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November 29, 2017

Approved By
European Department

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ECONOMIC EFFECTS OF WEAK CLAIMS ENFORCEMENT—INTERNATIONAL EVIDENCE AND IMPLICATIONS FOR CYPRUS[1]

A. Introduction

1. The ability to effectively enforce contracts is a fundamental requirement for the efficient functioning of markets. In theory, voluntary exchange between parties in spot markets—where exchange is instantaneous—is self-enforcing because the trade is—by definition—mutually beneficial.[2] However, in practice, increased specialization and complexity of production, large numbers of trade partners and physical displacement between parties increase the need for an external enforcement mechanism. Moreover, transactions involving intertemporal exchange cannot be self-enforcing as the executor of the future leg of the transaction could always choose to opportunistically default on his obligations. Therefore, intertemporal exchange, including provision of credit, generally requires third-party enforcement mechanisms or pledging of collateral, or relies on a good reputation built over time through repeated economic or social interactions.[3]

2. Enforcement of claims is aimed at securing property rights.[4] Enforcement mechanisms serve a dual purpose: encouraging voluntary compliance by credibly promising a penalty in the event of a breach and, if a breach occurs, providing mechanisms to ensure execution of the agreement. In addition, a creditor may decide not to exercise his property rights, either on temporary or permanent basis, if the cost of enforcement is perceived to be high relative to the amount expected to be recovered.

3. Enforcement arrangements may be formal or informal.[5] ***Formal*** (or legal) arrangements entail steps related to in-court procedures and post-court enforcement of the court decision. In-court procedures entail the creditor filing the case with the court, the debtor being summoned, and the case being litigated before a judge. Post-court enforcement includes seizure and liquidation of real and financial assets (including through foreclosure) and garnishment of wages in order to finance the decision awarded by the court. Post-court actions are typically undertaken by enforcement agents, who may be public officers or private sector actors—depending on the country. ***Informal*** enforcement encompasses a wide range of actions, including sending reminder letters, charging penalty interest or serving pre-court enforcement writs. Certain forms of out-of-court dispute settlement, such as mediation or arbitration, are sometimes considered informal.

[1] Prepared by Sebastiaan Pompe (LEG), Seung Mo Choi and Rachel van Elkan (both EUR).

[2] In the terminology of Arrow and Debreu, competitive markets can decentralize incentive-compatible allocations.

[3] For example, intertemporal exchanges in financial markets often require two-legged swaps.

[4] See Stigler (1974) for a discussion of optimal legal enforcement.

[5] In addition, customs and social norms may also play an important role in claims enforcement, as demonstrated by the very different outcomes in countries with similar formal arrangements (Berkowitz, Pistor and Richard, 2003).

As quantitative indicators of post-court and informal enforcement are generally not collected, most of the literature focuses on in-court enforcement.[6]

4. This paper discusses the costs of weak claims enforcement, provides a selective review of the literature, assesses the situation in Cyprus and proposes some directions for policy. In what follows, we focus specifically on weak enforcement in credit markets. Whereas previously, claims enforcement was primarily seen as a branch of development economics, it became apparent with the global financial crisis that weak enforcement is also a concern for numerous advanced economies, and that it carries significant macroeconomic and financial stability consequences. In the rest of this paper, we (i) discuss the sources and costs of weak enforcement; (ii) synthesize some of the rapidly-expanding international literature on claims enforcement; and (iii) examine the state of claims enforcement in Cyprus and draw some policy recommendations based on international experience.

B. Weak Enforcement—Sources and Costs

5. Ineffective enforcement may be caused by bottlenecks in any of the steps outlined in paragraph 3. Gaps or ambiguities in the legal framework, cumbersome court and/or appeals procedures (including scope for repeated appeals), staffing constraints, social sensitivities that make parties reluctant to proceed with claims (e.g., foreclosure and evictions), restrictions on third parties that prevent "asset discovery" (i.e., disclosing the location and size of assets) or legal protections granted to some forms of collateral may impede enforcement. Complexity of claims, including multiple claimants in an insolvency case, may also reduce efficiency. Enforcement may also be impeded by weak supporting infrastructure, such as inadequate public registers of asset ownership or by refusal of key stakeholders to cooperate. Without a streamlined process for small claims, it may be too costly for claimants to pursue low-value receivables.

6. Weak enforcement is a friction that increases out-of-pocket expenses for the lender while also raising social costs through higher uncertainty.[7] Direct costs include cash payments for legal and related services, as well as the opportunity cost of foregone access to the resources that are the subject of the claim owing to protracted payment delays and, possibly, only partial recovery of the amount owed.[8] In addition, risks associated with unpredictable or delayed enforcement of claims will tend to be priced into all contracts, thereby raising the generalized cost of intermediation or products.

7. Institutions and procedures well-adapted to coping with the normal traffic of claims enforcement may become congested and dysfunctional in the aftermath of a banking crisis.

[6] Statistics on the time span of the post-court enforcement tend to be insufficient due to the variety of these post-court enforcement procedures.

[7] As in Bernanke and Gertler (1989), these frictions can be considered dead-weight agency costs that arise in the context of asymmetric information in lender-borrower (principal-agent) arrangements, while here these costs may relate to asymmetric information in the context of strategic default (see below) as well as inefficient institutions.

[8] In fact, the recovery rate could decrease as delays lengthen. For example, Ciocchetta and others (2017) find that in Italy, the recovery rate decreases as the duration to recovery increases.

Enforcement of individual claims may take considerably longer in the wake of a financial crisis as the number of claims surges, institutional resources become stretched, while the rapidly-growing backlog of cases could potentially take years to clear. Scaling-up available resources to meet this peak in demand may not always be feasible given long lead times to train professionals. In addition, it may not be efficient to do so given the temporary nature of the claims increase and because some bottlenecks may be attributable to administrative procedures rather than resource availability. Moreover, separate fast-track enforcement procedures may be warranted to discourage debtors from exploiting the slower enforcement by intentionally defaulting.

C. Literature Survey

8. This section reviews the literature on the economic implications of slow claims enforcement. The focus is on links between weak enforcement and the credit market through economic and strategic default, and access to finance, as well as the implications of a crisis for enforcement capacity.

Default—Economic and Strategic[9]

9. Weak claims enforcement can give rise to increased economic (or involuntary) default. Late-repayment of inter-company trade credits is found to be an important cause of involuntary default and business failure in the UK, especially among small and medium-sized firms (Paul and Boden (2011). This is because when a firm is unable to secure payment from its customer, the resulting break in the chain of liquidity in turn prevents the firm from paying its suppliers, thereby triggering a liquidity-induced insolvency. More generally, the European Commission finds that late payment negatively affects the liquidity of enterprises—especially small and medium-sized enterprises—complicating their cash-flow management and limiting access to finance, often leading to bankruptcy, job losses and stifling entrepreneurship (European Commission, 2016).

10. Strategic (or voluntary) default on a mortgage loan can be considered as the exercise of a put option by the borrower. Whether this option is "in the money" depends on several factors, including whether the lender has recourse to the borrower's other assets in the event the value of the foreclosed property is less than the amount owed, and the length of time from default to foreclosure eviction (Ambrose, Buttimer and Capone (1997)). The latter, in turn, depends on the legal framework for foreclosure and the pace at which foreclosures can be processed. These factors become especially relevant during periods with high foreclosure rates when judicial and administrative resources are likely to be stretched. As discussed below, these predictions are generally borne out in the empirical literature.

[9] A key challenge in studying strategic default is that such defaults are observationally equivalent to economic defaults and, moreover, strategic defaulters have an incentive to disguise themselves as borrowers that cannot afford to pay. To overcome this problem, the papers discussed here rely on several identification strategies, such as event studies that track the effect of changes in the enforcement system, exploit within or cross-country variation in enforcement frameworks or rely on survey responses.

11. The prevalence of strategic default is related to weak enforcement, which reduces a borrower's expected cost of default. In contrast to an economic defaulter, a strategic defaulter has the financial means to service his debt but finds it in his personal interest not to abide by the credit contract. Jappelli, Pagano and Bianco (2005) develop a theoretical model of opportunistic borrowers and inefficient courts, whereby a solvent borrower may be unwilling to repay if the gain from defaulting exceeds the perceived cost of presumed sanctions. In turn, sanctions are a function of judicial efficiency, which determines how much collateral the lender can expect to recover from a defaulting borrower. An implication of their model is that poor judicial enforcement increases opportunistic behavior by borrowers who anticipate the high cost that creditors face to recover loans, thus tempting borrowers to default.[10]

12. These predictions are confirmed by cross-country experiences. The incidence of default on a mortgage loan is found to increase as borrowers are more underwater (in terms of negative equity in the home) (Gerardi and others (2017) and Bajari, Chu and Park (2008). In the US, the prospect of having to relinquish housing collateral is found to be a critical factor in deciding whether to default, with weak claims enforcement tilting the balance toward voluntary default by reducing the likelihood the borrower will face any enforcement action (Guiso, Sapienza and Zingales (2013). Also in the US, expected delays in foreclosure are associated with increased rates of mortgage default among underwater homeowners as defaulting homeowners can live in their home rent-free until the foreclosure process is complete (Chan, Haughwout, Hayashi and van der Klaauw (2016). The longer the expected rent-free period, the greater is the incentive to default.[11] China's firm-level loan data show that the likelihood of default by a firm is higher in provinces with weak legal enforcement (proxied by the number of lawyers and the number of courts in the area) (Gao and others (2016).

13. A higher incidence of strategic default is generally found with nonrecourse mortgages. For the US, Chan, Haughwout, Hayashi and van der Klaauw (2016) find that nonrecourse primary mortgages—where the lender may not pursue a borrower's other assets—increase the likelihood of mortgage default. However, this assumes that borrowers know the legal basis of their mortgage. Similarly, Ghent and Kudlyak (2011) find that recourse reduces mortgage default for underwater homeowners, especially those with higher-value properties. On the other hand, Guiso, Sapienza and Zingales (2013) observe that whether a US state requires mortgages to be nonrecourse does not appear to affect a borrower's willingness to strategically default, which they attribute to either a lack of awareness by most borrowers of the legal status of their mortgage, or that most people do not possess assets aside from their home, rendering moot the difference between recourse and nonrecourse loans. Consistent with their first hypothesis, they find that survey responses regarding the subjective probability that a bank would pursue a defaulted borrower does not to differ between recourse and no-recourse states.

[10] However, the effect of improved judicial efficiency on the aggregate default rate is ambiguous as it also depends on whether increased access to credit by poorer-quality borrowers—who were previously rationed out of the credit market as a result of weak enforcement but who are more likely to face economic default—pull up the economy-wide default rate.

[11] In addition, by not servicing their loans, borrowers keep their loan-to-value (LtV) ratio elevated, thereby reducing the benefit to the bank from foreclosing and selling the underlying collateral relative to other loans with lower LtV loans.

14. Initiatives introduced for social reasons may generate perverse outcomes. A moratorium on foreclosure and repossession can be considered an extreme form of lax enforcement. Using data from a large Greek bank, Artavanis and Spyridopoulos (2017) analyze the effect on mortgage loan performance of a law that places a moratorium on foreclosure of primary residences. They focus on borrowers eligible for both the moratorium and a separate debt discharge process for overly-indebted borrowers, which protects primary residences from liquidation but requires the borrower to disclose his true financial situation and subjects any other assets to liquidation. Strategic defaulters are defined as those who are delinquent on their mortgage but choose not to apply for debt relief under the debt discharge process, on the presumption that they wish to avoid disclosing hidden assets or income. Liquidity (or economic) defaulters are defined as those who apply for debt relief after defaulting. The authors find that nearly 30 percent of defaults on primary home mortgages in Greece are strategic. They also find that while less-privileged borrowers are more likely to default, they are less likely to be strategic, with opposite findings among higher-income or better educated borrowers. Finance and legal professionals have the highest propensity for strategic default, consistent with their better understanding of the economic and legal aspects of the moratorium. Similarly, Mayer and others (2014) find that a prospective change in policy in the US, whereby seriously-delinquent borrowers would be offered mortgage modifications, caused homeowners to strategically default. The largest increase in default rates was observed among borrowers in better economic positions.

15. Individual borrowers are found to default selectively across different forms of debt. For the US, Chan, Haughwout, Hayashi and van der Klaauw (2016) find that declines in home equity are associated with a lower probability of default on credit card and auto loans. This suggests that homeowners make strategic decisions to preserve access to other credit lines in anticipation of defaulting on their mortgage, with the resulting loss of credit secured by their home.

16. Borrowers are also found to act strategically toward weaker banks. In what is termed a "borrower run," debtors' choose to selectively default based on characteristics of the lending bank. Specifically, recognizing that a good track record on loan repayments is only valuable if the bank survives and can issue new loans, borrowers tend to discriminate against weaker banks by selectively defaulting against those banks. However, the likelihood that a bank survives depends on whether other borrowers repay their claims, resulting in an externality that can lead to coordination failure and a borrower run (Bond and Rai (2009) and Trautmann and Vlahu (2013). In Italy, where many firms borrow from multiple banks, firms are found to selectively delay repayments to those banks already weakened by past bad loans (Schiantareli, Stacchini and Strahan (2016). Moreover, they find that the tendency to delay payments to distressed banks occurs in regions where legal enforcement is weaker and recovery times are longer. As many of these loans become permanently impaired, banks then become caught in a vicious cycle of past distress that encourages future losses.

