WP/13/44

IMF Working Paper

Dealing with Private Debt Distress in the Wake of the European Financial Crisis

A Review of the Economics and Legal Toolbox

Yan Liu and Christoph B. Rosenberg

INTERNATIONAL MONETARY FUND

 WP/13/44

IMF Working Paper

Legal and European Department

Dealing with Private Debt Distress in the Wake of the European Financial Crisis

A Review of the Economics and Legal Toolbox

Prepared by Yan Liu and Christoph B. Rosenberg[1]

Authorized for distribution by Ross Leckow (LEG) and Aasim M. Husain (EUR)

February 2013

Abstract

The private non-financial sector in Europe is facing increased challenges in meeting its debt servicing obligation. In response, governments are revisiting legal tools and—in some cases—institutional arrangements to deal with over-indebtedness. For households, where the problem in some countries is large but no established best practice exists, reforms have generally sought to allow debtors a fresh start while minimizing moral hazard and preserving bank solvency and credit discipline. For the corporate sector, efforts have focused on facilitating debt restruturing (including through out of court mechanisms). Direct government intervention has been rare.

JEL Classification Numbers: K35, G33

Keywords: private sector debt, household insolvency, corporate insolvency

Author's E-Mail Address:yliu@imf.org, crosenberg@imf.org

[1] The authors would like to thank Christoph Klingen, John Simon, Aasim Husain, Kenneth Kang, Wolfgang Bergthaler, Katherine Christopherson, Maike Luedersen, Nadia Rendak, Jochen Andritzky, Bas Bakker, Alessandro Giustiniani, Gregorio Impavido, Engin Dalgic, Jose Garrido, Maral Shamloo, Shengzu Wang, and Jade Vichyanond for useful comments, and Upaasna Gupta for invaluable research assistance.

Contents **Page**

I. Introduction

The private non-financial sector in Europe is facing increased challenges in meeting its debt servicing obligation. With debt levels generally high and still rising, and the economic recovery halting, the problem is concentrated in several countries in the EU periphery and Eastern Europe. In a few cases it is particularly pronounced for the household sector, which is a novel feature of the present crisis—at least to the extent that it concerns emerging markets[2]. There is an increased recognition that in certain circumstances an NPV-reducing restructuring of private debts is necessary to create the conditions for a sustained recovery.

In response, governments across Europe are revisiting legal tools and—in some cases—institutional arrangements to deal with the private sector's over-indebtedness. In a number of countries new insolvency frameworks need to be created from scratch, often drawing on technical assistance from the IMF, the World Bank and other international institutions. A few have taken a comprehensive approach, integrating private sector debt restructuring with fiscal and financial sector reform. Overall, however, progress has been uneven, in part reflecting the large political and technical challenges in creating the necessary institutions as well as designing and implementing complex legislation in the midst of a crisis. Moreover, the need for effective and orderly debt resolution frameworks sometimes remains underappreciated.

Against this background, this paper takes stock of private sector debt restructuring efforts in select European countries. Specifically, it (i) provides an economic rationale for orderly private sector debt restructuring, (ii) briefly reviews what has been done in various European countries, especially those with IMF-supported programs, since the beginning of the crisis, and (iii) highlights emerging good practices in designing legal and other mechanisms to deal with excessive private sector debt.

II. Private Sector Debt and Economic Recovery

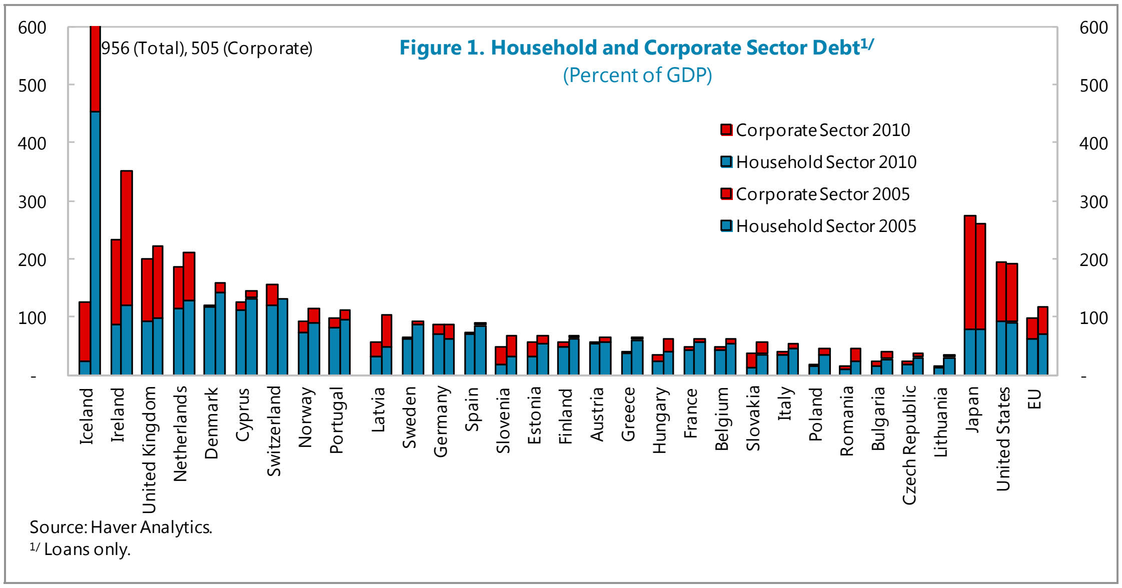
In the years following the 2008 global financial crisis, private non-financial debt-to-GDP levels have increased across Europe (Figure 1). This trend can be seen as both cause and effect of the great recession: loose credit conditions and the associated rapid accumulation of private sector debt increased country vulnerability to the sudden stop of capital inflows and contributed to the severity of the crisis.[3] And the ensuing recession-induced decline of GDP further pushed up debt ratios in all European countries except Switzerland and Germany. Not surprisingly, therefore, the increase in the private sector's indebtedness—although not necessarily the level—is particularly pronounced in the countries that experienced the strongest boom-bust credit cycle, such as in Iceland,[4] the Baltics, and a number of Eurozone periphery countries. For the EU as a whole, debt ratios—particularly those of households—have started to catch up to the high levels in the US and Japan.

