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Position Paper No 5

## Position Paper on the Insolvency Process

### 1. Executive Summary

Effective and transparent insolvency procedure is one of the key components that ensure solid economic growth and stability. According to the World Bank principles for effective insolvency, legal framework should provide for timely, efficient, and impartial resolution of insolvencies and prevent the improper use of the insolvency system. If the insolvency proceedings are misused, such abuse may result in significant negative influence on the economy and result in losses for key stakeholders of the economy: businesses, investors, employees and public sector.

Foreign Investors' Council in Latvia (hereinafter — “FICIL”) during the High Council Meeting of 2012 initiated a discussion on non-transparent and unpredictable insolvency system, indicating that the improvement of the Insolvency Law per se does not ensure legal and transparent insolvency processes as the quality of the insolvency system is determined not only by the provisions of law, but also the practice of application of those provisions that is in the hands of courts, supervision bodies and insolvency practitioners. At that time FICIL particularly emphasised the role of insolvency administrators requesting evaluation of their activities.

In recent years it has been widely discussed and accepted that significant legislative amendments of the last 7 years have been introduced in absence of a clear strategy and government policy, without specifying priorities, objectives and performance indicators that would allow assessing efficiency and integrity of the insolvency system. It has also been established that abuse of the insolvency system causes significant harm to Latvia. According to the research of the State Audit Office, Latvian State budget has lost hundreds of thousands of euros as a result of insolvency proceedings. But estimating the size of the problem for the whole economy of Latvia was complex.

FICIL commissioned Deloitte Latvia to undertake an independent study on legal and economic impact of the insolvency abuse in Latvia and present their findings in a report. The report, supported by a wide range of public and private sector organisations, analysed data about 9,512 companies that were announced insolvent during the period 2008-2014.

The research team has conservatively estimated that financial losses due to unrecovered creditor claims and costs related to insolvency proceedings amount to EUR 6.5 billion in the last seven years. But this figure reflects just the lowest possible amount of losses due to limitations of incomplete or non-available data. The State Revenue Service lost at least EUR 0.8 billion, financial institutions EUR 1.5 billion and the rest is borne by other involved stakeholders.

Total economic loss, including financial loss and induced costs to the economy, amounts to EUR 6.9 billion, including losses in the amount of at least EUR 0.5 billion due to insolvency abuse.

FICIL research study shows, that the average recovery rate of secured creditors in Latvia was 42% over the last 3 years which is substantially below the average recovery rate for secured creditors in OECD high-income countries (72%). Recovery rate of unsecured creditors (including State Revenue Service) in last 7 years was less than 1%, which is also behind international benchmarks.

FICIL research shows that not only the absence of the government's insolvency policy, but also chaotic and fragmented monitoring process of insolvency proceedings as well as ineffectiveness of law enforcement bodies is the main reason for low efficiency rates of insolvency system and wide recognition of the insolvency abuse in Latvia.

FICIL commends the work of the government and the parliament of Latvia in improving the current legal framework of insolvency system and implementing our recommendations. At the same time we insist on government's more active involvement in drafting long-term insolvency policy, establishing transparent supervision and monitoring system and fighting those who abuse the law. Based on the key findings of the research FICIL would like to propose specific recommendations for continuing improvement of the insolvency system in Latvia.

## 2. Recommendations

1. A system for monitoring efficiency of the insolvency system and particular insolvency cases and the performance of particular insolvency administrators has to be introduced. At least the following KPIs have to be observed:
  - Length of insolvency proceedings;
  - Costs of insolvency proceedings;
  - Recovery rate for both secured and unsecured creditors;
2. Fighting economic crimes (including insolvency abuse) has to be defined as high priority;
3. The capacity and competence of the state police, state prosecutors and judges has to be significantly increased for investigation of economic crimes;
4. The overall competency of the judges in economic and business matters has to be increased;
5. The capacity and efficiency of the Insolvency Administration in supervising the insolvency administrators has to be increased;
6. Disputes related to a particular insolvency case (creditor claims, claims against debtor's management and claims on transactions avoidance) have to be resolved within the court which opened the insolvency case
7. The competency of applying administrative sanctions for late insolvency has to be transferred from the state police to the Insolvency Administration.

## 3. Rationale for Recommendations

In cooperation with Deloitte Latvia, FICIL has conducted a research on the efficiency of the insolvency system and the scale and economic impact of potential insolvency abuse in Latvia. Within the research, relevant data about 9,512 companies that were announced insolvent during 2008-2014 was analysed. Key sources of information included the Company Registry, the Insolvency Administration, the State Revenue Service, the State Audit Office, the Central Bureau of Statistics, financial institutions, private and state owned companies and publicly available data.

Detailed information about the results of the research will follow in October 2015. However, based on the research FICIL summarises key findings on the efficiency and the challenges of the insolvency system in Latvia and the recommendations for improving the system.

There is no system for monitoring the effectiveness and efficiency of the insolvency system and its

key indicators:

- length of procedure,
- costs of the procedures and
- recovery rate of creditor claims.

Thus it is not possible to measure whether the insolvency law reforms of the previous years have achieved goals indicated by the legislator and the stakeholders and where other improvements are needed.

According to the Doing Business study Latvia has scored 12 points in the index of strength of insolvency framework, which is almost the average of OECD high-income countries where the index is 12.5. Based on these results, we conclude that the best international practise has been introduced in the Latvian Insolvency law. However, there is a significant gap between average recovery rate of secured creditors in Latvia (48%) and the average recovery rate in OECD high-income countries (72%) according to Doing Business. As FICIL's research shows, the gap is even wider – the average recovery rate of secured creditors in Latvia was 42% over the last 3 years. The average recovery rate of unsecured creditors (including the State Revenue Service) in last 7 years was less than 1%.

Since the reforms of the Insolvency law have been introduced in Latvia several years ago (2008-2011), the gap between insolvency efficiency rates in Latvia and the OECD benchmarks is a result of improper implementation of the law and undeveloped judiciary framework rather than wording of the Insolvency law.

The problem of application of the law is confirmed by a survey organised by the Latvian Chamber of Commerce in Industry, where 80% of entrepreneurs believe that insolvency proceedings are not conducted properly and transparently, 56% have been victims of insolvency abuse themselves, 75% of those who have suffered from insolvency system abuse, reported that there were no negative consequences for the abusers.

Another major issue is a significant number of “late” insolvency cases, which greatly influences the recovery of creditor amounts. At least 36% from all insolvency procedures commenced in 2008-2014 were delayed.

Suggested changes on the political level:

- The competence and the capacity of the Insolvency law enforcement authorities: the Insolvency Administration, the courts and the State police should be significantly increased;
- Effective investigation of economic crimes and fair trial should be defined as high priority.

Changes on legislative and institutional level:

- System for monitoring at least these KPIs should be introduced: 1) length of insolvency proceedings; 2) costs of insolvency proceedings; 3) recovery rate for both secured and unsecured creditors;
- Insolvency law dispute settlement (all proceedings related to the insolvency of a particular company) should be resolved within the court, which announced the insolvency proceedings;
- The competence of the State police to impose administrative sanctions for delayed insolvency should be transferred to the Insolvency Administration.