Insolvency Q&A

22 February 2016

1. What are your findings on the economic impact of insolvency reform?

We find that countries with strong insolvency regimes have lower borrowing costs. Specifically, we found that a 10 percentage point increase in expected recovery rate is associated with fall in bond spread of between 18 and 37 basis points. Based on these results we find that if all EU countries were to bring their recovery rates around the level of the top 6 EU economies, this should permanently add between €41bn and €78bn to EU GDP per annum (or between 0.3% and 0.55% of EU GDP) via lower borrowing costs. Total employment would increase by 600,000 to 1.2 million across the EU.

2. How do you derive your estimates of economic impact?

We use a pricing model to estimate the impact of insolvency regimes on bond spreads taking into account the multiple features that, in addition to insolvency regimes, define bond prices (i.e. credit ratings, liquidity, time to maturity, co-movement with market variables, among others). This result is then used to infer the potential long-term impact on EU GDP and employment by utilising previous published economic evidence of the relationship between macroeconomic performance and bond spreads.

3. How robust are your estimates?

The report contains several robustness checks and the main results hold with different assumptions and multiple variations to our main model. However our results do not capture important channels of impact including: (i) greater access to finance; (ii) greater levels of entrepreneurship; (iii) the benefits arising from a more integrated market; and (iv) progress in addressing Europe's high level of non-performing loans. The economic impact of insolvency reform in Europe is a relatively new area of research, where comparable data in the field are scarce. In our estimations, we used data that we believe are the most comparable across EU countries, which however are subject to assumptions which we have disclosed in our report.

4. What is the link between insolvency rules and banks' non-performing loans?

Based on a standard definition, the ECB's 2014 comprehensive assessment identified a total of €879 billion in non-performing exposures in the banking system. A recent EBA study found that in most Member States the highest share of NPLs (18.5% of the total) is in the SME lending book. The EBA explains that high NPL ratios for SMEs are caused by *"the relatively lower resilience of SMEs to adverse economic conditions compared to other corporates… and by legal and other difficulties surrounding the disposal/write-off of SMEs' NPLs."* A 2015 study by the Commission finds evidence of the contribution of sound insolvency regimes (among other factors such as GDP growth and debt ratios) to faster adjustment of non-performing loans.

5. Which EU Member States are reforming their insolvency rules?

In addition to the Member States mentioned in the chart in Appendix A of the insolvency report, the following are some of the Member States that have recently introduced insolvency reforms:

- Cyprus: In April 2015 the Cyprus parliament approved a new corporate and personal insolvency regime designed to streamline procedures and promote a "rescue culture", including amending the Companies Law introducing the process of "examinership". This is similar to administration in the UK, and aims to facilitate corporate rescue and restructuring of companies in distress.
- Poland: Introduced legislation in July 2015 giving new powers to restructure corporate bonds.
- Portugal: in 2015 Portugal introduced amendments to its pre-insolvency framework to address the Commission's Recommendation on a new approach to business failure and restructuring.
- Romania; introduced the concept of "group insolvencies" to its insolvency legislation based on the principles contained in the recast EC Regulations on Insolvency Proceedings.

7. In light of existing EU level provisions, and the reforms instituted by various European jurisdictions, why is it necessary to impose minimum insolvency standards across Europe?

While the EC regulation addresses some issues related to cross-border insolvencies, and EU Member States have implemented various reforms to their insolvency laws, the Commission has made clear that further action is necessary to adequately address problems caused by different insolvency regimes. In particular, the Commission found that adoption of its 2014 Recommendation did not succeed in having "*the desired impact in facilitating the rescue of businesses in financial difficulty and in giving a second chance to entrepreneurs because of its only partial implementation in a significant number of Member States, including those having launched reforms."* In addition, certain aspects of the existing framework favour large corporates which have sufficient resources and access to advisers to move their centre of main interest (COMI) to more favourable jurisdictions if they wish. In practice, this option is not open to most small firms.

8. What is AFME proposing by way of EU insolvency reform?

We welcome the Commission's intention to pursue a legislative initiative on business insolvency. We advocate pursuing a fairly narrow and focused EU legislative initiative to embed the key minimum standards of an effective insolvency law into national systems. Specifically, our report recommends:

- a Chapter 11-type stay of proceedings to enable quick and effective restructuring;
- granting super-priority status to new financing to provide working capital to a distressed company;
- giving creditors stronger rights to propose viable restructuring plans; and
- requiring national insolvency agencies to publicly report on outcomes.

9. Are AFME's proposals workable given the diversity of Member State regimes and legal approaches?

Our proposals go with the grain of reforms already being implemented at national level, which are outlined above and examined in detail in our report. Moreover, we would cite the reforms already completed with respect to legislative initiatives such as MiFiD II, MAR, AIFMD, EMIR and CSDR. The outcomes suggest that diverse national regimes can be accommodated in pursuit of necessary legislative goals. Furthermore, the implementation of BRRD provides a precedent for an effective EU-led legislative initiative, which has been imposed in spite of the diversity of European Member State regimes and legal approaches.

10. What is the European Commission planning under capital markets union?

The Commission published its action plan on CMU in September 2015, in which it noted that *"convergence of insolvency and restructuring proceedings would facilitate greater legal certainty for cross-border investors and encourage the timely restructuring of viable companies in financial distress."* Alongside its CMU action plan the Commission published a review of the effectiveness of its 2014 Recommendation on insolvency law. Based on this review and the Commission's objectives under CMU, the Commission has committed to propose a legislative initiative on business insolvency by the end of 2016. The Commission has explained that its legislative initiative *"will seek to address the most important barriers to the free flow of capital, building on national regimes that work well."*

11. What are the next steps on the EU policy process?

The Commission has confirmed in its 2016 work programme that it will introduce a legislative initiative on business insolvency. No further steps have been confirmed. Within the Commission, the policy lead sits with DG Justice and Consumers, working closely with DG Financial Services and Markets (FISMA).
In broad terms we would anticipate a Commission consultation to be issued in the spring. Based on feedback received in this consultation and from its own analysis we would expect to see a Commission legislative initiative published in Q4 2016, in line with its commitment under the CMU action plan.