---

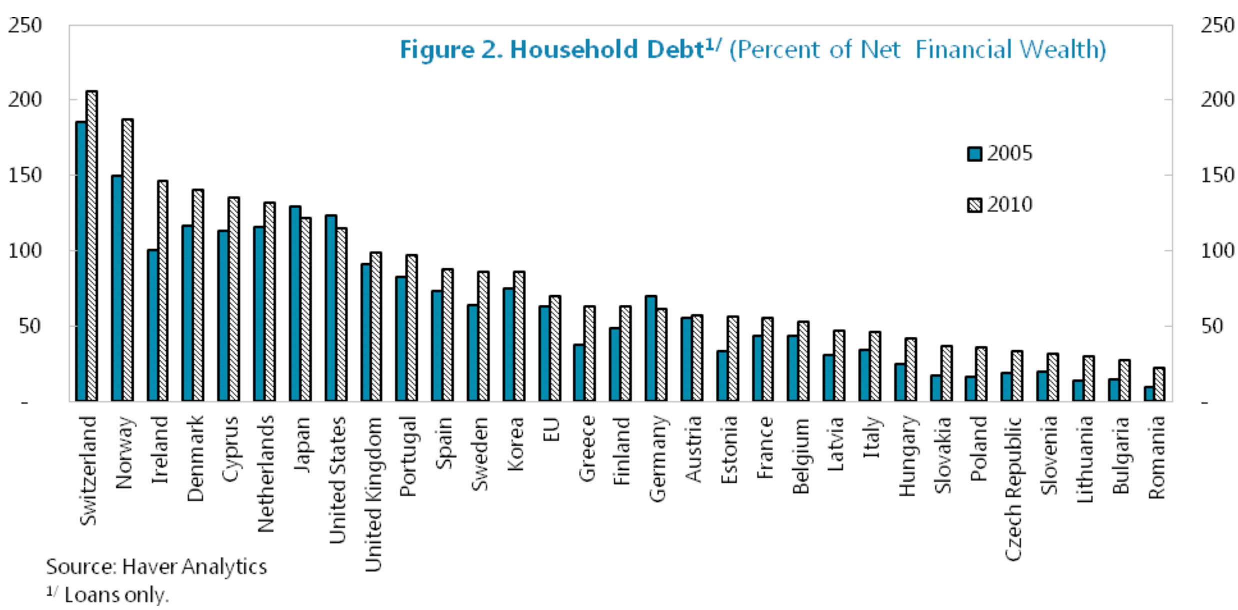
[2] The Scandinavian debt crisis in the early 1990s also involved household debt, while the emerging market financial crises of the past decades had been concentrated in the public and corporate sectors..

[3] The credit boom in Eastern Europe is documented in Bakker and Gulde (2010) and Cottarelli, dell'Ariccia and Vladkova Holler (2003).

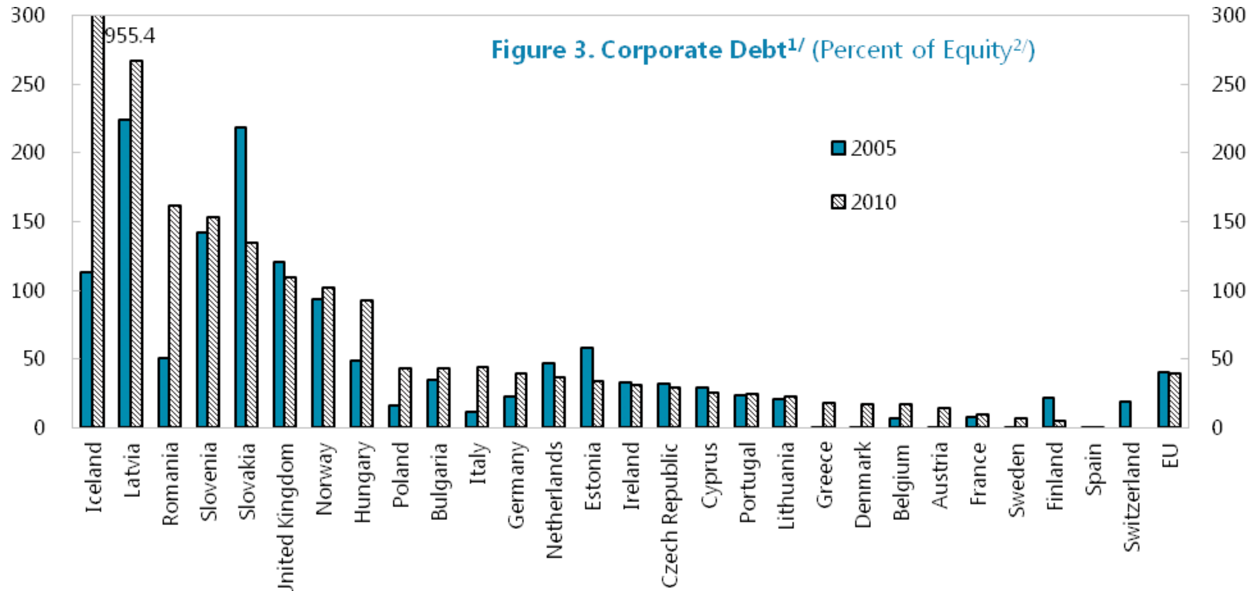
[4] A large share of foreign currency denominated loans in combination with a sizable devaluation contributed to the extraordinary increase in the debt to GDP ratio.



Debt levels have also increased when measured against borrowers' financial buffers. Household liabilities as a share of net financial wealth (Figure 2) are generally high in high-income countries, where households hold substantial assets; but they have surged in Ireland, Greece and a number of CEE countries. In addition to financial assets, households in these countries also experienced substantial declines of real estate property values. Measures of indebtedness in relation to debt servicing capacity (such as disposable income) paint a similar picture.



Overall, household indebtedness has grown in all European countries except Germany. By contrast, corporate leverage (Figure 3) has grown only in a handful of countries, most notably Iceland, Latvia, Romania, and Hungary; in Slovakia and Estonia the corporate sector in fact deleveraged [5]The significance of household debt constitutes a novel feature of the present crisis in many countries, in contrast to the relative greater importance of sovereign debt in the Latin American and Russian crises, and corporate debt in the Asian financial crisis.



Source: Haver Analytics.
1/ Loans only.
2/ Equity is the shares and other equity of corporations, valued at market prices

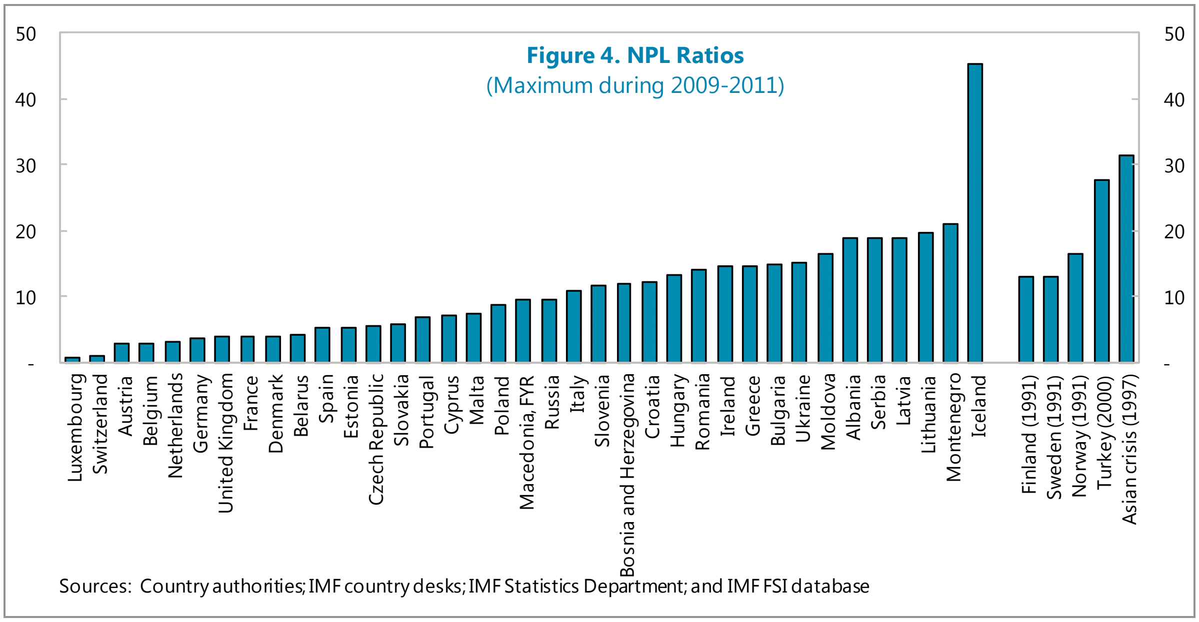
Left unresolved, high levels of private sector debt are likely to impede the recovery. A number of channels linking private indebtedness with economic activity have been identified in the literature:

