority areas of reform in the context of COVID-19 recovery. It is important to note that the World Bank's "Principles" and UNCITRAL's "Guide" include significant flexibility in how a MSME insolvency framework can be achieved.

Even before the onset of the pandemic, some jurisdictions implemented reforms tailored to MSMEs. For example, in February 2020 Myanmar implemented a MSME-specific insolvency regime that included a business rescue framework under a debtor-in-possession model. In the United States, the 2019 Small Business Reorganization Act introduced a distinct insolvency framework for small enterprises. Meanwhile, the Lao People's Democratic Republic's December 2019 Enterprise Rehabilitation and Bankruptcy Law contains provisions for small enterprises.[95]

The COVID-19 crisis spurred other jurisdictions to follow suit with temporary reforms. For example, Colombia introduced a temporary fast-track restructuring framework administered by the Chamber of Commerce for MSMEs.[96] Similarly, in December 2020 Singapore introduced a temporary Simplified Insolvency Program that lowers the proportion of creditors required to approve an MSME insolvency plan,[97] which expired on July 28, 2021.[98] The United States temporarily raised the debt threshold for business restructuring (thereby increasing the accessibility of more heavily indebted businesses to restructuring) and implemented other temporary insolvency reforms. These changes were initially set to expire in 2021, but were extended to 2022.[99] Addressing obstacles to creditor recovery, New Zealand introduced the COVID-19 Response Legislation Act 2020, which put in place a business debt hibernation scheme,[100] and Spain extended the duty of administrators to request the declaration of bankruptcy, while also increasing the standard of the liquidity test.[101]

Other jurisdictions have implemented longer-term reforms in response to COVID-19. These reforms are aimed at simplifying and demystifying the bankruptcy process for small businesses. In terms of simplification, legislation pending in Chile will streamline liquidation and reorganization proceedings for small businesses.[102] And in January 2021, the United Kingdom introduced a simplified process for restructuring and liquidating small businesses. As for demystification, in 2021 Australia introduced permanent reforms that create a role for a "small business restructuring practitioner" to advise and guide MSME debtors through the various stages of restructuring: development of the plan, approval by creditors, and implementation.[103] Also in 2021, Greece implemented a simplified electronic scheme for small

Table 3.1 Principles for adapting insolvency frameworks for MSMEs

Principle	Rationale
Lower or remove documentation requirements	Inadequate record keeping can mean MSMEs, especially microenterprises, are unable to provide the required pre-filing documentation such as audited historic financial records.[a]
Keep the debtor in control of the business	Although it can increase the risk that debtors dispose of assets in a manner adverse to the creditor's interests, a debtor-in-control model makes more sense in the context of MSMEs because the owner/manager is more likely to be indispensable to the continued operation of the business. Australia, India, and the Republic of Korea are examples of jurisdictions in which MSME debtors maintain control of their business.[b]
Ensure supervision by an insolvency/restructuring practitioner	An experienced, knowledgeable practitioner could ascertain business viability faster and more affordably than a court.
Simplify plan approval mechanisms and subsidize the costs of engaging facilitators/ insolvency practitioners	Measures like this are appropriate in the context of COVID-19 recovery, although policy makers should be aware of the trade-offs involved in facilitating restructuring approval at the expense of minority creditor rights. Alternative measures such as reducing the formalities involved in obtaining court approval (also part of the Singapore reforms described earlier) may be a more neutral way of simplifying restructuring plans.
Simplify procedures for the liquidation of businesses	Some jurisdictions implemented temporary fast-track liquidation schemes that removed procedural steps and evidentiary burdens and operated on a faster timetable.[c] Many of these temporary measures have since expired, revealing the need for more permanent reforms specific to small businesses, such as the removal of procedural steps, shortening time frames, and easing evidentiary burdens.
Provide access to fresh financing (including debt-to-equity financing)	Debt-to-equity financing allows MSMEs to continue operating without incurring more debt. It also gives creditors greater visibility into business operations.[d] Increased visibility may help reduce the extent to which creditors, lacking positive information, seek to liquidate viable businesses.[e] International best practice is for fresh financers to be given priority over the existing unsecured creditors, but not over secured creditors[f] because regimes that protect the absolute priority of claims increase the confidence of secured creditors.[g]
Ensure minimal or no use of the courts	Using scarce resources on court proceedings for MSMEs is inefficient. Providing ways to resolve insolvency outside court can have a large impact on managing large volumes of insolvent firms.