17. Unlike economic default, strategic default is found to be contagious and is spread through social networks. Exposure to other people who have strategically defaulted is found to increase the propensity that the individual will also strategically default. For the US, Guiso, Sapienza and Zingales (2013) find evidence that social contagion is the result of learning, whereby knowing

someone who has strategically defaulted reduces the perceived probability that a bank will pursue a defaulting borrower. Media coverage of strategic defaults may have also played a role. In their empirical study on Greece, Artavanis and Spyridopoulos (2017) find that relocating from an area with low- to high-incidence of strategic default is a strong predictor of strategic default within the next year. In contrast, economic default—while found to cluster, likely reflecting localized economic weakness—is not found to propagate.

18. Additional evidence of the influence of claims enforcement on strategic default behavior is obtained from research on the effect of strengthening enforcement. Visaria (2009) documents that with the introduction in India of debt recovery tribunals that sped up the judicial process, the probability of repayment of overdue loans increased significantly, which he attributes to borrowers' realization that collateral could now be seized more quickly.

19. On the other hand, excessively-strict enforcement may have adverse effects by sweeping up both economic—and strategic—defaulters. Olney (1999) finds that highly-indebted US households in 1930 sought to avoid default on consumer loans used to finance purchases of appliances and cars because, under the punitive laws at that time, repossession would have wiped out any accumulated equity.[12] In response, consumption fell sharply, turning a recession into the Great Depression. A change in the law in 1938 required return to the borrower of any acquired equity, thereby making default less costly. As a result, later recessions saw higher household default rates, while other borrowers rescheduled their loans, both of which helped to limit the severity of the downturn.

Access to Finance

20. Borrowing costs are generally found to increase in the presence of ineffective enforcement. Based on cross-country data, Bae and Goyal (2009) find that stronger enforceability of contracts is associated with lower interest rate spreads. They also find that during the 1997–98 Asian financial crisis, loan spreads widened more in countries with poor enforceability of contracts. Laeven and Majnoni (2003) find that judicial efficiency is a major driver of interest rate spreads across countries.[13]

21. The volume of loans outstanding is inversely associated with weak enforcement and judicial inefficiency. Levine (1998) finds that legal rights of creditors and the effectiveness of enforcement explain over half the cross-country variation in loans outstanding as a ratio to GDP. For India, Chemin (2009) documents causality from slow judicial speed to reduced access to credit, ultimately leading to lower output. Also for India, Gopalan, Mukherjee and Singh (2016) find that lower costs of enforcing debt contracts following the introduction of fast-track debt recovery courts was associated with lengthening the duration of firms' debt contracts. Based on panel data on

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[12] Down payments were large, and contract terms short, so equity was acquired quickly. If an installment payment was 30 days late, the item being purchased could be and often was repossessed. The defaulting household was not compensated for the difference between the net resale value of the good and the remaining payments.

[13] See also Jappelli, Pagano and Bianco (2005) and Djankov and others (2008) for similar findings. Bozavic, Karapandza and Urosevic (2009) apply an option-pricing model to show that a decrease in time to repossess decreases the cost of mortgage insurance.

Italian provinces, Bianco, Jappelli and Pagano (2005) find that where the backlog of pending legal trials is relatively long, credit is less widely available, average interest rates are lower (which they attribute to only low-risk borrowers being able to access credit), and the default rate is higher.

Enforcement During a Crisis

22. During a financial crisis, increased defaults create bottlenecks in formal enforcement that can generate benefits, but also opportunities for borrowers to exploit. Herkenhoff and Ohanian (2015) find that the temporary lengthening of time to foreclose in the US had the unintended, positive consequence of allowing unemployed homeowners time to find a well-paying job that provided them the income to become current on their mortgage, allowing them to remain in their home, rather than losing it to foreclosure, with positive effects on the macroeconomy. On the other hand, Drozd and Serrano-Padial (2017) document that the wave of defaults in the US during the global financial crisis (GFC) significantly lengthened foreclosure times, and delayed the threat of eviction by up to three years. The implicit transfer that borrowers receive as a result of the foreclosure delay incentivized others to default. They construct a theoretical model where contract enforceability is endogenous to the state of the economy. Specifically, borrowers know that when the ex-ante fixed enforcement capacity is fully utilized, additional defaults weaken enforceability, thereby strengthening incentives to default. As a result, one individual's decision to default may influence others' decisions to strategically default, potentially leading to clusters of defaults. Similarly, Chan, Haughwout, Hayashi and van der Klaauw (2016) document that expected delays in the foreclosure process are associated with increased rates of primary mortgage default among US underwater homeowners.

23. This literature points to several recommendations for avoiding or responding to enforcement constraints. Drozd and Serrano-Padial (2017) propose to reduce the adverse effects on aggregate credit supply of overburdened enforcement systems by attempting to prevent more default-prone borrowers from defaulting in the first place, thereby mitigating the snowball effect of clustered defaults. They provide as an example the 2009 US Home Affordable Modification Program, which targeted underwater but not yet defaulted households. Herkenhoff and Ohanian (2015) propose allowing unemployed-and-defaulting homeowners additional time before foreclosure to allow them to find a well-paying job that matches their skills.

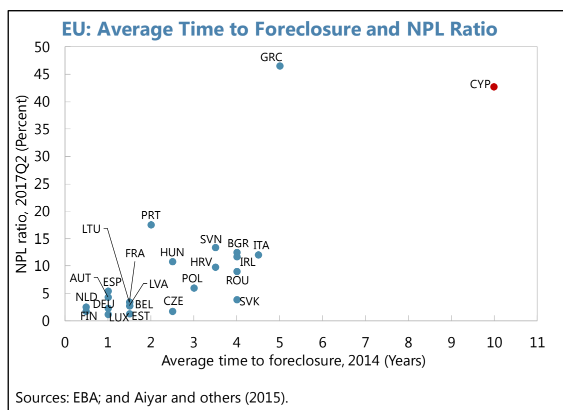
24. Some degree of centralized coordination is likely to be most efficient when responding to a systemic crisis. Pursuing a case-by-case approach would overwhelm courts and could also lead to coordination failures and externalities that impede debt restructuring (Laryea (2010).[14] On the other hand, an across-the-board approach where the authorities determine the method and distribution of burden sharing without regard to a borrower's individual conditions may relieve pressure on over-burdened enforcement resources, but at the cost of large dead-weight losses, moral hazard and damage to long-run credit supply (Andritzky (2014)). The appropriate strategy should weigh the costs of a centralized scheme against the inefficiencies from the potential

[14] For example, if a borrower's claims are dispersed across banks, it may be harder for the borrower to negotiate better terms, and could lead to holdouts and creditor runs.

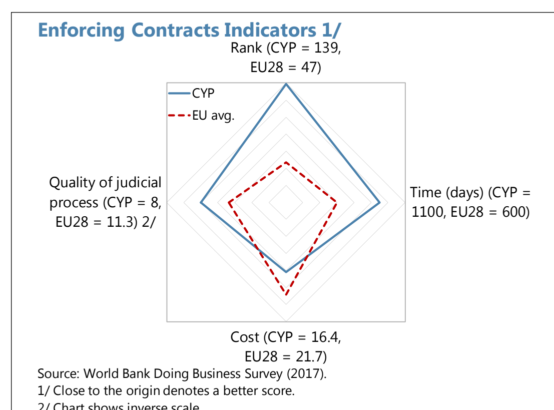
grid-lock created when the number of defaults is much larger than the institutional capacity can handle. Laryea (2010) also suggests establishing incentives through law to catalyze out-of-court restructurings and allow a qualified majority of creditors to be able to bind a dissenting minority to a restructuring agreement. Grigorian and Raei (2013) document that many crisis countries reformed or amended the law to facilitate post-crisis restructuring. In particular, Spain amended the insolvency law with the aim of eliminating legal uncertainty in out-of-court restructurings.

D. Claims Enforcement in Cyprus

25. Claims enforcement in Cyprus is considerably less efficient than in most European Union (EU) countries. Time to resolve a simple commercial dispute through in-court procedures and post-court enforcement (defined as the interval between filing a lawsuit and receipt of payment) was more than 1,200 days for Cyprus as of 2016, according to the World Bank's 2017 *Doing Business* Survey.[15] This was among the highest in the EU, about four times longer than the shortest-duration country, and more than double the EU median of about 500 days. Based on a composite indicator of time to resolve a commercial dispute and secure payment, out-of-pocket (attorney, court and enforcement) costs relative to the value of the claim and the quality of judicial processes, Cyprus ranks lowest within the EU, and below the world-average, on "enforcing contracts." At 10 years, Cyprus also had among the longest average "time to foreclosure" within the EU.[16] However, given the paucity of completed foreclosure cases, this number may not be reliable.



Sources: EBA; and Aiyar and others (2015).



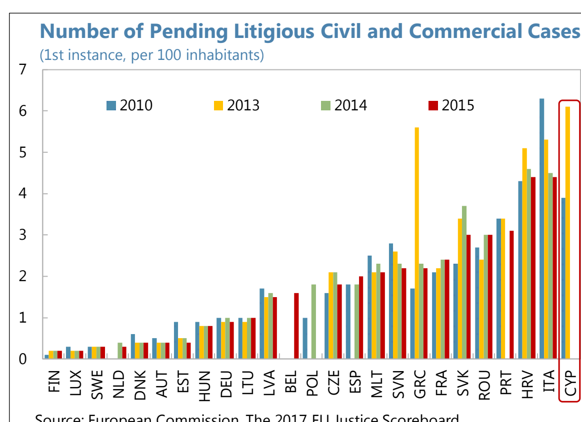
Source: World Bank Doing Business Survey (2017).
1/ Close to the origin denotes a better score.
2/ Chart shows inverse scale.

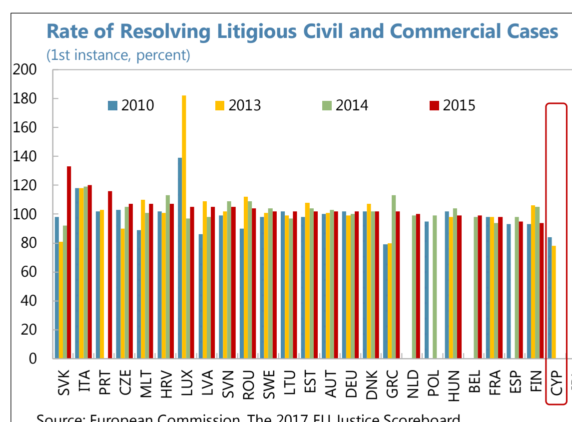
26. The banking crisis, which led to a spike in the number of pending litigious civil and commercial cases, could be a factor in the low enforcement efficiency. According to the EU Justice Scoreboard, the number of pending cases rose by 50 percent (from four to six per one hundred inhabitants) between 2010 and 2013. This was among the sharpest increase (and highest

[15] This refers to regular financial claims that are outside the foreclosure or insolvency processes.

[16] For Cyprus, the duration cited here refers to the pre-reform foreclosure system, and foreclosure is expected to be much speedier after the 2014 reform. Early indications are that some stages are indeed faster than under the previous system (see accompanying Selected Issues paper on reforming the legal framework to support private debt restructuring.)

levels) within the EU. In other countries that experienced banking stress, the number of pending cases quickly fell back. For Cyprus, while data beyond the onset of the crisis is not available, anecdotal evidence indicates that the number of pending court cases has risen further.[17]





27. Although incoming cases did rise, the major factor in the high and growing backlog of court cases appears to be the low, and declining, clearance rate. At around 80 percent, the ratio of resolved court cases to incoming cases is well-below the 100 percent needed to prevent the backlog of cases from expanding. Cyprus's clearance rate is one of the lowest in the EU, and was low even prior to the crisis.

28. As discussed below, ineffective enforcement of commercial claims reflects mostly structural—rather than cyclical—factors.

Civil Procedure

29. Civil Procedure is a Key Contributor to Slow Enforcement of Claims:[18]

- **The main legislation on civil procedure is outdated**. It dates to the colonial period, with some elements going back to the mid-19th century. These rules stipulate entirely paper-based in-court processes, with hand-written ledgers for record keeping and each page of documentary evidence hand-signed by the court clerk.[19]

- **Interim applications are used extensively and cause major delays.** Many elements of the legal process may be challenged by an "interim application," resulting in suspension of the main dispute and rescheduling of the case to a new hearing date, which—because of the heavy court schedule—may be one year later. The court's ruling on the interim application is often also appealed. Both debtors and lawyers (given their fee structures) have incentives to file multiple

[17] Cyprus's statistics on in-court procedures are outdated and insufficient.

[18] Civil procedure is the set of rules by which courts conduct civil trials. Civil trials concern the judicial resolution of claims by one party against another, and are distinguished from "criminal trials," in which the state prosecutes an individual for violation of criminal law.