- ***Investment*** will suffer as companies concentrate on deleveraging and repairing their balance sheets. They are unwilling to take up new projects if the returns primarily benefit existing creditors rather than equity holders (Myers, 1977; Occhino, 2010).
- Overleveraged households will cut back on ***consumer spending*** as their perception of permanent income and wealth is reduced (King, 1994).
- Mortgage debt creates additional feedback loops through the effects of ***declining real estate prices*** on wealth and consumption. As shown in IMF (2012), housing busts and recessions preceded by larger run-ups in household debt tend to be more severe and protracted.
- ***Banks' lending*** will suffer, as rising non-performing loans (NPL) erode banks' capital buffers, absorb management time and create uncertainties. Indeed, NPL levels in a few countries in Southeastern Europe and the Baltics have reached levels seen only in previous crisis episodes in Asia and Scandinavia (Figure 4)[6]. A recent study by IMF staff using data

[5] A deeper analysis using microeconomic data suggests that a few countries in the Baltics and Southeastern Europe can be characterized as experiencing a private sector debt overhang, although there are differences across sectors and countries (Herzberg, 2010; Gill and Raiser, 2012, pp. 155-173).

[6] Comparability between countries is hampered by differences in the definition of NPLs. See EBCI (2012) for an extensive discussion of practices across Europe.

from Emerging Europe (EBCI, 2012) shows that a 10 percentage point increase in NPL ratios lowers loan growth by some 4 percent through supply-side effects alone.



- ***Public sector debt sustainability*** may also be affected as excessive private sector liabilities often end up being transferred to the public sector's balance sheet.

While there is a general economic case to tackle private sector debt, its urgency depends on a number of country-specific factors. Reforms to facilitate private sector debt restructuring are not costless: they require time, effort and budget resources to design and implement, often associated with an upgrading of judicial capacity. There could also be a political cost, as the reform may be resisted by vested interests and individual creditors and debtors defend the status quo of leaving high debt unresolved. So when are such reforms worth the efforts? Philippon (2009) argues that there is an economic case to renegotiate debt contracts once indebtedness has reached levels that impede overall macroeconomic performance. This link between private debt levels and economic performance will depend on country circumstancs (e.g., the elasticity between net private liabilities and consumption or investment).

In the current situation, two considerations argue for taking action sooner rather than later. First, the initial crisis containment phase is arguably over. Laryea (2010) argues that in a situation, such as in 2008-10, of an uncertain macroeconomic path, falling asset prices and frozen credit markets, it is difficult to judge individual debtors' viability. As the environment starts to become relatively more stable, debtors' viability may be easier to assess and therefore the potential benefits of restructuring their debt become more tangible. Secondly, alternative policy options appear largely exhausted. Specifically, prospects for further macroeconomic stimulus that could sustainably increase debt servicing capacity appear slim as monetary policy has in most countries already eased considerably, fiscal space to boost government spending or provide tax relief is limited, and the potential for export growth is constrained by the weak global outlook.

Experience in previous crises suggests that the process should aim to maximize recovery rates and minimize the time and cost involved with debt restructuring. Ideally, there would be appropriate burden sharing between debtors (households and corporates) and creditors (usually banks). In select systemic cases, the public sector may also share some of the cost and impose across-the-board solutions, but it is difficult to see if anywhere in Europe the problem is big enough to justify such large-scale intervention. The role of the public sector should therefore be confined to (i) secure a reasonably predictable macroeconomic environment, including through strengthening the banking system and (ii) implement legal and institutional reforms to encourage timely market-based restructuring (Laryea, 2010), including the removal of tax and regulatory obstacles. In designing such measures, budgetary and broader macroeconomic constraints need to be kept in mind.

Any private debt restructuring strategy should be embedded in broader financial sector reform. For example, it would need to take into account banks' loss-absorbing capacity and be complemented by measures to safeguard financial stability—as successfully demonstrated in the case of Latvia (Erbenova, Liu and Saxegaard, 2011). In this context, it is important to distinguish between debt relief aimed at broader macro objectives and writing-off of or full provisions for bad loans to clean up banks' balance sheets. Depending on the legal framework banks may retain their claims on delinquent borrowers, with the attendant consequences for consumption and investment, even after recognizing them as non-performing in their balance sheets.[7]

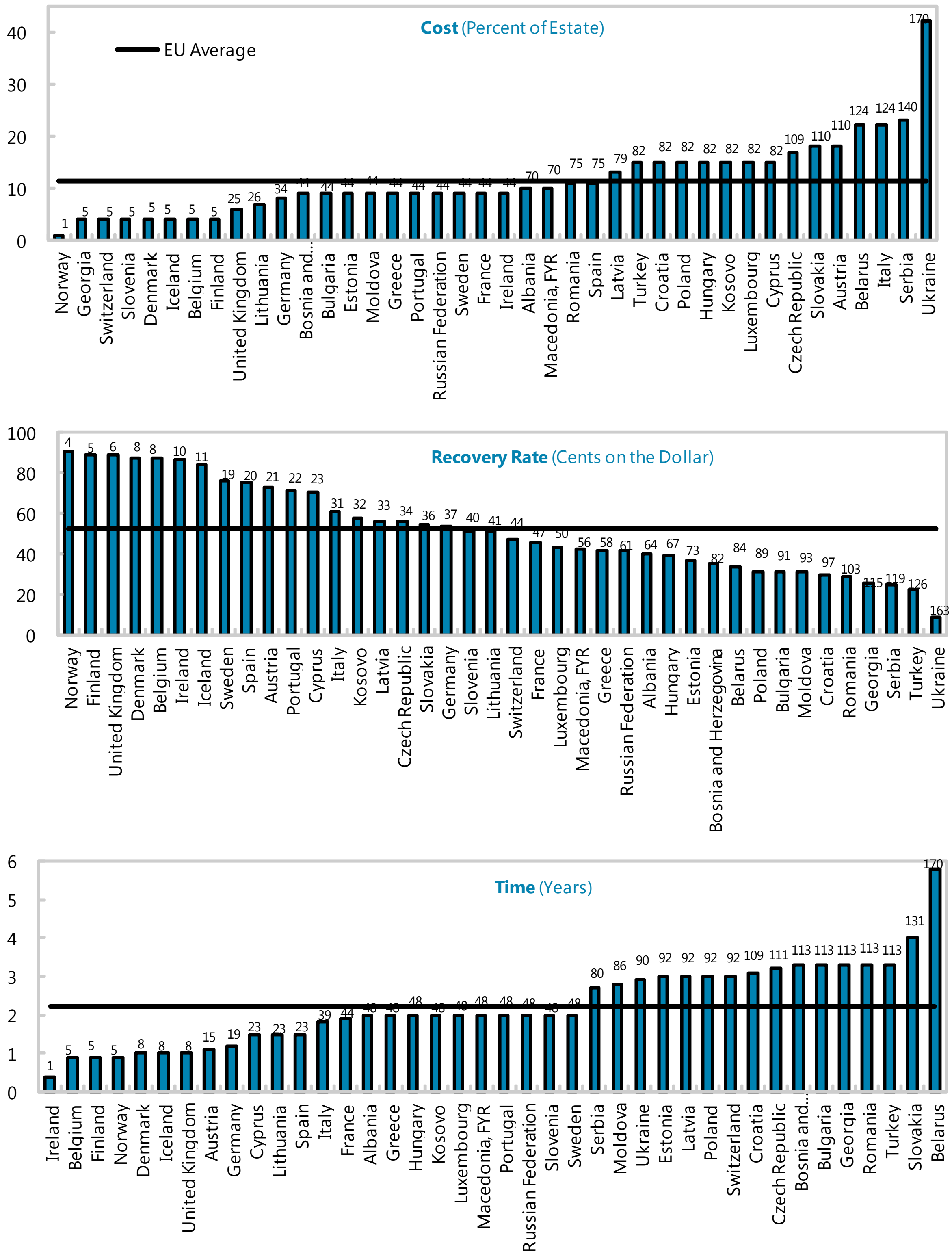
III. Recent Private Insolvency Reforms in Selected European Countries