Sources: United Nations Commission on International Trade Law (UNCITRAL), UNCITRAL Legislative Guide on Insolvency Law (dashboard), https://uncitral.un.org/en/texts/insolvency/legislativeguides/insolvency_law; World Bank 2021c.

Note: MSMEs = micro-, small, and medium enterprises.

a. World Bank (2017).

b. For Australia, see, for example, Corporations Amendment (Corporate Insolvency Reforms) Act 2020 (Cth); Frydenberg (2020). For India, see, for example, Sen (2020). A case study on this aspect of Korea's insolvency law appears in World Bank (2017). In India, the Pre-Packaged Insolvency Resolution Process for MSMEs, which keeps the debtors in possession, is an option only for the creditors. The main Corporate Insolvency Resolution Process, with creditor in possession, remains an alternative.

c. For example, in September 2020 the Australian government introduced a temporary new liquidation framework designed to allow insolvent MSMEs to exit the market quickly and cheaply.

d. Empirical evidence suggests that, for creditors lending to small enterprises, lack of information contributes to a greater likelihood they will seek liquidation, or it may raise credit costs. See Cook, Pandit, and Milman (2001).

e. Information asymmetry about MSMEs (that is, when creditors do not know as much as debtors about the debtors' operations) can affect the decision-making of creditors. See ICCR (2014).

f. Adalet McGowan and Andrews (2016).

g. Armour et al. (2015); Djankov (2009).

business insolvency that places a degree of responsibility with a trustee, reducing the burden on the courts. Another category of reform is India's Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021, which introduces a prepackaged insolvency resolution process for MSMEs.

Promoting debt forgiveness and discharge of natural person debtors

This section addresses the bankruptcy of natural person debtors—that is, individual entrepreneurs or just individual debtors. Because the pandemic has devastated many people's livelihoods through no fault of their own, debt forgiveness and discharge, as well as reputational protections, are critical tools in the COVID-19 recovery. The law and the courts should aim to quickly resolve no-income, no-asset cases and provide a discharge and fresh start for all natural person debtors.

Despite the potential benefits of personal bankruptcy frameworks, a significant proportion of emerging economies have none. In 2011, a World Bank survey of 25 advanced and 33 emerging economies found that 48 percent of emerging economies lacked a legal framework for the discharge or cancellation of an insolvent individual's debt, compared with 12 percent of advanced economies. Of the emerging economies, 51 percent lacked a legal framework for the restructuring of individual debt obligations, compared with 20 percent of advanced economies.[104]

Personal bankruptcy frameworks can benefit individual debtors both in their capacity as consumers and producers and in their ownership of unincorporated businesses because there is no legal separation between owners and their businesses. Personal bankruptcy laws, and particularly a pathway to discharge, are important for MSMEs, which are often financed at least in part by debt that has been personally guaranteed by the entrepreneur.[105] Comparable global data are limited on the share of personal bankruptcies resulting from business debt, partly because of the different ways in which business debt and nonbusiness debt are classified. However, statistics published by the Australian personal insolvency regulator suggest that between July 2019 and October 2021 about one in four personal bankruptcies was of a sole trader, partner in a partnership, or company officer.[106]

Personal bankruptcy laws provide an orderly framework for repaying or discharging the debts of individual debtors. This framework is especially helpful in periods of high levels of personal insolvency because the lack of a credible alternative to recover a debt often drives creditors to pursue piecemeal approaches. Those approaches can result in the unnecessary destruction of value stemming from court filing fees, enforcement costs, and the lost opportunity costs of a negotiated pathway to solvency and repayment.[107] Piecemeal approaches also clog the courts and impose avoidable hardships on debtors, including the loss of domicile and the stigma of ongoing debt collection.

Reforms of personal bankruptcy frameworks in response to COVID-19 have been minimal. One reform includes a framework for bankruptcy for natural persons in China's Shenzhen Special Economic Zone. The first of its kind in China, the framework provides for a three-year probationary period during which the bankrupt person's spending is subject to supervision before debts are discharged.[108] Temporary reforms enacted in Australia increase the threshold for the value of debts outstanding required to commence bankruptcy proceedings and facilitate the use of personal insolvency agreements for debt resolution.[109]

In addition to personal insolvency reforms, many countries have reformed their legal frameworks for dealing with the insolvency of MSMEs. To the extent that these reforms also apply to the owners of unincorporated businesses and address their personal liability for business debt, they fall into the category of personal insolvency reforms because they provide a pathway out of overindebtedness for individuals, including through discharge.[110]

A principal purpose of a personal insolvency regime is to rehabilitate insolvent debtors and restore their economic capacity.[111] In circumstances in which there is no prospect of repayment (or the societal cost of enforcing repayment outweighs the value of the repayment), there is no benefit to enforcement for creditors. However, the extent to which policy makers can and will allow debt forgiveness is a political decision and will depend on the context.