[19] Cyprus is one of the few EU countries that has no facility for electronic submission of claims, for monitoring proceedings online, or for courts and lawyers to communicate electronically.

applications in order to encourage delays. As a result, interim applications and appeals can lead to exponential growth in the number of system-wide cases, causing protracted delays.

- **Expedited enforcement of small claims is rarely used.** In January 2015, Cyprus enacted a new order to expedite processing of small-claims cases (up to €3,000), with minimal involvement by a judge. However, this process is subject to interim applications, thereby causing the expedited procedure to revert to a regular court procedure. Moreover, the court system operates on a first-come-first served basis, and must therefore first resolve the large number of pending cases filed under the old regime before beginning to hear small claim cases under the expedited procedures. At the current pace, the first case is not expected to be heard prior to 2020.
- **Enforcing a court decision is cumbersome and a source of further delay.** A decision by the court does not provide full title to enforce, and the creditor must return to court to secure a separate court order for each individual enforcement action (e.g., asset seizure, garnishment of a bank account). Further, these applications may be appealed by the debtor, thereby generating their own secondary litigation.
- **Salary and deposit garnishment systems are weak, further undermining claims enforcement.** Cross-country experience indicates that commercial claims in advanced economies are largely recovered through garnishments. The legal framework for garnishment exists in Cyprus, but is cumbersome and ineffective.

Public Data Systems

30. Public information infrastructure is not supportive of claims enforcement. There is no central registry of holders of bank accounts, making it difficult to access information on debtors' deposits. The land registry is cumbersome to search. Moreover, it is not possible to search the registry for the name of close relatives (e.g., spouse or children) to determine if the debtor transferred his property to avoid recovery procedures. The register of companies can only be searched by the company name, making it impossible to discover all the companies in which a debtor owns shares. Gaps and difficulties in search-ability of public records therefore impede discovery of debtors' assets, transforming full-recourse into no-recourse mortgages, and compounding difficulties with enforcement.

Alternative Dispute Settlement

31. Alternative means of dispute resolution (ADR) that take place outside the court system, notably mediation, remain under-utilized. Cyprus enacted a mediation law in 2012. The profession is open to lawyers, members of the Chamber of Commerce (a broad range of professionals, including accountants, bankers and industrialists) and members of the Association of Technical Civil Engineers. The Ministry of Justice maintains a registry of some 40 mediators. Commercial matters (i.e., disputes involving companies) may be heard by any mediator, but for civil matters (i.e., cases between private individuals), the mediator must be a lawyer. There have been no civil mediation cases so far, suggesting lawyers' preference for court-based procedures, which could reflect their lack of familiarity with ADR or attempts to protect their income.

Implications

Willingness to Pursue a Commercial Claim

32. Given the high pecuniary and non-pecuniary costs of claims enforcement, the minimum-value claim that creditors are willing to pursue is relatively high. Fewer Cypriots are likely to pursue a claim of €2,000 than are residents of other EU countries (35 percent in Cyprus against the EU average of 56 percent), according to Eurobarometer 395, which is indicative of the relatively high cost of pursuing the claim. A complementary indicator is the threshold value of a claim where the value at recovery is equal to the cost of enforcement. The higher is the break-even threshold, the more inefficient is claims enforcement. In Cyprus, anecdotal evidence suggests an amount of €3,000 in the case of unsecured commercial claims, which is high relative to other countries This high threshold may reflect that expedited procedures for small claims tend, in practice, to be converted back into regular court proceedings.

Foreclosure and Insolvency

33. Inefficient in-court procedures and ineffective post-court enforcement could have implications for the new insolvency framework and foreclosure procedures. Procedures for the new foreclosure and insolvency laws envisage recourse to courts at key stages, for example, courts issue debt-relief orders and protective certificates for personal repayment plans, appoint examiners, consider appeals by creditors, among others. The foreclosure procedure, designed to speed up enforcement, establishes strict deadlines on various steps, including by when an appeal may be filed (but not on by when it should be resolved). Given the very few insolvency and foreclosure cases that have come to completion under the new laws, the impact of judicial delays has yet to be fully seen.

34. More fundamentally, weak enforcement preserves poor payment discipline as the dominant strategy for many borrowers. Prolonged legal proceedings, challenges with asset discovery and garnishment, and popular distaste of eviction from primary residences—even for wealthier defaulters—render the new foreclosure and insolvency laws less effective as tools to incentivize repayment and provide partial debt relief for over-extended borrowers. The lack of demand for a primary residence protection scheme that provided subsidies to defaulting homeowners is revealing.[20] Similarly, use of the new insolvency tool—which requires full disclosure of all assets—has been very limited. This should not come as a surprise: in the absence of effective enforcement, there is no reason for borrowers to avail themselves of these tools. In fact, only for about one third of NPLs, have banks and borrowers engaged with each other to agree on a restructuring plan.

[20] The scheme, introduced in mid-2016, is open to owners of houses with a market value of up to €250,000 and an outstanding loan of less than €300,000, and entailed a subsidy in support of debt servicing of up to €10,000 per year for three years. While several applications were received, none were deemed eligible because they had not exhausted all debt restructuring procedures with the banks, pursued mediation procedures with the financial ombudsman or used the services on an insolvency practitioner.

E. Recommendations

35. Piecemeal reform of the enforcement framework may have limited success, and a wholesale review is likely needed. Adding updated components may not fit well with the underlying civil procedure. Instead a comprehensive review, with a focus on limiting case suspensions allowed under interim applications and considering an alternative compensation basis for lawyers should be considered. Other recommendations include: (i) remove simple claims disputes from the in-court process to reduce the strain on the courts, and process them through digital platforms; (ii) develop a sound statistical service that generates timely data on number of cases by type, disposition time and clearance rates, and extend it to post-court enforcement procedures and recovery rates; (iii) strengthen enforcement instruments by establishing an electronic system for automatic garnishment and digitizing public asset registries to enhance search-ability; and (iv) introduce a computerized case-management system for the courts and phase out reliance on paper-based record keeping and communication.

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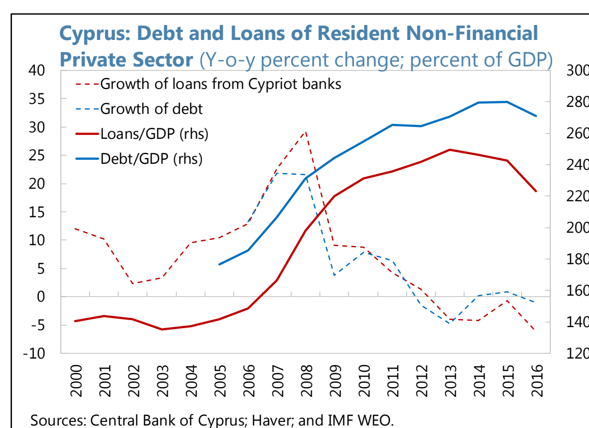
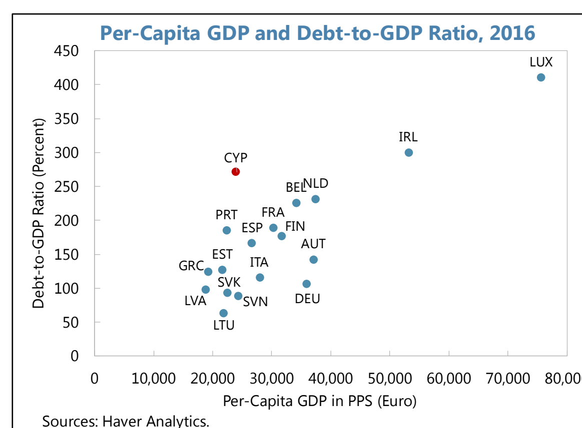
TOO MUCH OF A GOOD THING? CYPRUS'S PRIVATE DEBT AND A PATH TO DELEVERAGING[1]

A. Introduction[2]

1. Cyprus's nonfinancial private sector debt has risen rapidly since the mid-2000s, and despite some decline following the banking crisis, it remains extremely large. The prospect of accession to the European Union in mid-2004 and euro adoption in 2008 triggered an acceleration in domestic bank lending to residents (especially for housing), with growth rates reaching around 25 percent for several years, helping to fuel GDP growth. Loan growth slowed sharply after the global financial crisis (GFC) and turned negative in 2013 following the Cypriot banking crisis, where it has since remained. Nonetheless, loans from Cypriot banks and other debt is a very large 262 percent of GDP, and is among the highest in the EU.





2. This paper considers the appropriate level of private debt for Cyprus, how best to move toward that level, and the possible macroeconomic effects of doing so. It begins with a discussion of the evolution of debt in Cyprus, how it was financed, and the effect on output. It then draws on the literature on the credit cycle and financial deepening to assess the appropriate level of debt, and discusses how other countries that experienced significant aggregate deleveraging achieved debt reduction and the effects that it had on the macroeconomy. The paper concludes by drawing some possible implications for Cyprus.

[1] Prepared by Seung Mo Choi and Rachel van Elkan.

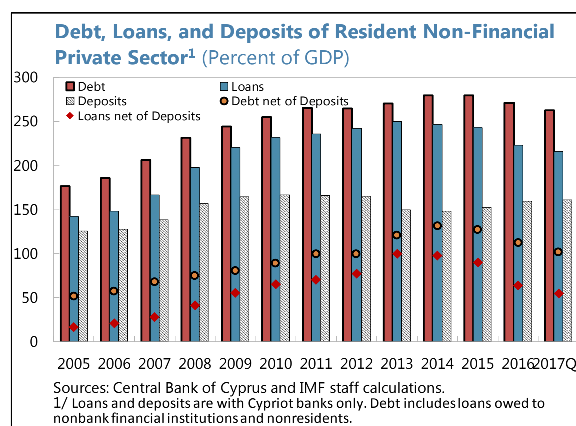
[2] Data on debt are available for the period since 2004, while data on loans and deposits at banks—consistent with ECB statistical standards—are available for the period from end-2005. Bank data from earlier periods may not be fully comparable. Excludes special purpose entities (SPEs).

B. Evolution of Cyprus's Private Debt

3. The nonfinancial private sector is highly indebted. Totaling 259 percent of GDP at Q2:2017, debt of the "indigenous" private sector is owed by households (119 percent of GDP) and nonfinancial corporates (NFCs) (140 percent of GDP).[3] Most household debt and three-quarters of NFC debt consists of loans from domestic banks. Other debt includes mostly loans from other domestic and foreign entities, and nonbank debt has risen to about 15 percent of total debt.[4]

4. The high level of debt partly reflects long standing structural features that encouraged accumulation of debt and deposits. Already by the turn of the century, bank credit was about 1.5 times GDP, where it remained for several years. This very high level of credit was mostly matched by the indigenous sector's deposits, reflecting households' desire to self-insure in the absence of well-developed social safety nets and to supplement mandatory pension contributions to provide for retirement. In addition, tax-deductibility of interest on debt made it more profitable for businesses to place savings in a bank and borrow against them, rather than invest directly in a company in the form of equity.[5] With their savings tied up in deposits, households and corporates "borrowed back" their savings through bank loans, which they used to finance house purchases, business investment and current expenditure. In fact, indigenous deposits increased in tandem with loans, and funded nearly all indigenous credit. Deposits likely acted as a restraint on credit in the aggregate, as well as at the individual-client level because a borrower's deposit was security for his loan.[6]

Debt, Loans, and Deposits of Resident Non-Financial Private Sector[1] (Percent of GDP)



Sources: Central Bank of Cyprus and IMF staff calculations.
1/ Loans and deposits are with Cypriot banks only. Debt includes loans owed to nonbank financial institutions and nonresidents.

5. Fundamental changes brought by closer integration with Europe triggered an acceleration in credit. Membership in the EU's single market for capital and elimination of currency risk following euro adoption reduced risk premia and permanently lowered interest rates, bringing an equilibrium credit deepening. Lower steady-state interest rates also implied higher equilibrium house prices. The transition to this new equilibrium was accompanied by very rapid credit growth,

[3] The indigenous nonfinancial private sector is defined to exclude SPEs, which have (mostly external) debt amounting to 81 percent of GDP, but have a small footprint in the Cypriot economy.

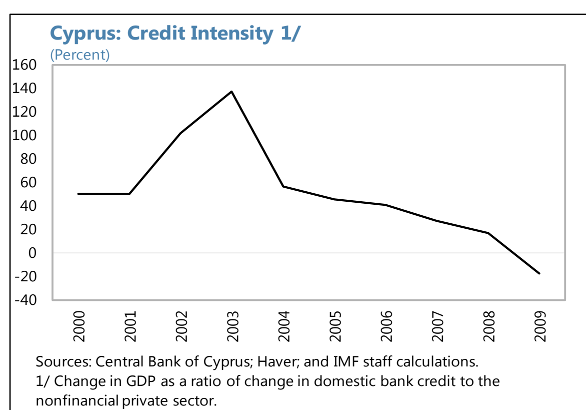
[4] The small size of the domestic capital market reflects the large share of micro-, small- and medium-sized NFCs. As a result, most firms rely heavily on bank funding.