The insolvency framework in a number of European countries is weak and inefficient. The World Bank's "Doing Business" survey data[8] suggest that insolvency frameworks function quite well in parts of Western Europe (especially Nordic and Benelux countries) where the time required is short, the cost is relatively low and recovery rates are high (Figure 5). But the insolvency framework is generally considered to be rather weak elsewhere—especially in Eastern Europe, where insolvencies (as indicated by high NPL levels) are widespread.

[7] Secured debt (including mortgages) is typically full recourse in many countries, namely if the proceeds from the collateral are insufficient to satisfy the outstanding debt, the debtor remains personally liable for the deficiency (i.e., the difference between the outstanding loan amount and the sale price).

[8] These data are derived from questionnaire responses of insolvency practitioners rather than direct observations from courts and insolvency institutions, and therefore need to be interpreted with caution.

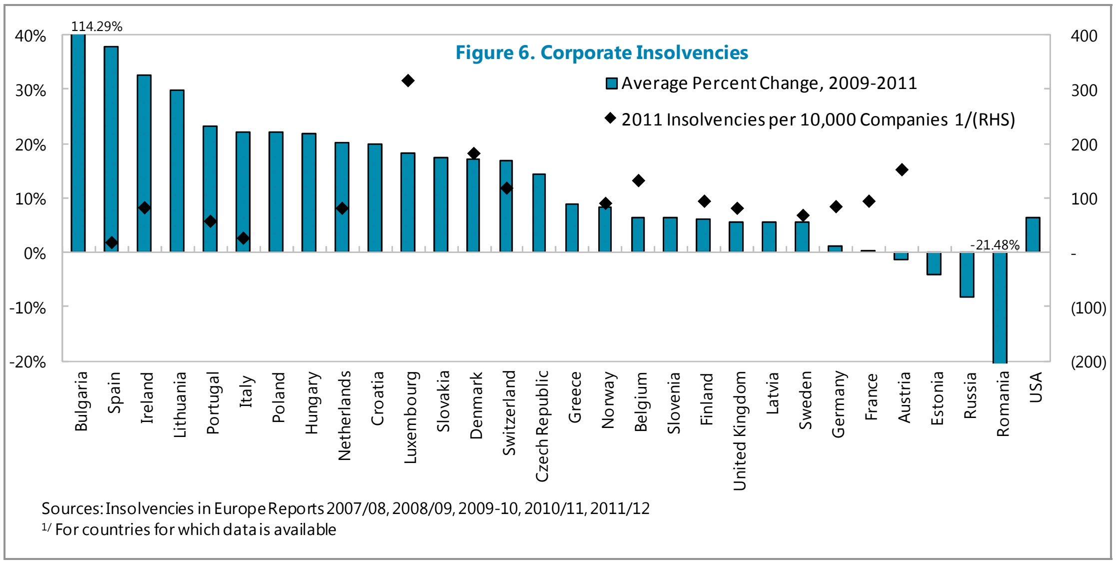
Figure 5. Resolving Corporate Insolvency Indicators[1/]



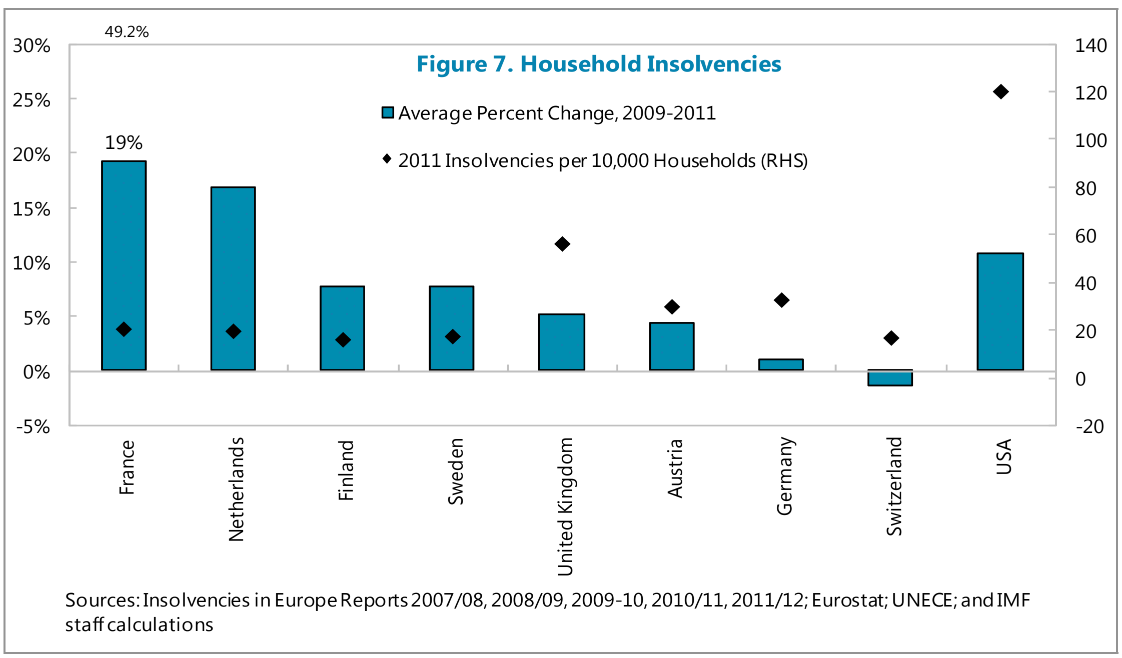
Source: World Bank - Doing Business 2012

[1/] Global Rankings are set as data labels

The current financial crisis has resulted in a sharp increase in corporate and household insolvency proceedings. Recent data suggest that in 2011 corporate insolvency cases increased by double digits in Greece, Italy, Portugal, Spain, Bulgaria, Czech Republic, and Hungary, many of them experiencing prolonged or double-dip recessions (Figure 6).