Excessive filing costs can deter debtors from filing for personal insolvency.[112] These obstacles should be removed for low-income and asset debtors. Examples of jurisdictions with frameworks to alleviate filing costs for low-income and asset debtors are Ireland, New Zealand, Scotland, and the United Kingdom (and Wales).[113] Regimes can target these procedures at those who are genuinely unable to meet their obligations. Digitalization also holds some promise as a means of lowering costs and increasing accessibility. In October 2020, Australia introduced a digital bankruptcy application process for personal bankruptcy.[114]

Another avenue for the protection of individual debtors is credit reporting frameworks. Many jurisdictions responded to the COVID-19 crisis by temporarily altering credit reporting frameworks to limit the long-term reputational harm to debtors temporarily unable to meet their debt obligations as a result of the pandemic. Crises tend to lower the credit scores of affected borrowers. A study of the impact of natural disasters on the financial health of US residents in affected regions found that credit scores declined by as much as 22 points.[115]

Forbearance programs to temporarily pause or reduce installments for a limited time were used in the COVID-19 pandemic by 57 percent of the 65 countries surveyed by the International Committee on Credit Reporting.[116] During the forbearance period—often three or six months and in some places up to a year—accounts were "frozen/paused" so that clients were reported as current even if payments were reduced or suspended. To reflect the forbearance programs, credit reporting bureaus implemented or used existing special reporting codes to flag the type of facilities affected by COVID-19.

In the United States, the CARES Act provided for 180 days of forbearance for federally backed loans, and credit providers were encouraged to consider their own programs for similar modification.[117] The main credit reporting agencies adjusted their algorithms to ensure that accounts affected by the COVID-19 pandemic were not negatively impacted. Kenya, Malaysia, and Greece took a more direct approach by barring the submission of negative credit data for a period of six months, nine months, and the pandemic period, respectively. During the prescribed period, credit bureaus did not include delinquency data on the credit report and scores. Four countries—Denmark, the Netherlands, Norway, and Tanzania—did not implement any specific measures to protect borrowers, which was largely consistent with the health policy positions of these countries during the pandemic. In the absence of any relief, delinquencies affected the borrowers' credit report and score in the ordinary manner.

Policies suspending adverse reporting on borrowers during a grace period should be phased out with an eye toward maintaining the integrity of the credit reporting system. In the absence of complete information, credit providers lack a full view of borrowers, and they may adopt a cautious lending approach that is counterproductive to the recovery. Suppression of data also introduces operational challenges. In the absence of data, TransUnion estimates that when full file information reporting resumed in Kenya, 12 percent of borrowers shifted to a high-risk score, reflecting increasing delinquencies.[118] In addition, banks' requests for credit bureau reports declined from 3.1 million a month in March 2020 to a low of 1.6 million in June 2020, but recovered to 3.6 million in December 2020.[119]

Conclusion

Debt is critical to prosperity and progress, but the complexity of the problems that arise when debtors cannot meet their obligations requires sophisticated legal and institutional frameworks. This is true in ordinary times, but the challenges are amplified when many debtors cannot meet their obligations within a short stretch of time. Inaction or mismanagement in such circumstances can lead to substantial economic harm. The reforms advocated in this chapter are directed at strengthening courts so they can continue to function in a period of high nonperforming loans, capture the value of debt for economic recovery in the form of new investment, and provide individual debtors with a degree of protection.