[5] The preferential tax treatment of debt was eliminated in 2016 with the introduction of a "notional interest deduction" on equity. Interest on housing loans was never deductible from personal income tax.

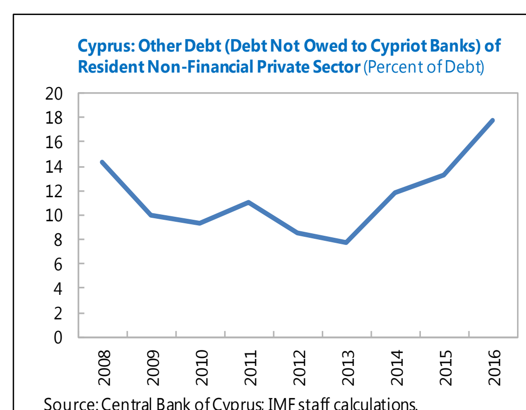
[6] Cypriots' preferences for larger houses may have also contributed to the high level of debt. Among EU members, Cypriots live in the largest dwellings, and those with a mortgage reside in even-larger dwellings.

with greater reliance on external funding and sharply appreciating property prices. This was supported by a decline in the Central Bank of Cyprus's marginal lending rate to banks from 7 percent in June 2001 to just above 4 percent in December 2007, as well as a sharp reduction in reserve requirements on (what were formerly) foreign-currency deposits.[7] Retail lending rates offered by banks also decreased strongly, including on housing loans. Loan-origination standards failed to restrain the credit increase because loan-to-value ceilings encouraged lending to keep up with rising house prices, while the value of collateral—rather than a borrower's ability to service his loan—was sufficient basis for granting a loan.[8] As a result, while loans had been primarily funded by deposits in 2005, after that, the loan-to-deposit ratio steadily increased, reaching almost 150 percent in 2012, reflecting the inflow of foreign funding of banks.[9] Since the onset of the banking crisis in 2013, loans have been on a declining trend, but largely offset by a 20 percentage-points-of-GDP increase in other forms of debt. Total debt as a share of GDP moderated slightly in 2016, but remains very large.

6. The stimulative effect of credit on output was initially very strong, but diminished as credit outstanding increased. Credit intensity of output— the amount of additional output generated per unit increase in bank credit—was initially very large, but then dropped sharply, suggesting that sustaining GDP growth had become increasingly dependent on credit expansion. At the onset of the global financial crisis, GDP growth turned negative, while credit growth remained positive. With the decline in bank credit, nonbank forms of financing have become increasingly important in supporting real activity since 2013, allowing sectors that were previously heavily-dependent on bank credit, including construction, to grow rapidly even though their credit stock is declining (including due to debt-to-asset swaps with banks).[10]



Sources: Central Bank of Cyprus; Haver; and IMF staff calculations.
1/ Change in GDP as a ratio of change in domestic bank credit to the nonfinancial private sector.



Source: Central Bank of Cyprus; IMF staff calculations.

[7] Cyprus's EU accession was formally announced in June 2001.

[8] PIMCO (2013) documents that the banking system relied heavily on collateral in the underwriting of loans, rather than a borrower's ability to meet his debt service payments. The CBC amended credit underwriting standards in 2015 to shift to ability to service the loan.

[9] The loan-to-deposit ratio increased further in 2013, largely as a result of the depositor bail-in. The ECB's Household Finance and Consumption Survey (HFCS) finds that financial assets decreased substantially following the crisis.

[10] Even where fully provisioned, banks do not tend to remove nonperforming loans from their balance sheets. Thus, this has not contributed significantly to the decrease in bank credit outstanding.

C. Perspectives on the Appropriate Level of Debt

7. Although not well-defined in the literature, the appropriate debt-to-GDP ratio is one that is affordable and is not associated with undue financial stability risks. Some approaches focus on credit cycles through time. Other methods explore the fundamental macroeconomic and financial determinants of credit, including feedback loops within the system. While there is no consensus on the methodology for determining the appropriate level of aggregate debt, let alone specific numerical values, these various approaches offer a range of insights.

8. The time-series-based "Basel" approach considers the trend as the equilibrium path for the debt ratio. In work associated with the BIS, deviations—positive or negative—from the long-term trend represent undesirable credit gaps. As Borio and Drehmann (2009) and Borio (2012) suggest, positive gaps beyond certain thresholds help to predict financial distress within the next two years, and thus can serve as an early warning. On the other hand, negative deviations imply unused scope to expand credit in support of output.

9. An alternative method recognizes that macroeconomic fundamentals play a role in determining the equilibrium level of debt. For the core euro-area countries, Schadler, Murgasova and van Elkan (2005) estimate the time-varying long-run credit-to-GDP ratio and the transition path toward that equilibrium in a vector error correction framework where the credit ratio, per-capita income and the long-run real interest rate are simultaneously determined. They find that the half-life of deviations from equilibrium is relatively short, with all variables adjusting simultaneously to restore equilibrium.[11] Albuquerque, Baumann and Krustev (2015) also apply a cointegration framework to the credit ratio in the US. In addition to macroeconomic variables, they find that in the long run, credit is related to the home-ownership rate, the loan-to value ratio and demographics, and that any positive credit gap will be eliminated through some combination of a lower actual credit ratio and an increase in the equilibrium ratio. Lang and Welz (2017) adopt a hybrid approach that combines fundamentals and time-series elements to decompose household credit into unobserved equilibrium and cyclical components, where the equilibrium depends on potential output, the real interest rate, quality of institutions and share of the population in middle age. They find that credit gaps open up about four years prior to a systemic banking crisis (and, similarly, that it takes four years after a crisis for credit to return to a sustainable level), and that peak credit-overshooting is about 20 percent—much less than the gaps typically found for some euro-area countries under the Basel approach.

10. A further strand of the literature points to the diminishing benefits for GDP growth from accumulating debt above some level, resulting in a "debt Laffer curve." At low levels of debt, an increase in debt tends to raise growth. However, beyond some threshold, the marginal effect of additional debt on growth turns negative (i.e., the growth rate decreases) because (i) the cost of servicing the entire stock of debt exceeds the marginal increase in debt, leaving nothing left over to spend on consumption or investment; (ii) heavily-indebted economies are more vulnerable

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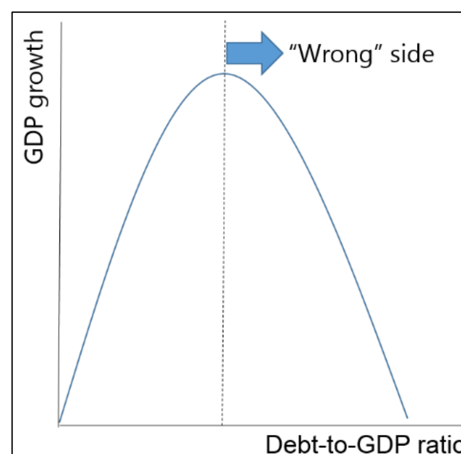
[11] IMF (2017b, Annex 3.1) estimates a single-equation reduced-form model of private-sector credit that is found to depend positively on per-capita income and negatively on interest rates.



to asset-price or interest-rate volatility and boom-bust cycles; and (iii) debt may be drawn into economic activities with weak productivity growth or an excessively-large financial sector may divert human capital and other resources away from activities where, at the margin, they would be more productive (Sahay and others (2015) and Cecchetti and Kharroubi (2012).[12] It is reasonable to expect that debt thresholds depend on numerous factors, which are present to differing degrees in individual countries (Sahay and others (2015) and IMF (2017a). Nonetheless, many studies provide a single (interval) estimate for groups of countries, and these thresholds tend to be considerably below actual credit ratios.[13] Cecchetti, Mohanty and Zampolli (2001) recommend that debt be kept well below the threshold during normal times to leave room to support growth with additional debt in the event of a severe shock.

D. Country Episodes of Private Debt Reduction

11. Historical episodes of private-sector debt reduction yield several key lessons. Private deleveraging (defined as a reduction in the debt-to-GDP ratio) often occurs following financial crises, including in Latin America (1980s), in the Nordic countries and Japan (early 1990s), in Asia (late 1990s), and in Argentina and Turkey (early 2000s). Many instances of declining nonperforming loans relative to total loans have also occurred. The GFC brought a cluster of deleveraging and NPL reduction cases. All told, about 85 separate episodes of private deleveraging and 75 episodes of NPL reduction have been identified (with several countries experiencing multiple episodes) in the literature. These episodes have been studied extensively, and a number of common threads emerge.[14]

12. Most deleveraging and NPL reduction episodes were relatively modest and were achieved over a short period, but a handful were extremely large and required a decade or more. Chen and others (2012) find that the average debt reduction was around 15 percent of GDP, but a handful of episodes exceeded 50 percentage points and topped out at almost 100 percentage points. Time to delever averaged 4½ years, with a maximum of 12 years. Reinhart and Reinhart

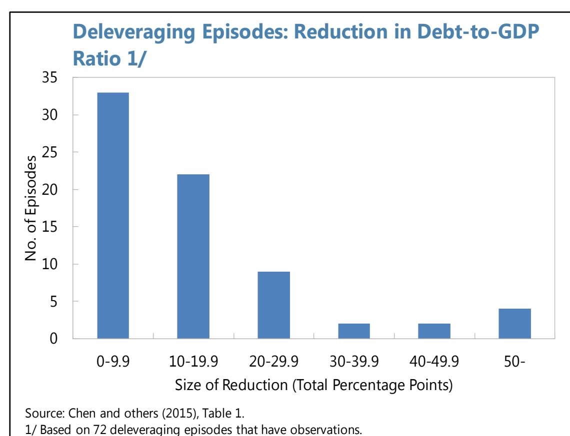
[12] Agenor and Aizenman (2002) document that lower productivity, higher costs of contract enforcement, and more volatile productivity shocks can shift the economy to the "wrong" side of the debt Laffer curve.

[13] For example, Berkes, Panizza and Arcand (2012) suggest that 100–110 percent of GDP is the threshold for non-financial private sector debt. IMF (2017a) finds that for household debt, the threshold is around 55 percent of GDP. Cecchetti, Mohanty and Zampolli (2011) estimate that when NFC debt exceeds 90 percent of GDP and household debt is more than 85 percent of GDP, it can be a drag on growth.

[14] See Reinhart and Reinhart (2010). In addition, Reinhart and Rogoff (2013) consider 396 crises, including banking, currency, sovereign default, and inflation crises, and stock market crashes, from year 1800. Chen and others (2015) identify 83 deleveraging episodes from 1960 to 2012. McKinsey (2010) studies the evolution of a more broadly defined debt, including the one owed by households, NFCs, financial corporates, and the government. For NPL reduction episodes, Balgova, Nies and Plekhanov (2016) identify 73 episodes from 1997 to 2014 in which the NPL ratio fell by more than 7 percentage points.

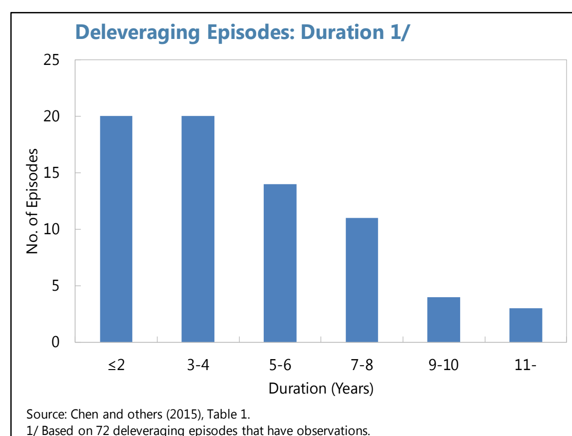
(2010) document that the amount of debt reduction is comparable to the pre-crisis debt build-up, begins 2–3 years after the crisis and lasts about seven years, on average. For NPL reduction episodes, Balgova, Nies and Plekhanov (2016) find an average reduction of 14 percentage points of loans, with a maximum of 44 percentage points, that required five years on average to achieve, with a maximum of 14 years.

Deleveraging Episodes: Reduction in Debt-to-GDP Ratio 1/



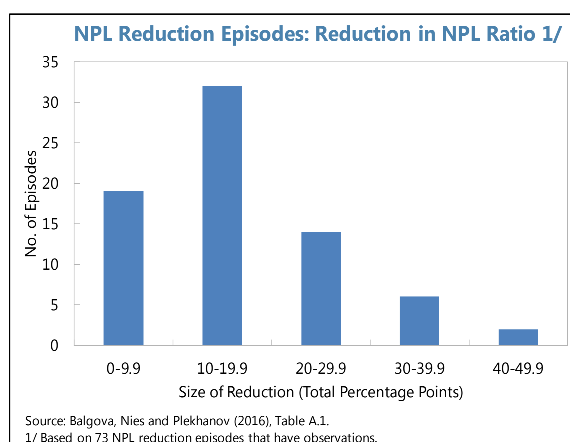
Source: Chen and others (2015), Table 1.
1/ Based on 72 deleveraging episodes that have observations.

