Scientific Papers (www.scientificpapers.org)
Journal of Knowledge Management, Economics and Information Technology

Vol. III, Issue 6
December 2013

The Corporate Insolvency's Evolution in the EU and India in the Period 2007-2012

Authors: **Ileana Ashrafzadeh - Nișulescu,** Bucharest Academy of Economic Studies, Romania, nisulescu_ileana@yahoo.com, **Marușa Beca,** Bucharest Academy of Economic Studies, Romania, marushabk@yahoo.com

This article's goal is to compare the impact of the global economic crisis on the corporate insolvency's evolution in the EU and India in the period 2007-2012. We want to highlight India's position compared to the European Union in terms of time, cost of insolvency and recovery rate and to propose specific measures to improve its situation.

Keywords: *insolvency; recovery rate; economic crisis; India; EU.*

Introduction

The negative consequences of the 2008 financial crisis impacted the economic activity globally. The significant raise in the number of insolvent companies emphasize the importance of improving insolvency regimes. Some of the legislative changes made in 2009-2011 by many EU member states were inspired by the economic crisis that had been a good opportunity for governments and policymakers to engage in significant reform of the bankruptcy process. According to Doing Business 2013, India has eased the process of closing a business by making processes more effective thus reducing time needed in 2009.

This paper presents a comparative analysis of the type of legal system, the number of business insolvencies' dynamics, the time and cost of insolvency and the recovery rate in the European Union and India during the 2007-2012 periods.

Speed, low costs and continuation of viable businesses characterize the top performing economies. A solid insolvency system acts as a filter and ensures the survival of efficient firms. By increasing the return of creditors good bankruptcy systems facilitate access to finance and thus improve development in the economy (Doing Business 2013).

An effective insolvency regime should enable a distressed business and its creditors to reach an optimal outcome that preserves firm value and maximizes stakeholder returns. (Global Insolvency and Restructuring Review 2012/2013).

Research Methodology

We have gathered data from Creditreform, Doing Business, Euler Hermes and BIFR in order to make a comparative analysis between the EU average and India's business insolvencies in the 2007 - 2012 period. We have used the following variables:

- Time to resolve insolvency (years) represents the average time to close a business.
- Cost (% of debtor's estate) represents the average cost of bankruptcy proceedings. The cost of the proceedings is recorded as a percentage of the estate's value.
- Outcome (0 as piecemeal sale and 1 as going concern)
- Recovery rate (cents on the dollar): it calculates how many cents on the dollar claimants (creditors, tax authorities, and employees) recover from an insolvent firm.

The Comparative Analysis between India's and Eu's Insolvencies' Evolution

The eye of the global financial storm stalled over Europe in 2012, where the tempest continues to threaten the 27-nation European Union, or at least the 17-member eurozone. Austerity measures implemented by Greece, Spain, Italy, Britain, and Portugal, among others, have proved to be both unpopular

and unsuccessful. S&P downgraded the credit ratings of France, Italy, Spain, and six other European countries in 2012 - a reminder that Europe's economic woes are far from over. The only eurozone nations retaining their top AAA ratings are Germany, the Netherlands, Finland, and Luxembourg (Oellermann and Douglas).

According to La Porta (1997, 1998) the legal system should protect investors ensuring sustainable financial development leading to economic growth. This theory distinguishes countries based on the following criteria:

- The type of regulatory framework applied, that is civil law or common law;
- Whether bankruptcy regulations are favorable to debtors and creditors.

All countries in Europe have legal systems based on civil law, except the United Kingdom and Ireland which have common law and Cyprus and Malta that have pluralistic law (elements from common and civil law).

Among the countries with civil law, there are 3 sub-groups of legal systems, those influenced by the French civil law, those influenced by the German civil law and those influenced by Scandinavian civil law, while some countries have legal systems with elements from both the French and German civil laws (European Commission). India's legal system fits into the Common Law.

According to a European Commission's survey, the majority of the EU member states are creditor – friendly (15 out of 27), 5 countries are debtor-friendly and the rest of them are neutral. India is among the creditor-friendly countries.

In relation to the impact of debtor-friendly vs. creditor-friendly bankruptcy framework, debtor-friendly bankruptcy systems have a higher rate of insolvencies than creditor-friendly ones (European Commission).

From the Doing Business data presented in table 1 reflect a below-average profile for India compared to the EU-27 in terms of resolving insolvency. In the EU, in terms of resolving insolvency indicators, all three registered improvements: the time and the cost to resolve insolvency slightly decreased, whereas the recovery rate increased with 3.2 cents on dollar.