Notes

1. In the aftermath of the 2007–09 global financial crisis, the Financial Stability Board created in 2011 the Insolvency and Creditor Rights Standard (ICR Standard) and designated it as one of its key standards for sound financial systems (FSB 2011). The unified global standard for insolvency is represented by two international instruments: the World Bank's "Principles for Effective Insolvency and Creditor/Debtor Regimes," first published in 2001 and periodically revised (World Bank 2021c), and UNCITRAL's "Legislative Guide on Insolvency Law," which was first adopted in 2004, with new "parts" added over time. See UNCITRAL Legislative Guide on Insolvency Law (dashboard), United Nations Commission on International Trade Law, Vienna, https://uncitral.un.org/en/texts/insolvency/legisla tiveguides/insolvency_law. The ICR Standard informs the findings in this Report because it is integral to helping countries further develop such systems.
2. Terminology in this area can be confusing because different terms are used to describe similar processes in different jurisdictions. In this chapter, the terms *insolvency* and *bankruptcy* are used interchangeably to describe both liquidation and restructuring. *Restructuring* can refer to both formal and informal (out-of-court) processes to reorganize a firm's operations, finances, or both.
3. Consolo, Malfa, and Pierluigi (2018); D'Apice, Fiordelisi, and Puopolo (2021).
4. Araujo, Ferreira, and Funchal (2013).
5. Fonseca and Van Doornik (2020).
6. Lim and Hahn (2003); Neira (2017).
7. See Acharya and Subramanian (2009); Araujo, Ferreira, and Funchal (2013); Dewaelheyns and Van Hulle (2010); Gamboa-Cavazos and Schneider (2007).
8. Giné and Love (2006).
9. Zombie firms are firms unable to cover debt servicing costs from current profits over an extended period.
10. Andrews, Adalet McGowan, and Millot (2017); Banerjee and Hofmann (2018).
11. Menezes and van Zwieten (forthcoming).
12. Laeven, Schepens, and Schnabel (2020).
13. Acharya et al. (2019).
14. Menezes and van Zwieten (forthcoming).
15. Menezes and van Zwieten (forthcoming).
16. The issue of quantifying informal MSMEs is considered by Stein, Ardiç, and Hommes (2013) and International Finance Corporation, MSME Finance Gap (dashboard), SME Finance Forum, https://www.smefinance forum.org/data-sites/msme-finance-gap.
17. World Bank (2017).
18. van Zwieten, Eidenmüller, and Sussman (2020).
19. Casey (2021).
20. Agarwal et al. (2017); Bolton and Rosenthal (2002); Mukherjee, Subramanian, and Tantri (2018).
21. Alston (1984); De and Tantri (2014); Guiso, Sapienza, and Zingales (2013); Kanz (2016); Mayer et al. (2014); Rucker and Alston (1987).
22. Giné and Kanz (2018).
23. Mayer et al. (2014).
24. See De and Tantri (2014); Mukherjee, Subramanian, and Tantri (2018).
25. Giné and Kanz (2018).
26. Guiso, Sapienza, and Zingales (2013).
27. G30 (2020, 3, 30).
28. Ayotte and Skeel (2010).
29. Calomiris, Klingebiel, and Laeven (2004).
30. Cirmizi, Klapper, and Uttamchandani (2012); World Bank (2021b, 2021c, 2022).
31. World Bank (2021c).
32. The case is *Bell Group (UK) Holdings Limited (In Liquidation)* [2020] WASC 347.
33. Laryea (2010).
34. This was identified as a particular challenge in responding to the Asian financial crisis. See OECD (2001).
35. Jappelli, Pagano, and Bianco (2005); Menezes and van Zwieten (forthcoming).
36. Esposito, Lanau, and Pompe (2014).
37. World Bank (2021c).
38. More in-depth comparative analysis is available in Adalet McGowan and Andrews (2016).
39. Chapter 3 annexes can be found at http://bit.do /WDR2022-Chapter-3-Annexes.
40. See, for example, Gadgil, Ronald, and Vyakaranam (2019).
41. See Menezes and van Zwieten (forthcoming).
42. Menezes and van Zwieten (forthcoming).
43. This measure, now ended, is summarized in AFSA (2021).
44. Air Mauritius (2020). A watershed meeting describes the turning point at which critical decisions are made about the future of an insolvent business—in particular, whether it will undergo restructuring or proceed to liquidation.
45. Via confirmation of a restructuring plan under Chap-ter 11 of the Bankruptcy Code (§ 1129).
46. Corporate Insolvency and Governance Act 2020.
47. Harris (2017).
48. World Bank (2019b).