Deleveraging Episodes: Duration 1/



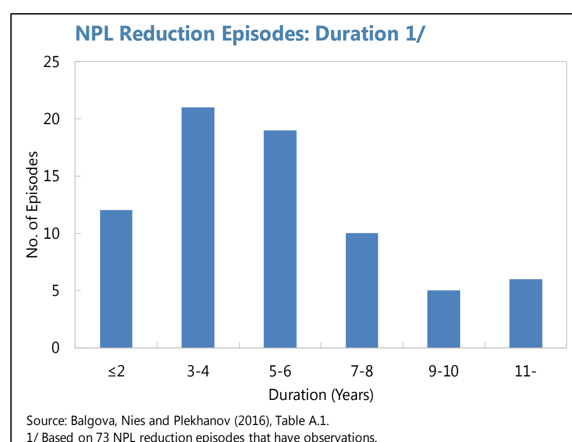
Source: Chen and others (2015), Table 1.
1/ Based on 72 deleveraging episodes that have observations.

NPL Reduction Episodes: Reduction in NPL Ratio 1/



Source: Balgova, Nies and Plekhanov (2016), Table A.1.
1/ Based on 73 NPL reduction episodes that have observations.

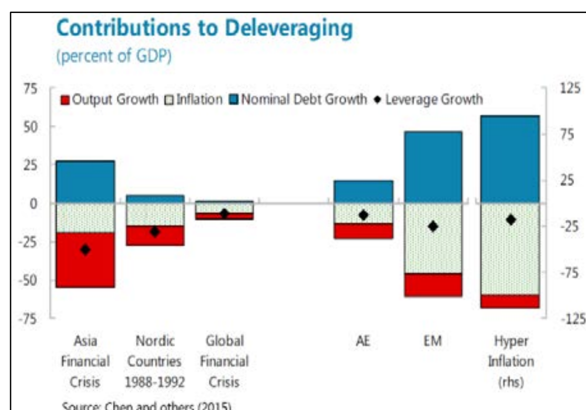
NPL Reduction Episodes: Duration 1/

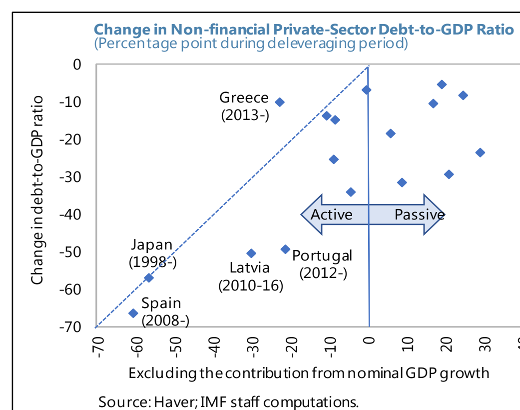


Source: Balgova, Nies and Plekhanov (2016), Table A.1.
1/ Based on 73 NPL reduction episodes that have observations.

13. In a majority of cases, deleveraging was achieved by growing nominal GDP (denominator effect), but where deleveraging was very large, nominal debt reduction also contributed. Chen and others (2015) find that in most instances, nominal GDP was faster than growth of debt (with inflation—rather than real GDP growth—often playing the dominant role), even though nominal debt continued to increase. In only six instances did the level of debt decline for several consecutive years, and those occurred in the 1990s (although their study does not extend to the most-recent post-GFC period). Instead, nominal debt generally increased—but more slowly than nominal GDP growth—so that the denominator effect was dominant. Active reduction in nominal debt—including through higher saving or lower investment, loan forgiveness and debt-to-asset swaps and other balance-sheet operations—has been more common since the GFC in countries that achieved more than a 50-percentage-point reduction in the debt-to-GDP ratio.[15]

[15] For episodes of sizable debt reduction in the 1990s, Pontuch (2014) and Bornhorst and Ruiz-Arranz's (2013) also show that active measures tended to be an important contributor to deleveraging.





14. About half of the NPL reduction episodes relied primarily on the denominator effect by growing the loan book. Balgova, Nies and Plekhanov (2016) find that active and passive NPL reduction episodes share similar starting and terminal NPL ratios, but differ considerably in terms of loan growth. For passive and mixed-strategy cases, loans grew on average by nearly 20 percent per year, and NPLs declined at an annual 15 percent. For active cases, annual loan growth was a much-smaller 5 percent, while NPLs declined by larger 24 percent per year. At the end of the NPL reduction episodes, debt to GDP had decreased only slightly in the active NPL cases, but for passive (and mixed) cases, the debt ratio had risen sharply (to the same level as the active cases). Given the limited increase in debt and the large decline in NPLs in active cases, this implies that much of the NPL reduction was achieved by transforming NPLs into performing loans.

15. Deleveraging and NPL reduction are found to raise future growth rates, particularly under active strategies, but growth is moderately lower during the deleveraging phase. Excessive debt and NPLs can trap resources in unproductive sectors, impairing productivity growth. On the other hand, deleveraging could weigh on domestic demand and output to the extent it is achieved by cutting back on consumption or investment.

- ***Long-term benefits.*** Chen and others (2015) find that more intensive unwinding of a debt overhang is accompanied by economically-sizable gains in GDP growth in the subsequent five years (0.3–0.7 percentage points per year), but do not distinguish between active and passive debt reduction strategies. Extreme reductions in leverage (defined as the top five percent of the distribution) were associated with an even larger support to medium-term growth. They also find that real depreciation or a cut in the policy interest rate is associated with higher future growth following deleveraging episodes. In the context of NPL reduction, Balgova, Nies and Plekhanov (2016) find that an active strategy brings a positive medium-term benefit, increasing growth by more than 2 percentage points per year, on average, while a passive strategy of increasing the loan book brings few growth benefits.[16]

[16] In Balgova, Nies and Plekhanov (2016), active episodes of NPL reduction also correspond to reductions in the debt-to-GDP ratio.

- ***Short-term costs***. Ongoing deleveraging is associated with a contemporaneous dampening of output growth, and, while the effect is generally modest and growth remains positive, it is reasonable to expect a somewhat larger effect under an active (than a passive) deleveraging strategy (Chen and others, 2015). McKinsey (2010) finds that in active ("belt-tightening") episodes of debt reduction, real GDP growth initially slows. Looking at consumption, Albuquerque and Krustev (2015) compare behavior across US states that differed in terms of the extent of deleveraging. They find that where more deleveraging took place, private consumption was lower during the deleveraging episode (2010–2012) by 1–2 percentage points.[17] That the negative effect on private consumption tends to be larger than for output may reflect that net exports were boosted by a real depreciation, as indeed was found to have occurred during several major deleveraging episodes. On contemporaneous growth rates during NPL reduction, Balgova, Nies and Plekhanov (2016) find only a small difference, on average, between active and passive episodes (4.3 versus 4.6 percent per year).

E. Possible Implications for Cyprus

16. Although there is no consensus on the appropriate level of debt for Cyprus, the preceding discussion is suggestive of the need for a sizable debt reduction. After trending upward during the preceding decade, the ratio of gross debt to GDP declined modestly in 2016, moving *below* its long-term trend. However, the estimated trend path has "inherited" much of the past increase, thereby reducing the usefulness of the resulting debt gap as an indicator of the amount—or even the direction—of debt disequilibrium.[18] In fact, numerous indicators suggest that gross debt remains excessive: (i) gross debt is much higher than predicted on the basis of per capita GDP among Cyprus's EU peers; (ii) the stimulus to output from additional debt has been on a declining trend; and (iii) the NPL ratio is extremely high. These factors point to a level of gross debt that may not be affordable and could bring financial vulnerabilities, consistent with debt being on the wrong side of the Laffer curve,[19] although the prevalence of debt defaulters could, in the short run, raise the debt threshold by lowering borrowers' carrying cost of debt.[20] That said, part of the increase in gross debt can be considered an equilibrium financial deepening associated with membership in the EU and euro area.

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[17] See Dynan (2012) for a related study. In addition, Juselius and Drehmann (2015) document that debt service burdens tend to have negative impacts on the US household expenditure.

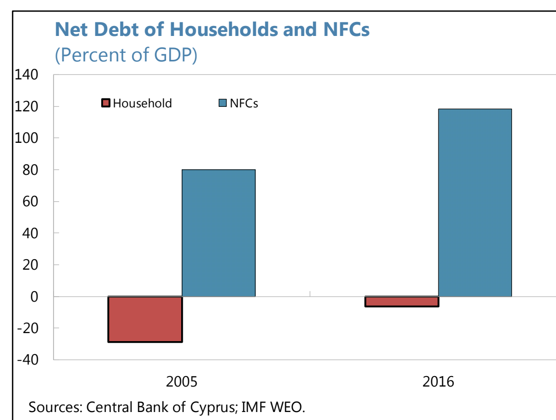
[18] Lang and Welz (2017) note that when a deleveraging phase follows a prolonged credit expansion, an excessively large negative credit gap can seemingly open up under the Basel approach, partly explained by the higher-than-justified estimated statistical trend. Looking at bank credit, they find that seven euro-area countries had negative credit-to-GDP gaps (i.e., insufficient credit) of between -30 and -50 percent as of Q3:2016, with Cyprus at -40 percentage points.

[19] Pontuch (2014) reports the debt reduction need for Cyprus at around 75 percentage points of GDP as of 2013.

[20] Default on debt reduces the borrower's cost of servicing debt, thereby raising the threshold where further increases in debt reduce growth, while also causing GDP growth to peak at a higher rate. However, not servicing debt adversely affects banking-sector profitability, building up financial sector risks, and thus lowering the threshold over the longer run. See the accompanying Selected Issues paper "Economic Effects of Weak Claims Enforcement—International Evidence and Implications for Cyprus."

17. While the literature focuses on gross debt, Cypriots' large financial assets should also be considered. Wealth is unaffected by an equal increase in financial assets and liabilities.[21] This is consistent with the tendency for Cypriots to borrow back part of their financial savings, instead of spending them directly. In fact, possessing liquid assets—with a matching amount of debt—provides greater flexibility than would an equivalent amount of wealth but no liquid assets or debt in the context of imperfect capital markets.

18. Net debt—defined as gross debt minus deposits—while much smaller than gross debt, is still large at 100 percent of GDP. After rising from 75 percent of GDP in 2008, net debt peaked at 130 percent of GDP in 2014, and has since moderated. From a sectoral perspective, NFCs increased their net debt position, while households reduced their financial net worth. The current level of net debt is not far from numerous cross-country empirical estimates of the threshold where (gross) debt begins to detract from GDP growth, which many authors identify as being somewhat in excess of 100 percent of GDP.

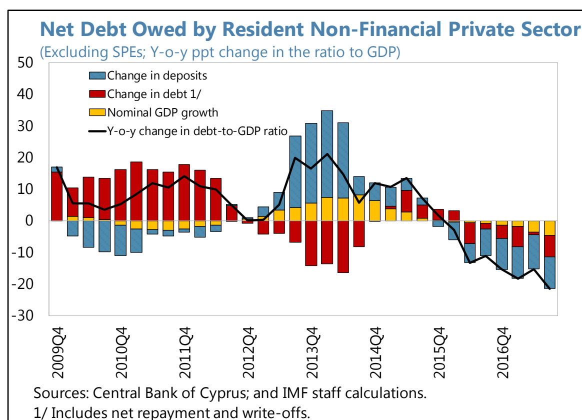


Sources: Central Bank of Cyprus; IMF WEO.

19. While the previous increase in net debt partly reflects equilibrium financial deepening, a portion of the increase is likely excessive. As discussed above, structural changes brought by EU accession and euro adoption—permanently lower interest rates and elimination of intra-euro area currency risk—justify some financial deepening. These factors were already having their effect by mid-2006, and further increases in net debt beyond that time likely reflect unsustainable exuberance. This implies that the remaining net debt gap is around 40 percent of GDP. If, however, the distribution of (the increase in) debt is different from that of (the increase in) deposits, such that some entities saw a much larger increase in net indebtedness, the remaining aggregate debt gap could be larger.

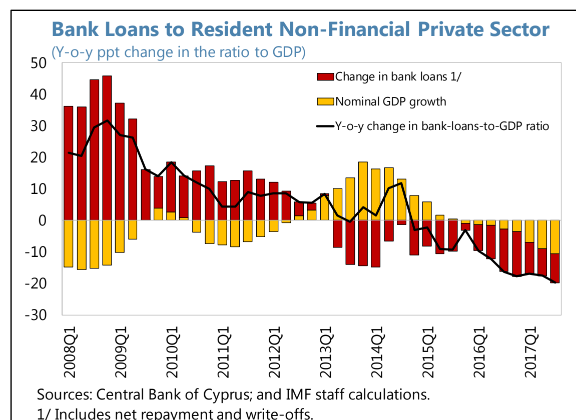
20. Active strategies should continue to be the main contributor to deleveraging. While robust GDP growth has helped to lower the gross debt ratio through the denominator effect, GDP growth has been much less effective at reducing the net debt ratio because gross debt and deposits are both sizable (so their difference is relatively small). Growing out of excessive net debt by raising the denominator could therefore be a slow process. Active measures could include debt-asset swaps, some burden-sharing on debt, as well as foregoing some consumption and investment to reduce debt and/or accumulate deposits. This latter channel would raise the saving-investment balance (supported by higher real interest rates and a real depreciation as inflation moderates in the context of fixed nominal interest and exchange rates), thereby reducing net international liabilities and cushioning the effect of weaker domestic demand through stronger external demand.