Similar trends can be seen for household insolvencies in the—mainly West European—countries that have a personal insolvency framework (Figure 7), although data are much less reliable (partly due to incidents of bankruptcy tourism[9]). The rising number of insolvency cases is clogging up courts and exacerbating social problems.



---

[9] Bankruptcy tourism, which is an emerging phenomenon within the EU, refers to debtors filing for bankruptcy in countries with favorable personal insolvency laws, such as England and Wales.

Many European countries have been undertaking reforms to speed up debt restructurings. These reforms, some of which were designed with input or assistance from IMF staff, rely primarily on a market based approach and seek to minimize moral hazard. They generally include the following elements: (i) improving the legal framework that would support effective and efficient individual (e.g. foreclosure)[10] and collective (through insolvency proceedings)[11] enforcement of creditor claims, (ii) facilitating out of court workouts by issuing guidelines or establishing a legally binding framework given the limited capacity of the judicial system, and (iii) implementing an information strategy to raise public awareness of the restructuring tools (see Table 1). In a few cases, the authorities have resorted to temporary direct government intervention to deal with household over-indebtedness. Finally, these reforms have been complemented by measures to strengthen banks' capacity to manage distressed loans, which are not covered by this paper.[12]

Table 1. Recent Corporate Insolvency Law Reform and Out of Court Restructuring: Selected European Countries

Country	**Insolvency Law Reform**		**Out of Court Mechanism**	
	Rehabilitation	Liquidation	Voluntary Guidelines	Binding Legal Framework
Estonia	√	√		
Germany	√			
Greece	√	√		
Iceland	√	√	√	
Italy	√	√		
Latvia	√	√	√	
Lithuania	√	√		
Moldova	√			
Portugal	√		√	
Romania	√	√	√	
Serbia	√			√
Spain	√	√		

10 An individual enforcement action typically involves a creditor obtaining and enforcing a court judgment against the debtor and its assets. If the debt is secured, the collateral can be sold through, e.g., auction and the proceeds of the sale is used to satisfy the secured creditor's claim. If the debt is unsecured, the creditor may seek to satisfy its claims from the debtor's unencumbered assets.

11 In cases where the debtor has more than one creditor, individual enforcement may not be optimal as the debtor's asset may not be sufficient to satisfy all claims. Collective enforcement of claims through insolvency proceedings could maximize recovery for all parties.

12 Greece and Portugal are implementing measures under the Fund-supported programs to improve the efficiency of the judicial process, while some European countries such as Moldova and Serbia are enhancing the insolvency administrator regime. Measures to improve NPL resolution in Eastern Europe are discussed in EBCI (2012).

A. Corporate Debt Restructuring

Corporate insolvency reforms undertaken in the wake of the recent financial crisis focus on better supporting the early rescue of viable firms. In many European countries and in particular transition economies, insolvency proceedings are used as a debt collection tool and often result in liquidation. Recognizing the importance of insolvency law in tackling the economic consequences of over indebtedness, several European countries including Latvia, Moldova, Portugal and Ukraine[13] have introduced fast track court approval procedures (see Box A). Italy, Moldova and Serbia also introduced pre-packaged procedures, which provide for expeditious court approval of pre-negotiated restructuring plans that bind minority creditors.

Box A. Fast Track Court Approval Procedures

Fast track court approval procedures refer to those under which the court expeditiously approves a debt restructuring plan negotiated between the debtor and its creditors in a consensual manner before the initiation of an insolvency proceeding. This technique draws upon the most significant advantage of a court-approved restructuring plan—the ability to make the plan binding on dissenting creditors or cram down—while leveraging speedy out-of-court negotiation process. In practice, the procedures typically work as follows:

- As a first step, the debtor and its secured and sometimes selected unsecured creditors negotiate a debt restructuring plan. Typically participating creditors would first agree on a clearly defined short-term standstill period during which they will refrain from enforcing their claims; this provides breathing room for the debtor to concentrate on developing an acceptable plan without the fear of enforcement actions. The debtor commits not to take actions that would adversely affect creditors' interests during the standstill period, and agrees to provide timely and detailed information on its finances, operations and future business prospects.

- After the plan is accepted by a qualified majority of creditors, the debtor files an insolvency petition, together with, inter alia, the restructuring plan, information on all creditors involved and their claims, the most recent balance sheet, and an overview of the debtor's assets and vested security rights on these assets. The court could immediately appoint an insolvency administrator to review the plan, and order the convening of a creditors meeting to hear the views of creditors, the administrator and the debtor on the plan.

- The court will approve the plan swiftly if certain conditions are met, including that the plan is approved by a qualified majority of creditors and is not fraudulent or more detrimental to creditors' interests than the outcome of liquidation. Unless the court approval is timely appealed, the plan would be binding upon all creditors' (including those voting against the plan) claims existing on the day of the commencement of the insolvency proceeding.

- The ability to expeditiously bind-in dissenting creditors while minimizing the cost and delay associated with formal insolvency procedures is often critical to the success of debt restructuring efforts. For debtors, it provides certainty with respect to its retention of control of the enterprise and minimizes the disruption of the business. For creditors, it may generally lead to a swifter and more transparent negotiation process and a better financial result and help maintain their business relation with the debtor.

[13] A new insolvency law was passed in Ukraine in December 2011. The law has a 12 month transitional period and will become effective in early 2013. The authorities are considering further amendments to the new law to, inter alia, facilitate corporate restructuring.

Facilitating rehabilitation has been at the center of the reform efforts in several countries. Improvements include modification of requirements to encourage debtors to file in the early stage of their financial difficulties (Estonia, Latvia, Lithuania, Romania), affording flexibility in the use of restructuring tools such as debt to equity swaps (Estonia, Germany, Latvia), simplifying procedures to facilitate creditor action on the restructuring plan (Estonia, Germany, Italy, Latvia, Portugal, Romania, Spain, and Ukraine), and according priority repayment status to creditors that provide new financing (Latvia). These reforms, all aimed at facilitating rehabilitation opportunities, are generally in line with international best practices in this area (see Box B).

At the same time, insolvency reforms also aim at streamlining liquidation procedures to speed up the exit of nonviable firms and thus help to maximize value for all interested parties. Baltic countries have taken the lead in simplifying liquidation process, e.g., through electronic filing, providing more flexibility in the modality for the sale of a debtor's estate; and incentivizing administrators to conduct a sale in a speedy manner.