49. This program is led by the World Bank's Development Impact Evaluation (DIME) team. See World Bank (2019a).
50. INSOL International and World Bank (2021a).
51. INSOL International and World Bank (2021d).
52. INSOL International and World Bank (2021c).
53. OECD (2003).
54. A regulatory framework for professional insolvency practitioners is a key component. Many countries—such as Australia, Brazil, Canada, China, Japan, Mexico, the Republic of Korea, the Russian Federation, and the United Kingdom—have facilitated the development of an insolvency practitioner profession whose members manage the economic and operational aspects of a proceeding. Practitioners are subject to strict qualification, training, monitoring, and licensing or registration requirements.
55. See, among others, EC (2011).
56. Directive 2019/1023 on Restructuring and Insolvency.
57. Procedure is applicable to the largest companies only (*société anonyme*). See Article L234-1 of the French Commercial Code.
58. World Bank (2021a).
59. Menezes and Muro (forthcoming).
60. INSOL International is a worldwide federation of national associations of accountants and lawyers who specialize in turnaround and insolvency. It has over 10,500 members. For more information, see https://www.insol.org/. For information on the International Association of Insolvency Regulators, see https://www.insolvencyreg.org/.
61. INSOL International, International Association of Insolvency Regulators, and World Bank (forthcoming).
62. In constructing these estimates, it was assumed that all measures were introduced on March 1, 2020.
63. See Allianz Research (2020); Banerjee, Cornelli, and Zakrajšek (2020).
64. World Bank (2022).
65. World Bank (2021c).
66. Part 13, Aristotle ([350 BCE]).
67. A review of the empirical evidence of alternative dispute resolution in civil law, family law, and workplace law is available in Veen (2014).
68. Cutler and Summers (1988).
69. Boon et al. (2019).
70. Armour and Deakin (2001).
71. Kent (1993).
72. Lucarelli and Forestieri (2017).
73. Kastrinou (2016).
74. Lucarelli and Forestieri (2017).
75. Madaus (2020).
76. Act on Court Confirmation of Extrajudicial Restructuring Plans.
77. Lipton and Sachs (1990).
78. Bogdanowicz-Bindert (1997).
79. Montes-Negret and Papi (1997).
80. Bogdanowicz-Bindert (1997).
81. Pomerleano and Shaw (2005).
82. Palinksi (1999), cited by Hersic (2007).
83. Pomerleano and Shaw (2005).
84. Montes-Negret and Papi (1997).
85. The survival rates of MSMEs may also be shorter than those of large firms when sales fall off because they are not well managed or have less liquidity.
86. The World Bank's 2017 "Report on the Treatment of MSME Insolvency" is a comprehensive review of the economic importance of MSMEs, their particular needs and challenges, and the insolvency reforms recommended for addressing these challenges.
87. Gurrea-Martínez (2021).
88. World Bank (2017).
89. Gurrea-Martínez (2021, 4).
90. World Bank (2018).
91. Tambunan (2018).
92. Bakiewicz (2005).
93. Mako (2005).
94. World Bank (2017).
95. For a more comprehensive review of such reforms, see Gurrea-Martínez (2021).
96. Decreto Legislativo 560 de 2020, https://dapre.presidencia.gov.co/normativa/normativa/DECRETO%20560%20DEL%2015%20DE%20ABRIL%20DE%202020.pdf.
97. Insolvency, Restructuring and Dissolution (Amendment) Act 2020.
98. Ministry of Law, Singapore (2021).
99. For a summary of the CARES Act and COVID-19 Bankruptcy Relief Extension Act, see ABI (2021).
100. COVID-19 Response Legislation Act 2020.
101. INSOL International and World Bank (2021d).
102. INSOL International and World Bank (2021b).
103. Corporations Amendment (Corporate Insolvency Reforms) Act 2020 (Cth). See Frydenberg (2020).
104. World Bank (2014b).
105. World Bank (2017).
106. The share is 8,889 of 34,339 personal bankruptcies. See Australian Financial Security Authority, Quarterly Personal Insolvency Statistics (dashboard), https://www.afsa.gov.au/about-us/statistics/quarterly-personal-insolvency-statistics.
107. IMF (1999); World Bank (2014b).
108. Reuters (2020).
109. Attorney-General's Department (2021).
110. For more detailed consideration of the blurred lines between personal and corporate insolvency frameworks, see Spooner (2019).
111. World Bank (2014b).
112. Heuer (2020).
113. Respectively, "Debt Relief Notice," "No Asset Procedure," "Minimal Asset Process," and "Debt Relief Order."
114. AFSA (2021).
115. Data from the International Committee on Credit Reporting, which conducted a survey in 65 countries in September and October 2020 on COVID-19 credit support programs; see ICCR (2020).
116. ICCR (2020).
117. Forbes and Sparkes (2020).
118. TransUnion presentation at the 2021 Kenya CIS Virtual Conference. See CIS Kenya (2021).
119. Central Bank of Kenya presentation at the 2021 Kenya CIS Virtual Conference. See CIS Kenya (2021).

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