[21] Cuerpo and others (2014) and Pontuch (2014) suggest that the debt-to-asset ratio should be stationary for debt to be sustainable.



Net Debt Owed by Resident Non-Financial Private Sector
(Excluding SPEs; Y-o-y ppt change in the ratio to GDP)

Sources: Central Bank of Cyprus; and IMF staff calculations.
1/ Includes net repayment and write-offs.



Bank Loans to Resident Non-Financial Private Sector
(Y-o-y ppt change in the ratio to GDP)

Sources: Central Bank of Cyprus; and IMF staff calculations.
1/ Includes net repayment and write-offs.

21. Active measures would also help lower the NPL ratio. With gross and net debt already high, reducing the NPL ratio by expanding debt would be counterproductive, and the active measures mentioned above should be used. In addition, sustainably curing NPLs would also reduce the NPL ratio without the need to increase the stock of loans.

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REFORMING THE LEGAL FRAMEWORK TO SUPPORT PRIVATE DEBT RESTRUCTURING[1]

A. Background

1. Cyprus was ill-prepared to deal with massive increase in NPLs that followed the collapse of the credit and property boom. As of end-2013, private sector debt in Cyprus was one of the highest in Europe, and nonperforming loans (NPLs) in Cypriot banks reached unprecedented levels: NPLs in the domestic banking sector stood at 50 percent of total loans (or 135 percent of GDP).[2]

2. The legal framework for private debt restructuring could not cope with the massive increase in loans defaults. Major shortcomings had to be remedied in order to incentivize banks and borrowers to voluntarily restructure or otherwise resolve distressed debt. In addition, several Cyprus-specific structural issues complicated debt restructuring even further and had to be addressed. Those included the prevalence of secured credit combined with excessive use of personal guarantees (banks often relied primarily on real estate collateral without adequately assessing repayment capacity of either the debtor or the loan guarantor), irregularities with the issuance and transfer of title deeds[3] resulting in divergence between legal and economic ownership, and growing delays in court procedures.

3. This paper discusses the reform of the legal framework for private debt restructuring in Cyprus and early experiences with the implementation of the new legislation.[4] It focuses on foreclosure and personal insolvency reform, while also briefly touching on other measures adopted to facilitate NPL resolution.[5] The remainder of the paper is structured as follows. Section B discusses the development and implementation of a comprehensive strategy for reform of the legal framework for private debt restructuring. Section C reviews initial experiences with the implementation of the new framework. Section D concludes with recommendations.

[1] Prepared by Nadia Rendak (LEG).

[2] Some loans that may have been already non-performing were not captured as such by the loan classification used at that time by the Central Bank of Cyprus.

[3] A "title deed" is a document evidencing ownership of the property.

[4] These reforms were implemented in the context of the economic adjustment program supported by the IMF and European institutions. Reports on the first through ninth reviews under the IMF Extended Arrangement for Cyprus cover selected developments and are available at: www.imf.org.

[5] The accompanying Selected Issues paper on E*conomic Effects of Weak Claims Enforcement—International Evidence and Implications for Cyprus* discusses challenges with enforcement of claims in Cyprus and its impact on NPL resolution.

B. Designing and Implementing the Reform

4. Before the crisis, the legal and institutional systems in Cyprus appeared to adequately support the growing economy. Cyprus is a mixed-law system with a strong common-law influence. Much of the legislation is still based on mid-last century English law, while selected areas reflect influences from other systems and, following accession to the EU, the law of the European Union. The courts follow precedent case law developments in the UK and other Commonwealth jurisdictions.[6] The judiciary in Cyprus generally holds a reputation for high quality and integrity. Indeed, the solid legal system, combined with a strong professional services industry and a favorable tax regime, had contributed to the success of Cyprus as a regional business and financial center. However, tensions in the legal and institutional frameworks started to emerge in the run up to the crisis: for example, procedures for the issuance of title deeds for immovable property had not kept up with the construction boom of the early-mid 2000s, and delays in court proceedings were on the rise.

5. The crisis put the legal system and institutions under strain and exposed the underlying weaknesses. While the system functioned relatively well in benign conditions, weaknesses became apparent as households and companies failed to meet their contractual obligations, putting banks under stress. In particular, it became obvious that the existing laws and procedures for debt enforcement and debt restructuring were inadequate: the enforcement regime was weak and slow, foreclosure took years, and insolvency laws were outdated. Procedures for issuance and transfer of title deeds became a major stumbling block as some of the largest real-estate developers collapsed, "trapping" buyers—who borrowed to buy their properties—in houses or apartments to which they had no legal ownership rights (see Box 1). [7] Substantial delays in processing cases through the courts made resolution of commercial disputes lengthy and inefficient. As a result, payment discipline was weak, strategic defaults were on the rise, and incentives for the parties to renegotiate debt were absent.[8]

6. Early actions to deal with NPLs focused on promoting voluntary negotiations. In 2013, the Central Bank of Cyprus (CBC) adopted the Directive on Arrears Management that included a Code of Conduct for banks. Modeled after a similar code in Ireland, the Directive required banks to offer troubled borrowers customized restructuring solutions and provided banks with guidance on engaging with borrowers and multi-creditor coordination. Consideration was also given to expanding the role of the Financial Ombudsman in facilitating negotiations between debtors and creditors. At the same time, the authorities undertook a review of the corporate and household debt restructuring framework to identify impediments to debt restructuring and measures to address them.

7. The review revealed substantial gaps in the legal framework. In particular:

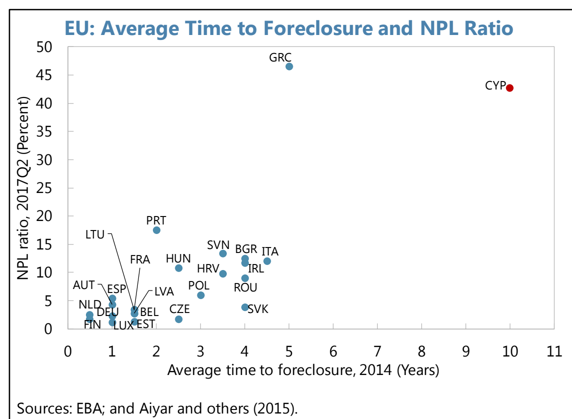
- **The foreclosure process** was not effective (foreclosure could take up to 20 years), encouraging potentially fraudulent behavior, undermining payment discipline and reducing incentives for debt restructuring.

[6] See S. Symeonides (2003).

[7] As of March 2015, there were around 30,000 "trapped buyers" without title deeds.

[8] See M. Clerides et al. (2017).

- **The corporate and personal insolvency regimes were outdated**. Cyprus lacked procedures to restructure viable companies, liquidation of non-viable firms was slow and inefficient, and there were no procedures for individual debtors to restructure their debt as an alternative to bankruptcy.



Sources: EBA; and Aiyar and others (2015).

- **The institutional framework** to support debt restructuring and NPL resolution was weak: insolvency professionals (IPs) were unregulated (opening the possibility of abuse and excessive fees) and courts were slow and inefficient, partly due to civil procedure rules being out-of-date.

Box 1. Title Deeds and Debt Restructuring in Cyprus

There are significant delays in issuance and transfer of title deeds in Cyprus. Over time, procedural impediments and high costs of issuance of title deeds for immovable property have led to an increasing discrepancy between the economic ownership and the formal possession of titles. Ideally, once construction of individual units is completed, separate title deeds would be issued and transferred to the buyers. However, for a large number of transactions, this has not happened. Due to delays with the issuance and transfer of titles (it can take up to 10 years to get a title deed in Cyprus), thousands of homeowners currently reside in houses/apartments that they do not legally own even though they may have paid the purchase price in full and fulfilled other obligations under the purchase contract, making them "trapped buyers".

The disconnect between economic and legal ownership complicates debt restructuring by creating potential conflicts between multiple debtors in foreclosure and insolvency procedures. For example, if the developer defaults on a bank loan that financed the development (or if there is an insolvency proceeding against the developer), and if title deeds for individual units have not been issued and transferred to buyers, the developer's bank can foreclose on the individual units and evict persons residing in those units, while it would be difficult for the buyer to claim back the purchase price from the developer. At the same time, the buyer continues to be liable to his lender for the repayment of his home-purchase loan. This situation creates disincentives for all parties to act: the risk of foreclosure undermines incentives for the buyer to continue to service his home loan; it is also difficult, if not impossible, for the bank to foreclose or take any other action against the developer. The desire to protect "trapped buyers" prompted the inclusion of special provisions in the foreclosure law (see Box 2).

Steps have been taken to address the problem but it is not fully resolved. A law adopted in 2011 ('The Sale of Immovable Property (Specific Performance)' Law of 2011) provided some protections to buyers whose sales contracts pre-dated the law but these protections have limited value in the event of a foreclosure by the developer's lender. A Law adopted in September 2015 ('Transfer and Mortgages of Real Property' (Amending) Law of 2015, also referred to as the "trapped buyers law") seeks to facilitate title transfers in legacy cases by allowing the lifting of the encumbrances resulting from a developer's mortgages and transfer of title to a buyer who has paid the purchase price for the property. In those cases, the law allows the corresponding encumbrance to be transferred to other of the developer's properties or, if the developer has no other property, to the property of the guarantors, directors, or shareholders of the developer. To avoid the re-emergence of the "trapped buyers" problem in the future, the authorities committed to develop solutions that would incentivize swift and timely transfers of titles in a property sale.

8. Given the magnitude of the gaps, addressing them through incremental changes was not an option. Thus, the authorities decided to tackle them through a comprehensive reform strategy, in line with relevant international best practices. The strategy, prepared by an interagency team, in cooperation with international experts, was adopted by the Council of Ministers in July 2014. It envisaged (i) strengthening the foreclosure regime, (ii) a comprehensive reform of the corporate and personal insolvency regime, and (iii) institutional reform to support the new insolvency framework. The urgency of addressing exceptionally-high NPLs limited room for experimentation and pointed towards reliance on tested solutions. Accordingly, it was decided to model the new insolvency regime on that of Ireland, a country with a similar legal system and relative success in implementing a major personal insolvency reform in 2012.[9]

9. The reforms were designed to balance the interests of creditors and debtors and were carefully coordinated but still proved difficult. In particular, the reform of the foreclosure regime was key to incentivize restructurings by strengthening enforcement, while the new insolvency legislation would provide tools to borrowers to restructure their debt while protecting, to the extent possible, their primary residence. The introduction of an automatic debt discharge for individual debtors after three years would also make the personal bankruptcy regime more debtor-friendly. To reflect this balance, the coming into effect of the new foreclosure law with regard to primary residences was timed to coincide with the adoption of the new personal insolvency legislation. This coordination, however, did not help to ease tensions, resulting in a protracted legislative process and the introduction of last minute amendments to the foreclosure and insolvency laws that risk undermining their effectiveness. The rest of this section describes the implementation of the reform, focusing on foreclosure and personal bankruptcy and insolvency, and touching briefly on other measures that were adopted to facilitate NPL resolution.

Foreclosure Reform

10. Foreclosure in Cyprus was slow and inefficient. *The Immovable Property (Transfer and Mortgage) Law of 1965* (the "1965 Law") and related Sales Regulations governed the creation, transfer and enforcement of mortgages. While a secured creditor could initiate foreclosure directly through Department of Land and Surveys (DLS) or through court, the collateral had to be sold in a public auction conducted by the DLS. There were long delays in the foreclosure process due, inter alia, to slow property valuations and the high workload of the DLS. Moreover, foreclosure was socially unacceptable, partly due to Cypriot's deep attachment to their land and homes, especially following large-scale displacements during the 1974 conflict. (If auctions were conducted in a small town or village, social pressure often prevented potential buyers from bidding on the property.)

11. Strengthening the foreclosure process was critical to advance debt deleveraging and NPL resolution. As foreclosure was not perceived as a credible enforcement tool, borrowers did not have incentives to pursue voluntary debt restructuring or use the insolvency system. This encouraged strategic behavior by borrowers, eroding payment discipline, and depriving banks of an effective collection mechanism.

[9] The UK insolvency regime was also an influence, in particular for bankruptcy and company liquidation.

12. Against this background, the foreclosure procedure was enhanced to establish a transparent and swift creditor-led process without the involvement of government agencies, with adequate safeguards for all parties. Under the new rules, a secured creditor could initiate foreclosure by sending a notice to the debtor if the debtor remained in default on the mortgage loan for more than 120 days. If the default was not cured within the period specified in the first notice, the second notice could follow informing the debtor that the property would be sold by auction on a specified date and time. The parties could retain independent appraisers to estimate the market valuation of the property, and the law provided a mechanism for reconciling diverging valuations. While the property must initially be sold by public auction with a specified reserve price (80 percent of valuation for the first auction, reduced to 50 percent after 12 months), other sale modalities (e.g., private sale) were allowed if the auction failed. If the property was not sold after 12 months, the secured creditor could buy it at the re-assessed market value. Importantly, the law envisaged that the new procedure could be used for cases initiated prior to the effective date of the law, to facilitate clearance of the backlog of foreclosures at the DLS.[10]

13. While the importance of an effective foreclosure regime was recognized, concerns about the potential impact of mass foreclosures complicated the legislative process. The amendments to the foreclosure law proved controversial: following adoption in September 2014, the new law was repeatedly suspended, and several debtor-friendly provisions were introduced (see Box 2). Moreover, an amendment to the Central Bank law was passed requiring the CBC to report quarterly to Parliament on the use of foreclosure by banks, signaling the intention of legislators to closely monitor developments. It took until mid-2015 to adopt the necessary implementing regulations (e.g., establish procedures for the selection and remuneration of auctioneers, designate auction venues, design auctions rules).