Box B. Corporate Insolvency Law – Key Features

Two critical objectives of an effective corporate insolvency law are to allocate risks among market participants in a predictable, equitable and transparent manner and to maximize value for the benefit of all interested parties and the economy in general. To achieve these objectives, an insolvency law would include the following features, in line with international best practices[1]:

- ***Clear filing criteria*** – The law must include clear thresholds such as a missed payment for creditors and debtors to file for insolvency. These thresholds should be designed in a manner that encourages debtors to take appropriate actions sufficiently early on in their financial difficulties, thereby increasing the chances of a successful rehabilitation.
- ***Supporting rehabilitation of viable firms*** – The law should provide a mechanism that allows a restructuring agreement agreed to between the debtor and a requisite majority of creditors to become binding on all creditors. At the same time, the interests of dissenting creditors should be protected by ensuring that they are treated in the same way as similarly situated creditors. In addition, insolvency law should enforce pre-packaged restructurings negotiated out of court.
- ***Speedy liquidation of non-viable firms*** – The law should facilitate the sale of business as a going concern, afford flexibility in the liquidation modality, and incentivize speedy exit of non-viable firms from the economy so as to maximize value for all parties.
- ***Stay on enforcement actions*** – Such stay would provide breathing room for parties to negotiate without the interruption of enforcement actions. This should be balanced by the need to adequately protect secured creditors' interests by preserving their rights to enforce against collateral (e.g., by allowing them to request a relief from the stay under certain specified conditions).
- ***Priority status to fresh money*** – The insolvency law should accord legal priority (before payment of pre-existing debt) to new financing provided during the insolvency proceedings to ensure a successful restructuring. This would facilitate provision of new credit which is vital for the continuation of the business during the restructuring period**.**
- ***Cross-border insolvency*** – To mitigate delays associated with insolvency proceedings of enterprises with assets and liabilities in different countries and to facilitate reorganization of multinational entities or groups of enterprises, the insolvency law should incorporate procedural rules on cross-border insolvency in line with the UNCITRAL Model Law on Cross-Border Insolvency.

[1]See the IMF Orderly and Effective Insolvency Procedures (IMF, 1999), the World Bank Principles and Guidelines for Effective Insolvency and Creditor Rights Systems (World Bank, 2001) and UNCITRAL Legislative Guide on Insolvency Law (UNCITRAL, 2004).

While recent insolvency reforms are starting to yield results in some countries, their effectiveness is yet to be tested. The effectiveness of an insolvency law depends on an adequate institutional framework that implements the law in a transparent, predictable and consistent manner. While petitions to participate in the improved rehabilitation proceedings have increased in Estonia, Iceland, Latvia, and Serbia, institutional frameworks in many of these reform countries are still weak: the court system is overloaded, the judicial process is lengthy and costly (Figure 5) and there is a perceived lack of well-trained and competent judges and insolvency administrators. Thus, despite the recent legal reforms, the judiciary process and institutions may not be able to handle increasing insolvency cases resulting from the crisis. This raises the need for alternative restructuring tools.

Out of court restructuring provides a speedy, cost effective, and market friendly alternative to formal insolvency procedures. It involves restructuring of the business and finances of debtors in financial difficulty without resorting to a full intervention by the courts (Garrido, 2012). Drawing on IMF and World Bank assistance, a few countries such as Iceland,[14] Latvia, Romania, and Portugal[15] have recently issued nonbinding guidelines on out of court corporate debt restructuring. Serbia[16] went further by establishing a legally binding mechanism with voluntary participation in corporate workouts.[17] While the design of these mechanisms varies, they all seek to avoid the costs and delays that are typically associated with the formal insolvency process in line with international best practices.[18]

Achieving effective out of court restructuring requires, however, a robust insolvency regime and adequate incentives for creditors and debtors to participate in the restructuring. As out of court restructuring takes place in the shadow of the formal insolvency regime, it is critical to have in place an effective insolvency law which provides clear benchmarks to incentivize debtors and creditors to reach a restructuring agreement. In addition, a regulatory framework requiring financial institutions to write down the value of distressed debt should be put in place, tax disincentives for debt write-downs or transfer of a distressed loan to a third party should be removed (as was done in e.g., Latvia, Romania, Serbia), the tax and social security administrations should be encouraged to participate in debt restructurings in accordance with clearly defined rules (Portugal), and foreclosure procedures should be streamlined and expedited to induce debtors to participate in negotiations (Latvia).

[14] In the case of Iceland, each commercial bank developed its own out of court restructuring guidelines based on international best practices which are subject to review by the Financial Sector Supervisory Agency.

[15] Portugal also adopted guidelines to facilitate out of court negotiations of a debtor's recovery through mediation of IAPMEI, an agency of the Ministry of Economy, with a focus on SMEs.

[16] The Serbia regime follows the Istanbul approach with some modifications. Under the Istanbul approach, the Turkish Bank Supervision and Regulation Agency issued binding principles that facilitate corporate workouts. See Law on Restructuring Debts to Financial Sector No. 4743/2002 published on January 31, 2002 at https://bddk.org.tr.

[17] Instead of issuing guidelines, Montenegro promoted the use of mediation in out of court restructuring by requiring judges to invite the parties to mediate under the insolvency law when a bankruptcy petition is filed.

[18] See, for example, INSOL (2000).

The evidence to date suggests that these initiatives to facilitate out of court workouts have generally been successful. For instance, in Iceland data collected by the authorities and banks show tangible progress in corporate and household debt restructuring (IMF, 2011). In Latvia, a 2010 survey conducted by the Ministry of Justice indicates that the guidelines were successfully used in 90 per cent of out of court restructurings (EBCI, 2012, p. 49). However, experience with out of court restructuring in these countries is still limited mainly due to multi-creditor coordination hurdles, weak credit enforcement mechanism, slow and lengthy legal proceedings, and lack of trust among the relevant parties. The full benefits of these initiatives will only be evident once market participants and other stakeholders become familiar with the new framework and more experience is gained with its application.

B. Household Debt Restructuring

A number of European countries have introduced or refined personal insolvency regimes to achieve orderly resolution of the debt overhang over time.[19] For example, Estonia, Iceland, Italy, Latvia, Lithuania, and Poland adopted or amended the personal insolvency law. The Irish Parliament recently adopted an entirely new personal insolvency law to, inter alia; shorten the discharge period from 12 years to 3 years subject to certain conditions.[20] The German government is also considering a reform of the personal insolvency regime that includes a shortening of the discharge period.[21]

In designing such regimes, these countries have faced a number of challenges. First, unlike corporate insolvency, there is no established international best practice at all in this area, especially with regard to the treatment of residential mortgages in insolvency proceedings. Second, as individuals are involved, the design of the law is inevitably driven by social policy considerations; these include the goal to reinvigorate individual productive potential in the mainstream economy and to reduce the social costs of leaving debtors in a state of perpetual debt distress. Third, the law needs to keep an appropriate balance between maintaining credit discipline and affording financially responsible debtors a fresh start. Finally, the design of the law needs to take into account institutional infrastructure that is critical to the predictable and transparent implementation of the law, including the availability and quality of judges and trustees, administrative capacity, accounting, and valuation systems.

A number of basic design features for an economically efficient personal insolvency law have emerged from the early cross-country experience:

- Allocate risks among parties in a fair and equitable manner;
- Provide a fresh start through discharge of financially responsible individuals from the liabilities at the end of insolvency proceedings (typically after 3-5 years);

[19] The personal insolvency law may also cover natural persons who are engaged in business activities (traders or merchants).

[20] The bill also allows the court to require repayments for up to five years in the bankruptcy process.