Short-term growth nearly ground to a halt in India during 2012, dampening hopes that India, along with China and other non- Western economies might help revive the global economy, as happened after the 2008 financial crisis. India is now facing a political reckoning, as the

country's elected leaders address difficult, politically unpopular decisions. India's currency (the rupee) is falling, investment is down, inflation is rising, and deficits are eroding government coffers (Oellermann and Douglas).

Reforms which focus on reducing the time required to resolve debt recovery claims reduce the cost of credit as well as increase the aggregate supply of credit in an economy. Out of court debt recovery tribunals in India have not only increased the speed of repayments, but have also yielded to creditors a greater claim to an increased value on collateral, and led to lower interest rates on larger loans (Global Insolvency and Restructuring Review 2012/2013).

The establishment of the new Debt Recovery Tribunals reduces delinquency by 3-10 percent. Furthermore, new loans sanctioned after DRT establishment are charged interest rates that are lower by 1.5- 2 percentage points. Debt Recovery Tribunals were established as the Indian government's attempt to improve the legal channels for loan recovery, without overhauling the entire judicial system. By accommodating the opposition without diluting the intent of the act, the government successfully implemented the reform. This is a reasonable representation of judicial reform as it might be carried out in developing countries. Anecdotal evidence suggests that these DRTs have reduced the time taken to process debt recovery cases. (Visaria 2009).

According to the World Bank's Doing Business Report India ranked 116th (of 174 economies) in 'Resolving insolvency' in 2012. In comparison to 2011 its position dropped with 7 points.

In India, resolving insolvency takes 4.3 years on average and costs 9% of the debtor's estate with the most likely outcome being that the company will be sold as piecemeal sale. The average recovery rate is 26 cents on the dollar. In 2009 India has eased the process of closing a business by making processes more effective thus reducing time needed (Doing Business 2013).

Table 1: Resolving Insolvency India – EU average

Economy	Year	Resolving Insolvency			
		Time (years)	Cost (% of estate)	Outcome	Recovery rate (cents on dollar)
European Union	2007	2.11	10.52		59.41
	2008	2.08	10.69		57.55
	2009	2.08	10.77		57.56
	2010	1.95	10.54		60.36
	2011	1.99	10.52		60.85
	2012	1.99	10.22	1	62.61
India	2007	4.3	9		24.3
	2008	4.3	9		23.1
	2009	4.3	9		23.1
	2010	4.3	9		24.3
	2011	4.3	9		27.6
	2012	4.3	9	0	26

Source: Doing Business

Regarding the outcome (0 as piecemeal sale and 1 as going concern), in India we encounter a piecemeal sale whereas in the majority of the EU member states (17 of 27) there is a going concern sale. Recovery rates are higher in going-concern sales than in piecemeal liquidations (Ravid and Sundgren (1998)). This is also true in the case of India.

According to Board for Industrial & Financial Reconstruction (BIFR) the objectives of this Act (SICA) as incorporated in its preamble, emphasises the following points: the SICA had been enacted in the public interest to deal with the problems of industrial sickness with regard to the crucial sectors where public money is locked up and it contains special provisions for timely detection of sick and potentially sick industrial companies, speedy determination and enforcement of preventive, remedial and other measures with respect to such companies. The number of registered cases of reorganization in India increased steadily in the period 2008-2012 from 57 to

80 (BIFR) but the number is still low and we can state that India needs a US Chapter 11-style bankruptcy code.

According to the Credit reform, Coface and Euler Hermes data, the number of insolvencies in the EU this number has raised in 2009, diminished in 2010 and then increased again in 2011. In terms of insolvencies dynamics, the highest decreases were registered in Latvia (-65%) and Estonia (-39,5%) and the highest increases in Greece (+33%) and Slovenia (+32%). Taking into consideration the fact that the average EU change in insolvencies between 2010 and 2011 was +0,19% we can say that the number of insolvencies stagnated.

According to the Euler Hermes and Creditreform data, among the EU member states, the highest recovery rate is registered in Finland (89,7%) and the lowest in Romania (29,2%), the fastest insolvency procedure is encountered in Ireland (0.4 years) and the slowest in the Slovak Republic (4 years), the cost of the recovery (% of the debtor's estate) is the lowest in Belgium, Denmark, Finland, Netherlands and Slovenia (4) and the highest in Italy (22).