Reform of the Personal Insolvency Regime

14. Given a large share of household debt in NPLs, Cyprus needed a modern personal insolvency regime that could adequately support private debt deleveraging and NPL resolution. The reform had two key objectives: to enhance the existing bankruptcy regime and to introduce alternative solutions to bankruptcy. These reforms were important beyond dealing with NPLs: an effective personal bankruptcy regime that provides a "second chance" to debtors encourages risk taking and promotes entrepreneurship, which contribute to productivity and economic growth. Many European countries have recently reformed their insolvency regimes to address household debt distress, paying special attention to mortgages over primary residences.[11]

[10] Reportedly, as of early 2014, around 6,000 foreclosure applications were pending at the DLS.

[11] See: Liu, Y., and C. Rosenberg (2013).

Box 2. Debtor and Primary-Residence Protections in Foreclosure and Insolvency

Some of the provisions included in the Cypriot reforms, while reflecting specific national considerations, are not in line with cross-country practice, and may undermine incentives for debt restructuring and the effectiveness of the new legal frameworks. For example:

- Individual debtors with insufficient repayment capacity ("nonviable debtors") can apply to court for suspension of enforcement, foreclosure or bankruptcy proceedings for up to six months, if the debtor's financial difficulties are considered to be due to the financial crisis. Once granted, the suspension is subject to periodic reviews and, possibly, further extensions. (Personal Insolvency Law)

- The creditor cannot start any foreclosure or other court proceedings against the debtor unless and until the mediation procedure is completed, unless the debtor fails to request the Financial Ombudsman to appoint a mediator within a specified deadline. (Financial Ombudsman Law (2014 amendment))

- If a bank sells the mortgage to a third party (individually or packaged with other loans), the debtor retains certain rights vis-à-vis such third party (e.g., the right to request mediation under the Financial Ombudsman). (The Sales of Loans Law)

- Properties of "trapped buyers" where at least 80 percent of the purchase price was paid are shielded from foreclosure indefinitely. (Foreclosure Law)

In addition, the following specific protections for the primary residence were included:

- The debtor has a preferential right to buy the mortgaged property that is the debtor's primary residence (with no upper limit on the value of the property) at the price equal to the highest bid offered at the foreclosure auction. This new rule seems to apply to any auction or sale at any stage of the foreclosure procedure, and allows the secured creditor to retain the mortgage as security for any deficiency claim, while prohibiting enforcement actions for two years. (Foreclosure Law, as amended in May 2015).

- The law limits the ability of the creditor to sell a guarantor's primary residence in recourse to the guaranteed liability for pre-existing guarantees.

Modernizing the Personal Bankruptcy Regime

15. Cyprus already had a personal bankruptcy regime, but it was out of date. The legal framework for personal bankruptcy was based on the 1931 Bankruptcy Law and related rules and regulations, with subsequent amendments. The bankruptcy procedures, administered by the office of the Official Receiver (who was part of the Bankruptcies and Liquidations Section under the Ministry of Energy, Commerce, Industry and Tourism), were lengthy and inefficient and did not provide for a "fresh start" for the debtor at the end of the process. As a result, bankruptcy was a protracted process with limited distributions to creditors and limited incentives for debtors to cooperate. Not surprisingly, less than 2 percent of debtors exited bankruptcy during the five years preceding the reform.

16. Amendments to the Bankruptcy Law strengthened the personal bankruptcy regime in two key areas:[12]

- Debtors would be *automatically discharged* from remaining pre-bankruptcy debt after 3 years. [13]To ensure that discharge is available only to honest debtors, the law required debtors to fully disclose their financial situation, to act in good faith, and to cooperate during the bankruptcy process. If the debtor failed to comply with its obligations, the discharge period could be extended up to eight years or revoked altogether. The most egregious offences were subject to criminal penalties.

- The bankruptcy procedure was *made more efficient*. The process by which the Official Receiver could realize debtor's assets was simplified, the scope of non-dischargeable debt and exempt assets was clarified, and the procedure of proof of debt claims and the fee structure for bankruptcy managers was updated. Secured property—previously excluded from the bankruptcy process—was included. The amendments also established a link between bankruptcy and the new personal insolvency procedures and incorporated into the bankruptcy process the guidelines on reasonable living expenses adopted in the context of the new personal insolvency regime.

Introducing a New Personal Insolvency Regime

17. Prior to the reform, insolvent debtors in Cyprus had virtually no alternatives to bankruptcy. The new personal insolvency law, modeled after the Irish Personal Insolvency Act of 2012, sought to change this by introducing new solutions for borrowers—(i) debt relief orders (DRO) offering speedy debt relief for debtors with little income or assets from unsecured debt of up to €25,000 and (ii) personal repayment plans (PRP) providing debt restructuring for debtors with some capacity to repay, allowing the debtor to return to solvency within five years, while allowing him to maintain a reasonable standard of living during the repayment period and, where possible, to keep his primary residence (see Box 3).[14, 15]

[12] Bankruptcy (Amending) Law, adopted April 18, 2015.

[13] There are no international best practices in the area of personal insolvency, although some common trends have emerged. The discharge period in bankruptcy varies across countries, e.g., from one year in the UK and Ireland to longer periods in other countries. The European Commission recently proposed a maximum period of 3 years for the discharge of individual entrepreneurs (see EC, Proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures (11/22/2016), COM (2016) 723 final.

[14] The Insolvency of Natural Persons (Personal Repayment Schemes and Debt Relief Order) Law of 2015 adopted on April 18, 2015.

[15] On the personal insolvency reform in Ireland, see, e.g. Appendix I of Selected Issues paper "United States Foreclosure Crisis: Can Modification of the Personal Bankruptcy Framework Facilitate Residential Mortgage Restructuring", IMF Report No. 12/214 August 2012; J. Spooner (2012).

Box 3. Debt Relief Orders and Personal Repayment Plans

The DRO procedure is initiated by the debtor by filing an application with the Insolvency Service, which assesses the application and accompanying financial disclosure by the debtor and submits the application to a court. Once issued by the court, the DRO has an effect of discharging the debtor from his obligations covered by the DRO and any guarantees provided to third parties. All DROs are entered into a register maintained by the Insolvency Service and remain in the register for one year.

The PRP procedure is also initiated by the debtor through the Insolvency Service, which appoints an IP to assist the debtor in preparing a repayment plan. The Insolvency Service applies to the court for a temporary protective certificate that stops legal action against the debtor, while the IP develops a debt restructuring proposal. The terms of a PRP are negotiated by the IP with creditors but the plan must meet the so called "liquidation test", i.e., creditors shall receive at least as much under the plan as they would have received if the debtor's estate was liquidated in bankruptcy proceedings.

Generally, a PRP becomes binding on all creditors once it is approved by the required majority of creditors and confirmed by the court. However, the law allows the court in certain cases to impose a plan rejected by creditors (a "non-consensual PRP"). This procedure allows the debtor to restructure inter alia the mortgage over his primary residence by writing it down to the current market value of the property. (A secured creditor whose claim is written- down is protected by a "claw-back" provision that entitles the creditor to receive the difference between the written-down value of his secured claim and the (higher) price at which the property is sold within 10 years from the effective date of the plan.)

The introduction of non-consensual PRPs was prompted by the disappointment with a slow pace of debt restructurings and unwillingness of banks to offer sustainable restructuring solutions to borrowers. However, due to concerns about the possible impact of these plans on banks and moral hazard the law restricted the availability of non-consensual PRPs by setting limits on the market value of the primary residence and overall assets (excluding the primary residence) and debt levels of eligible debtors, and by making the provisions on non-consensual PRPs expire in three years. In addition, to ensure that all assets of the debtor are used to maximize repayments to creditors the law established specific rules for the treatment of debtor's assets other than the primary residence under the plan: for example, to the extent necessary for the plan to meet the liquidation test, the debtor must sell his liquid and luxury assets and other unencumbered immovable property the value of which exceeds a specified threshold. Restructuring mechanisms similar to non-concessional PRP are available only in a few countries. The introduction of non-consensual PRPs in Cyprus's personal insolvency regime therefore represents a novel development in addressing residential mortgage distress.[1]

Once the PRP is effective, it can be modified if the debtor's financial situation changes. Upon successful completion of the plan, the debtor is discharged of the remaining unsecured debts, while he remains liable for secured debt obligations on the new terms.

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[1] These countries include Norway and Ireland, where a similar provision was introduced in 2015, three years after the adoption of the 2012 Personal Insolvency Act, reflecting limited cooperation by banks in the restructuring process. Other countries, e.g., the Unites States, allow cram-down with regard to secured claims other than the mortgage over the primary residence, while in many countries mortgages and other secured claims generally remain outside of the insolvency framework. (See IMF Country Report No. 12/214.)

18. A distinctive feature of the Cypriot personal insolvency regime is the treatment of the primary residence and guarantors. Protection of the primary residence is a key objective of the law, which requires the IP, "insofar as reasonably practicable", to formulate a repayment plan that allows the debtor to keep his primary residence. However, given the sensitivity of the issue, and to balance the strengthened foreclosure procedure, additional protections for primary residences were included in the insolvency and foreclosure laws during the legislative process (see Box 2). As a result,

while Cyprus had not introduced a formal moratorium on foreclosure (unlike some countries, e.g., Greece, Ireland), these provisions taken together have contributed to the perception of a blanket protection for the primary residences, undermining incentives for debtors to engage with creditors, including through the new insolvency framework, and encouraging strategic default behavior. In addition, the wide-spread use of personal guarantees in Cyprus prompted inclusion in the insolvency laws of special protections for guarantors (see Box 4).

Box 4. Special Protections for Guarantors in the Insolvency Procedures

In the run-up to the crisis, banks in Cyprus excessively used personal guarantees, while often not adequately assessing the payment capacity of guarantors. Even secured claims were often backed by a personal guarantee, or even multiple guarantees. The widespread use of guarantees raised a concern in the aftermath of the crisis that enforcement of guarantees may trigger mass insolvencies among guarantors due to the deterioration of their financial situation, with a ripple effect on the economy and a negative social impact. Mass insolvencies among guarantors could in turn lead to further increases in NPLs.

These concerns prompted the introduction of special protections for guarantors. General protections for guarantors in the personal insolvency process include enhanced disclosure obligations, limiting the obligations of the guarantor to the difference between the estimated market value of the collateral and the outstanding amount of the debt, limiting recourse by creditor to the guarantor to 2 years following approval of the debtor's PRP, and by the guarantor to the debtor and other guarantor(s) to 3 years following the payment by the guarantor to the creditors. Additional protections apply to *pre-existing guarantees,* for example allowing guarantors to make payments in monthly instalments, taking into account the guarantor's reasonable living expenses and their own debt obligations, limiting the interest rate on such monthly payments, and a 3-year prohibition on foreclosure against the guarantor's primary residence in recourse to the liability under the guarantee. Moreover, for pre-existing guarantees *on loans that were already non-performing at the time the Law came into force*, a creditor cannot take legal action against the guarantor if the guarantor's net worth (excluding the primary residence) does not exceed €750,000 and if the guaranteed debt secured by a mortgage over debtor's primary residence, at the time of the issuance of the guarantee or at the time the Law comes into force, did not exceed €250.000. Similar protections, with some variations, were included in the laws amending the Bankruptcy Law and introducing examinership.

Similar protections for guarantors are typically not found in the laws of other countries. Although some of the provisions are limited to pre-existing guarantees and/or have a sunset clause, limiting the liability of guarantors without due regard to their ability to pay raised concerns about moral hazard, undermining the value of personal guarantees as a financial instrument, and limiting repayments to banks.