[21] The proposal envisages to reduce the discharge period from six years to three years provided that at least 25 percent of all debt must be repaid by an individual debtor.

- Establish appropriate filing criteria to make insolvency procedures accessible to individual debtors while minimizing abuse;
- Impose automatic and temporary stay on enforcement actions with adequate safeguards of creditor interests;
- Set repayment terms that accurately reflect the debtor's capacity to repay to ensure an effective fresh start; and
- Recognize foreign proceedings and enable cross-border cooperation to avoid bankruptcy tourism.

The unprecedented challenge of excessive mortgage debt has prompted some European countries to introduce special legislation.[22] Faced with wide-scale household mortgage distress in the aftermath of the recent crisis and the bursting of the real estate bubble, Greece, Spain and Portugal have introduced special legislation to address unsustainable residential mortgage debt burdens on households while limiting adverse effects on banks' balance sheets and minimizing moral hazard. All of these regimes provide for strict eligibility criteria,[23] but they differ in several respects. First, while the Spanish regime allows financing institutions to opt into the scheme[24], banks' participation is mandatory for Greece and Portugal. Second, Spain and Portugal allow mortgage debtors, subject to certain conditions and as a last resort, to transfer the mortgaged property title to the bank (or a government agency in Portugal) and obtain cancellation of the mortgage debt (up to the assessed value of the residence in Portugal).[25] Greece, on the other hand, allows the court to grant a full discharge of the mortgage debt if the debtor repays up to 85 percent of the commercial value of the principal residence determined by the court over up to 20 years. It is yet too early to assess the effectiveness of the Spain and Portugal regimes, but the Greek authorities are revisiting their framework due to its low rate of successful restructuring to date.

A number of countries have adopted measures to facilitate out of court settlement for distressed mortgages. For example, Iceland, Ireland, and Latvia adopted voluntary guidelines or codes of conduct that provide guidance on mortgage restructurings for borrowers in financial

---

[22] Norway, when facing its own banking crisis and recession in the early 1990s, adopted the Debt Reorganization Act in 1993 to provide debt relief to debtors who are unable to meet their obligations for a period of time. The law provides for voluntary debt settlement and compulsory debt settlement (e.g., reduction of principal of a residential mortgage to 110 percent of the market value of the residence).

[23] Law No. 3869 of 2010 of Greece applies to individuals with excessive debt who cannot seek protections under the existing Bankruptcy Code of Greece. The Royal Law Decree of March 9, 2012 of Spain introduces measures for debt restructuring available to distressed individual mortgage debtors falling under the poverty line. In Portugal, the Law Establishing a Special Regime to Protect Housing Loan Debtors in a Dire Economic Situation of September 2012 applies to mortgage debtors who meet certain conditions such as income level, the suffering of income loss, the value of the house, and the existence of no other assets.

[24] Once a financial institution opts in, it must implement for at least two years a Code of Good Practices which provides for measures aimed at achieving a viable mortgage restructuring for debtors covered by the regime.

[25] Under the Spanish regime, the transfer of the property title and the cancellation of the debt can only happen after it has been proven that neither restructuring of the debt nor application of a partial release is viable.

distress. In 2012, Portugal introduced voluntary out of court guidelines for banks to restructure household debt including residential mortgages more generally with the assistance of debt mediation facilities. Estonia adopted a law effective in April 2011 aimed at supporting the out of court restructuring of debt obligation, including mortgages, of natural persons facing financial difficulties—although the procedure relies heavily on court input. To reduce the burden on the court system, the personal insolvency law recently adopted by the Irish Parliament introduces three non-judicial debt settlement procedures for household debt including a personal insolvency arrangement for settlement of secured debt up to €3 million and unsecured debt (no limit) over six to seven years. The effectiveness of these approaches in tackling mortgage distress remains to be seen.

A few countries have looked beyond improvement of the legal framework and resorted to direct government intervention. Measures include the imposition of a temporary moratorium on foreclosure (e.g., Greece and Hungary), and conversion of foreign currency denominated debt into local currency (e.g., Iceland and Hungary). While temporary in nature, these measures have proven costly and administratively burdensome. Most importantly, the implied interference with private contracts undermines credit discipline. Some countries adopted a government support scheme (e.g., Latvia though never implemented and Hungary) and/or set up an asset management company (e.g., Hungary, Spain). Experience shows that direct government support may be needed in cases where the debt overhang is so severe and widespread that market mechanisms no longer work and/or financial stability is at risk (see Box C).

C. Information Campaigns

Several countries have supplemented their legislative efforts with a public information campaign about available restructuring tools. Examples include Latvia, Romania and Portugal which sought to raise the public and stakeholder awareness about the new legal framework and, more broadly, change the business and legal culture towards early rescue of viable firms. Specifically, Latvia and Portugal engaged in extensive consultation with stakeholders through joint seminars with the IMF Legal Department, and also published articles on the modified insolvency regime.

Box C: Direct Government Intervention in Private Debt Restructuring

Though usually not necessary, direct government intervention in private debt restructuring can be appropriate. The bar for across-the-board government action (as opposed to a case-by-case approach) is typically set high as any interference in the market mechanism necessarily causes distortions and is often associated with additional budgetary outlays. Recent literature (Laeven and Laryea, 2010, pp. 3-6; Gill and Raiser, 2012, p 157) argues that it is only justified if the debt problem is systemic in the sense that speedy resolution using the usual legal tools is no longer possible. For example, a sudden, sharp, and widespread deterioration in banks' portfolio quality may endanger financial stability. In such circumstances, the sheer quantity of needed restructurings can clog the courts, individual bank incentives may conflict with broader macro objectives, and the cost of restructuring can swamp banks' buffers.

A few helpful design features have emerged that can help the benefits of government involvement outweigh the cost. These include:

- ***Targeting.*** For equity reasons and to avoid moral hazard, the scheme should be time-bound, selective and provide debt relief only to those borrowers whose ability to service their debt is likely to be restored after restructuring.
- ***Managing expectations.*** Simply talking about government-sanctioned bailouts may undermine credit discipline. Equally, it may contribute to irresponsible lending behavior. This calls for clear communication, including a firm commitment to abstain from taking further measures once a support scheme has been put in place.
- ***Appropriate burden sharing***. The scheme should distribute the cost of restructuring between borrowers and lenders while taking into account their respective loss-absorption capacity. This also applies to any share of the cost to be assumed by the government, which should be strictly determined by the available fiscal space.
- ***Collaborative approach***. Participation in any government-coordinated scheme should ideally be voluntary. At a minimum, all stakeholders need to be involved in its design. Schemes that retroactively revise existing private contracts need to be avoided as they undermine the rule of law and hurt the investment climate.

Only a few governments in Europe have directly intervened to coordinate debt restructurings, all of them for households. To various degrees, this was prompted by fears about the impact of private sector debt servicing difficulties on both the financial sector and the real economy.