We have analyzed the EU member states recovery rates according to their type of regulatory framework applied (civil, common or pluralistic) and whether bankruptcy regulations are favorable to debtors and creditors (debtor-friendly, creditor-friendly and neutral) and we conclude that the countries that are ranked above the EU average recovery rate of 62,61% belong to the following categories: Scandinavian Civil Law debtor friendly (89,70%), Common Law creditor-friendly (88,05%), German Civil Law debtor-friendly (83,30), Scandinavian Civil Law neutral (80,90%), French Civil Law creditor-friendly (72,18%) and the Pluralistic Law creditor-friendly (70,70%).

Although India is a Common Law creditor-friendly country and it should have a high recovery rate as United Kingdom and Ireland have, it doesn't due to the long delays, followed frequently by liquidation and low creditor returns.

Conclusions

The Doing Business statistics reflect a below-average profile for India compared to the EU-27 in terms of resolving insolvency. India scores under the EU average in terms of recovery rate and cost of recovery and above it regarding the time of insolvencies'.

India has a very low recovery rate compared to the EU-27 one due to the excessive length of the insolvency procedure and by the piecemeal liquidation because the recovery rates are lower in this kind of sales compared to the going-concern sales. The number of registered cases of reorganization in India increased steadily in the period 2008-2012 from 57 to 80 (BIFR) but the number is still low and we can state that India needs a US Chapter 11-style bankruptcy code.

Economies with good bankruptcy procedures are those that maximize the total value of recovered debt at a low cost. India needs to increase the recovery rate in order to determine creditors to reinvest in viable firms and to continue lending by diminishing the time and cost to resolve insolvency and by selling in going concern, taking into consideration the fact that recovery rates are higher in going-concern sales than in piecemeal liquidations. By taking these actions India will have a more developed credit market.

Considering that economies where resolving insolvency is fastest, the majority have systems where reorganization is more likely than foreclosure or liquidation, India needs to support reorganization, to reduce the share of liquidation among insolvencies. A faster insolvency procedure determines lower costs and an increase of the recovery rate.

References

[1] Board for Industrial and Financial Reconstruction (BIFR), available at http://bifr.nic.in/casesregd.htm

[2] Coface, Insolvencies opened in Central and Eastern Europe January - December 2010 and 2011, available at http://www.cofacecentraleurope.com/CofacePortal/ShowBinary/BEA%20Repository/CE/en_EN/documents/infocorner/InsolvenciesData/InsolvenciesData2011

[3] Creditreform, Insolvencies in the European Union 2011/2012, available at https://www.uc.se/download/18.782617c713603ab70837ffd368/Europa_statistik_konkurser_2011.pdf
[4] Doing Business, Closing a business 2011, available at http://www.doingbusiness.org/reports/global-reports/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB11-Chapters/DB11-CB.pdf
[5] Doing Business, Resolving insolvency 2012, available at http://www.doingbusiness.org/reports/global-reports/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB12-Chapters/Resolving-Insolvency.pdf
[6] Doing Business, Resolving insolvency 2013, available at http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB13-Chapters/Resolving-insolvency.pdf
[7] Doing Business in India, available at http://www.doingbusiness.org/data/exploreeconomies/india#resolving-insolvency
[8] Euler Hermes, (2012), *Global Macroeconomic and Insolvency* Outlook Q3-2012
[9] European Commission, Business dynamics: Start-ups, business transfers and bankruptcy 2011, available at http://ec.europa.eu/enterprise/policies/sme/business-environment/files/business_dynamics_final_report_en.pdf
[10] Global Insolvency and Restructuring Review 2012/2013, available at http://www.potamitisvekris.com/_control/admin/_files/binaries/publications/fil_publications114409934.pdf)
[11] La Porta, R., F. López-de-Silanes, A. Shleifer, and R. Vishny, (1998), *Law and Finance*, Journal of Political Economy, CIV, 1113-1155
[12] Oellermann, Charles and Douglas, Mark, *The year in bankruptcy: 2012, Recent developments in bankruptcy and restructuring*, Volume 12, no. 1, 2013
[13] Ravid, Abraham S. and Stefan Sundgren, (1998), *The Comparative Efficiency of Small-Firm Bankruptcies: A Study of the US and Finnish Bankruptcy Codes*, Financial Management, 27, 28–40

[14] Visaria, Surata, *Legal Reform and Loan Repayment: The Micoreconomic Impact of Debt Recovery Tribunals in India*. American Economic Journal: Applied Economics 1 (3): 59-81. 2009). available at http://ipl.econ.duke.edu/bread/papers/0509conf/bread0509_visaria.pdf