A Coordinated Mechanism for Micro-SMEs and Their Owners

19. The new personal insolvency law established a specific mechanism to restructure debt of a person who is also a micro-SME owner. Addressing SME debt restructuring was particularly important in Cyprus given that SMEs make up around 90 percent of companies in Cyprus, with nearly 96 percent of those being Cypriot micro-SMEs.[16] As assets and liabilities of SME owners and

[16] SMEs are defined by the European Commission as enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding 50 million euro, and/or an annual balance sheet total not exceeding 43 million euro. Micro-SMEs are companies with less than 10 employees and with the annual turnover and an annual balance sheet total not exceeding 2 million euro. See European Commission Recommendation 2003/361. The Cypriot Personal Insolvency Law defines a "micro-enterprise" as a company which employs less than ten persons as per the recommendation of the European Commission but without taking into account the criteria on the annual turnover or annual balance sheet total.

those of the SME itself are often intertwined, it may be difficult to restructure personal debt of the owner without addressing the situation of the SME. There are few successful models internationally for dealing with SME debt restructuring: countries have used different approaches ranging from regular or simplified in-court insolvency procedures, to hybrid mechanisms, to voluntary schemes.[17]

20. Cyprus took the approach to rely on coordinating procedures for personal and corporate debt restructuring. The law allows the debtor to initiate a PRP procedure while also requesting appointment of the same IP to act as an examiner for the micro-enterprise under the Company Law. Upon the issuance of a protective certificate by the court, the IP prepares a PRP for the debtor and a restructuring plan for the micro-enterprise. While each plan should meet the requirements under the respective statutes, the plans are expected to be coordinated to the maximum extent possible, to allow return to sustainability both for the debtor and for the micro-enterprise.

Modernizing the Institutional Framework

21. The institutional framework supporting the reformed insolvency regime was modernized. In particular:

- A framework for qualification, licensing and supervision of IPs was established. Prior to the reform, IPs and their fees were unregulated. Cyprus adopted a decentralized structure of supervising IPs whereby primary supervision is conducted by a professional body to which the IP belongs, with the Insolvency Service providing general oversight. In addition to the qualification requirements, IPs are subject to professional integrity and ethics standards, and can be sanctioned for breaches. Remuneration of IPs varies depending on the capacity in which he or she acts.

- The Insolvency Service of Cyprus was established to facilitate the implementation of the new insolvency framework**.** Based in the Department of Registrar of Companies and Official Receiver Office at the Ministry of Energy, Commerce, Industry and Tourism, the Insolvency Service is responsible for licensing and general oversight over IPs, maintaining registers of insolvencies and IPs, submitting applications to court for DROs and PRPs, issuing guidelines on reasonable living expenses, collecting information on insolvency related matters, preparing periodic reports, and contributing to development of policies in the area of personal insolvency.

Reforming the Corporate Insolvency Regime

22. An effective corporate insolvency regime should achieve two objectives—allow for a speedy liquidation of non-viable companies, while providing mechanisms to restructure viable businesses. Prior to the reform, the corporate liquidation process in Cyprus was lengthy and inefficient, and there was no special reorganization procedure for companies.[18] While it was possible

[17] For a discussion of the international experience of SME debt restructuring, see W. Bergthaler et al. (2015).

[18] The Cyprus' Company Law was the English law dating to the 1950s but did not reflect the subsequent developments that occurred in this area in the UK.

to reorganize a company under the provisions of the Companies Law (using schemes of arrangement),[19] it rarely happened and most of the distressed companies ended up in liquidation.

23. The reform sought to address these weaknesses consistent with practices in other countries and in line with international best practices:[20]

- To support restructuring of viable companies, a new *corporate reorganization procedure, examinership,* was introduced.[21] Under examinership (modeled after a similar procedure in Ireland), the company, its directors or shareholders can petition the court to appoint an independent expert examiner, for a fixed period, to prepare a restructuring plan for the company. Once the plan is approved by the required majority of creditors and confirmed by court, it becomes binding on all creditors.
- To support speedy exit of non-viable companies from the economy, the *liquidation process* was streamlined. The winding-up provisions were modelled after the English provisions in the Insolvency Act and the Enterprise Act 2002.

Other Reforms

24. In addition to foreclosure and insolvency reform, several other measures were adopted to facilitate NPL resolution:

- In July 2014, *a voluntary mediation scheme* was introduced to support debtors in negotiating debt restructuring with banks. .[22] Under the scheme, a debtor who files a complaint with the Financial Ombudsman about the handling by the bank of a restructuring of his mortgage loan (of up to €350,000) over his primary residence can request the Financial Ombudsman to appoint a mediator to help the debtor reach a negotiated solution with the bank.
- In mid-2016, a *special scheme* was introduced *to subsidize mortgage payments for low-income debtors* who seek to restructure their debt through the PRP procedure. The scheme, administered by the Cyprus Land Development Corporation, is available to individuals and small businesses and is subject to strict qualification criteria. If a repayment plan is approved,payments under the scheme can cover up to 60 percent of loan payments (interest and principal) up to €10.000 per debtor per year for the maximum of 3 years. Under the amendment to the 2002 Law on Legal Assistance, low-income debtors are also entitled to free legal advice in foreclosure.

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[19] See Neocleous and Labropoulos (2015).

[20] For discussion of key features of effective insolvency regimes, see IMF, Orderly and Effective Insolvency procedures (1999); UNCITRAL Legislative Guide on Insolvency law (2005); World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes (2016).

[21] Companies (Amending) Law (No 2) Law of 2015. regarding a mechanism for restructuring corporate debt (Examinership).

[22] The Establishment and Operations of a Single Body for the Out-of-Court Settlement of Disputes of Financial Nature (Amendig) Law of 2014. Financial Ombudsmen also played a role in debt restructuring in Iceland and Ireland.

- To facilitate the creation of a secondary debt market, *a law on the sales of loans* was adopted in November 2015.[23] Transferring individual loans or packages of loans to third parties, often specialized loan servicing or workout firms, allows banks to clean up their balance sheets, while allowing for a more efficient workout of NPLs by the parties who are bettered positioned to do it. The law allowed the sale of large (over €1 million) loans by banks with few restrictions, while preserving safeguards mandated for small borrowers under the Code of Conduct.[24]

C. Experiences with the Implementation of The Reformed Frameworks and Current Challenges

25. Following the legislative reform, substantial progress has been made in putting in place new institutional arrangements to support debt restructuring. In particular:

- The new foreclosure regime has become fully operational, with the first auctions having started in 2016.

- The Insolvency Service of Cyprus has been established and started accepting DRO and PRP applications in mid-2016, and there are currently around 300 licensed IPs in Cyprus who can assist debtors with the new corporate and personal debt restructuring procedures. The Insolvency Service has engaged in building up capacity and promoting the new insolvency tools, and has started to collect data that can be used to assess the effectiveness of the new insolvency framework and to develop policy recommendations.

26. However, the use of the new procedures remains limited. Debt-for-asset swaps, combined with some repayments and write-downs, remain the preferred modality for NPL resolution.

- **Foreclosure**: Banks have been initiating more foreclosures but the number of successful auctions remains low. Foreclosure auctions remain unpopular, and are often met with protests. Banks have continuously emphasized their intention to prioritize foreclosure against commercial property and land, as well as against strategic defaulters, while protecting primary residences and vulnerable groups. At the same time, however, it appears that the reform has facilitated restructurings "in the shadow" of foreclosure thus indicating that it has been more successful in achieving its objective to provide incentives for debt restructuring than the auction statistics would imply.

- **Insolvency:** The introduction of a "fresh start" has allowed to discharge over 9,000 debtors from bankruptcy (that lasted in some cases for over 5 years), allowing those individuals a "second chance" to re-engage in the economy. The number of DRO applications has been increasing: according to the data of the Insolvency Service, over 1,200 DRO applications have been received with over 300 DROs approved by the courts. However, the use of PRPs has been limited, with only a handful of PRPs confirmed/imposed by the courts. There have been very few applications

[23] The Law "On the Sale of Credit Facilities and Other Related Issues".

[24] See IMF Country Report No. 13/93, April 2013, page. 23.

for the mortgage subsidy scheme and no applications so far for the joint PRP/micro-SME examinership procedure. Few applications for examinership have been filed.

27. Several reasons may explain low use of the reformed frameworks. With regard to foreclosure, while the new procedure is a step forward, a number of legal and operational issues have been identified that may hinder its effectiveness such as notification rules, a lack of cooperation by debtors (e.g., in allowing access to the property for potential buyers) and the structure of the auction process. The uncertainty as to whether the new procedure can be used for 'legacy cases' due to recent contradictory court rulings discourages banks from tackling long-standing NPLs.[25] Potential court delays due to challenges and appeals contribute to the perception that the reformed procedure is still weak. Finally, residential foreclosure continues to be socially sensitive, drawing protests even in cases that may involve strategic default. The limited use of the new personal insolvency tools can be explained by several factors. First, the new legislation is complex, implying a steep learning curve for all stakeholders. This is particularly important, as these tools are *voluntary*. Thus, encouraging debtors to use them may require both educating debtors (and other l stakeholders) and providing additional incentives. Other reasons may include narrow qualification criteria for non-consensual PRPs, and unwillingness of borrowers to submit to the scrutiny of their financial affairs by the IP and by courts (possibly indicating a degree of strategic default in the system). Importantly, creditors' incentives to use the enhanced frameworks to facilitate NPL reduction are shaped by supervisory action. Until recently, banks have faced limited pressure to act more aggressively to reduce NPLs.[26] There may be other reasons as well, although understanding them would require a deeper analysis and better data, including on the financial conditions of borrowers.

28. Despite some progress, the backlog of unissued and un-transferred title deeds remains large. While DLS has proceeded with the issuance and transfer of titles, the backlog of around 71,000 cases is reported. Recent court challenges of the 2015 "trapped buyers" law have increased the uncertainty.[27] On the positive side, the authorities have engaged international experts to assess the current legal framework and prepare recommendations on modernizing the process of issuing building documentation and title deeds, although those recommendations will not address legacy cases, for which solutions need to be found.

29. The law on the sales of loans remains mostly untested. Since its adoption, only one transaction was completed whereby one Cypriot bank sold a small portfolio of restructured non-performing loans of developers and construction companies to another local bank.

[25] In September 2016, the Larnaca district court ruled that the new procedure cannot be used for cases where a court decision authorizing foreclosure had been issued before the new law came into force. The ruling concerned a mortgage signed in 1997, for which the bank obtained a court decision in 2006 authorizing foreclosure. However, the district court in Limsassol have subsequently upheld the application of the new procedure to a legacy case. Reportedly, the decision of the Larnaca court was appealed, with the appeal currently pending at the Supreme Court.

[26] The CBC is currently considering revisions to the targeting framework.

[27] In early 2017, the District Courts in Limassol and Paphos ruled parts of the law unconstitutional, although another court subsequently upheld the law by ruling that buyers are untitled to obtain title deeds irrespective of the developers' commitments to banks.

30. Court delays and weak enforcement regime remain a key impediment to NPL resolution and may undermine the implementation of the reformed foreclosure and insolvency frameworks. For example, there have been reports of foreclosure auctions being suspended in the eleventh hour through court action. Delays in court processes are also cited as an obstacle to timely processing of insolvency cases. Progress on strengthening the enforcement regime has remained limited. While the establishment of the Administrative Court and plans to establish a commercial court are positive developments, measures taken so far are not sufficient and decisive action is needed.[28]

31. New developments in NPL resolution include outsourcing of NPL management to third parties. Recently, several banks announced their intention to facilitate NPL management and resolution by using specialized companies, including those with the participation of foreign investors. Such companies can leverage the workout expertise, know-how and their arms-length relationship with borrowers to manage NPLs more effectively by using the full range of available tools.

D. Recommendations

32. The key elements of the legal and institutional frameworks for private debt restructuring are in place in Cyprus but effective implementation is key for these tools to contribute to orderly private debt deleveraging and NPL reduction. To strengthen implementation, consideration can be given to the following:

Foreclosure

- In line with the authorities' earlier commitments, conduct a comprehensive review of initial experiences with the implementation of the reformed foreclosure and insolvency frameworks to identify the remaining impediments and develop recommendations for adjustments.
- Address legal and operational issues that hinder smooth implementation of the foreclosure procedure (e.g., notifications, auction procedures, application to legacy cases), if necessary, through targeted amendments.
- Modernized enforcement by using technology to advertise and conduct auctions (e.g., by introducing E-auctions).

Insolvency

- Educate borrowers and other stakeholders about new insolvency solutions, e.g., through a national information campaign and other means.
- Extend provisions of the Personal Insolvency Law on non-consensual repayment plans, set to expire in May 2018, to allow more borrowers to take advantage of this restructuring tool. Reassess and adjust qualification criteria for non-consensual PRPs to make them available to

[28] See accompanying Selected Issues paper on E*conomic Effects of Weak Claims Enforcement—International Evidence and Implications for Cyprus.*

more debtors.

- Revisit protections for debtors and guarantors in light of the improving economic situation in Cyprus and associated improvements in repayment capacity.

- Assess whether additional restructuring modalities (e.g., "pre-packaged" restructuring plans, greater use of out-of-court procedures) should be introduced in Cyprus.

Other Issues:

- Expedite the clearance of the backlog of unissued and un-transferred title deeds and put in place procedures to avoid recurrence of the current problems. Assess the magnitude of NPLs associated with untitled properties to facilitate search for solutions.

- Modernize the rules of civil procedure to expedite the judicial process and improve case management. In the meantime, consider introducing procedures for expedited handling of foreclosure- and insolvency-related cases, e.g., by designating judges within each court to handle these cases.

- Consider specialization in insolvency (personal and corporate) within the existing courts and, in medium- to long-term, establishing specialized insolvency courts or chamber(s) within the existing courts.

- Enhance data collection to facilitate assessment of effectiveness of the new debt restructuring frameworks and policy making.

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