- ***United Kingdom*** (2008): Deferral of interest payments permitted and supported by limited government guarantees.
- ***Latvia*** (2009—never implemented): Government guarantee for restructured household mortgages on the condition that the debt service is reduced and part of the loan is forgiven once the borrower has resumed payments.
- ***Iceland*** (2010): Write-down (on a case-by-case basis) of mortgages—a relatively small share of overall private debt— to 110 percent of collateral value and of SME debt to the value of the firm (all based on eligibility criteria); interest rebate and subsidy; conversion of fx-indexed loans to local currency; installation of a debtor's ombudsman to arbitrate individual debt mitigation applications. The scheme is voluntary, but strongly encouraged by the government.
- ***Hungary*** (July 2011): Possibility to service fx-denominated mortgages at a preferential exchange rate, with the difference rescheduled (largely NPV-neutral) and partly government-guaranteed; quota on the number of foreclosures; national asset management company that buys some distressed properties.
- ***Croatia*** (July 2011): Extension of repayment period and possibility to service fx-denominated mortgages at a preferential exchange rate (similar to Hungary's July 2011 scheme).
- ***Hungary*** (September 2011, partly modified December 2011): Time-bound offer to debtors to fully prepay outstanding fx mortgages at a preferred exchange rate (implying a debt relief of 20-30 percent), with loss fully borne by the banks (later partially assumed by the state). Modification of the September scheme was designed to shift the effect of further currency depreciation to banks and government.
- ***Hungary*** (December 2011): The Government and the Hungarian Banking Association reached an agreement on a number of measures to support lending and address distressed private sector debt.

The sharp deterioration of debt indicators in Iceland (Figures 1-3) seems to justify the extensive government intervention employed there, especially since the authorities took care to preserve a market-based approach as much as possible. The case is much less clear-cut, however, in other countries where debt restructuring schemes were put in place.

IV. Conclusions

There is an increasing recognition that leaving high private sector debt unresolved helps neither debtors nor creditors. Removing uncertainty and, in some cases, providing debt relief (in NPV terms) will have positive externalities for the economy as a whole, although these benefits will need to be weighed against the fiscal and political cost associated with reforms. With the immediate crisis over but the recovery still tepid, now is the time to start creating conditions for meaningful debt restructuring in a number of highly indebted countries—all the more because it could take several years until tangible results become evident.

Private sector debt restructuring works best if it is part of a comprehensive approach. This is demonstrated in the Baltics and Iceland, where legislative changes were embedded in broader institutional, fiscal, and financial sector reforms that took into account the macroeconomic impact and burden-absorption capacity of the various stakeholders. On the other hand, piecemeal changes or reforms that do not take into account, e.g., institutional constraints (such as the capacity of courts) are likely to be less successful.

In corporate debt restructuring, experience to date shows that an effective insolvency regime is critical to facilitate the early rescue of viable firms and the speedy exit of non-viable ones. The insolvency law should allocate risks among market participants in a predictable, transparent and equitable manner and maximize value for all parties. In line with international best practices, the law should include provisions that support orderly rehabilitation and efficient liquidation, including fast-track court approval procedures and flexibility in the liquidation modalities. The effectiveness of an insolvency system is dependent on a strong institutional infrastructure as very few elements of insolvency law are self-executing. It should be recognized that institutional reforms take time to implement.

Voluntary out of court restructurings provide a speedy, cost-effective and market friendly alternative to court supervised insolvency proceedings. This tool is particularly useful in cases where there is a lack of confidence in the institutional capacity to support the operation of the insolvency system. As out of court restructuring takes place in the shadow of the in-court insolvency regime, it is essential to put in place an effective insolvency law. In addition, other laws need to be supportive of out of court restructurings by, for instance, creating tax and regulatory incentives for creditors and debtors to participate in the restructuring.

High household debt, especially related to residential mortgages, has prompted a wave of legal reforms in the most-affected countries. As this is a novel feature of the recent crisis, no best practices exist. In creating or reforming personal insolvency frameworks and—in some cases—instituting special regimes for household mortgages, legislators have had to balance the desire to provide debt relief with the need to preserve bank solvency and credit discipline and minimize moral hazard. While there is some variation between countries, the approach that is emerging appears less punitive towards individual debtors than traditionally seen in Northern European countries.

Direct government involvement in private debt restructuring has been relatively rare. Most countries have steered clear of heavy-handed and across-the-board solutions. Indeed, the case for such intervention appears weak in all but the most heavily indebted countries.

References

Bakker, Bas B. and Anne-Marie Gulde (2010), "The Credit Boom in the EU New Member States: Bad Luck of Bad Policies?", IMF Working Paper, WP/10/130.

Cottarelli, Carlo, Giovanni Dell'Ariccia and Ivanna Vladkova Hollar (2003), "Early Birds, Late Risers, and Sleeping Beauties: Bank Credit Growth to the Private Sector in Central and Eastern Europe and the Balkans", IMF Working Paper 03/213.

EBCI (2012), European Bank Coordination Initiative, "Report of the Working Group on NPLs in Central, Eastern and Southeastern Europe", March 2012.

Erbenova, Michaela, Yan Liu and Magnus Saxegaard (2011), "Corporate and Household Debt Distress in Latvia: Strengthening the Incentives for a Market-Based Approach to Debt Resolution", IMF Working Paper, WP/11/85.

Garrido, Jose (2012), "Out-of-Court Restructuring", The World Bank, mimeo, www.worldbank.org.

Gill, Indermit and Martin Raiser (2012), "Golden Growth. Restroring the Lustre of the European Economic Model", The World Bank.

Grigorian, David and Faezeh Raei (2010), "Government Involvement in Corporate Debt Restructuring: Case Studies from the Great Recession", IMF Working Paper, WP/10/260.

Herzberg, Valerie (2010), "Assessing the Risk of Private Sector Debt Overhang in the Baltic Countries", IMF Working Paper, WP/10/250.

IMF (1999), Orderly and Effective Insolvency Procedures", Washington, DC www.imf.org/external/pubs/ft/orderly/

IMF (2012), "Dealing with Household Debt", World Economic Outlook April 2012, Chapter 3, pp. 89-124.

INSOL (2000), International Federation of Insolvency Professionals, "Statement of Principles for a Global Approach to Multi-Creditor Workouts", London, October 2000. www.insol.org/statement

King, Mervyn (1994), "Debt Deflation: Theory and Evidence", Volume 38, pp. 419-445.

Laeven, Luc and Thomas Laryea (2009), "Principles of Household Debt Restructuring", IMF Staff Position Note, SPN/09/15, June 26, 2009.

Laryea, Thomas (2010), "Approaches to Corporate Debt Restructuring in the Wake of The Financial Crisis", IMF Staff Position Note, SPN/10/02, January 26, 2010.

Myers, Steward (1977), "Determinants of Corporate Borrowing", Journal of Financial Economics, Volume 5, 99. 147-75.

Occhino, Filippo (2010), "Is debt Overhang Causing Firms to Underinvest?", Federal Bank of Cleveland Economic Commentary, July 20, 2010.

Philippon, Thomas (2009), "The Macroeconomics of Debt Overhang", Paper presented at the 10th Jacques Polak Annual Research Conference, Washington, DC, November 5-6, 2009.

UNCITRAL(2004), United Nations Commission on International Trade Law, "Legislative Guide on Insolvency Law", Parts one and two, Vienna, 2004.
http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html

World Bank (2001), "Principles and Guidelines for Effective Insolvency and Creditor Rights Systems", Washington, DC, 2001. www.worldbank.org/ifa/ipg_eng.pdf