Lack of Insolvency-Related Information as a Factor Limiting the Reform of the Insolvency System

EVA KISLINGEROVÁ
Department of Business Economics, Faculty of Business Administration
University of Economics, Prague
W. Churchill Square 4, 130 67 Prague 3
CZECH REPUBLIC
eva.kislingerova@vse.cz  https://webhosting.vse.cz/ekisl/index_en.html

Abstract: The fundamental idea of this work is based on the conviction that without more accurate statistical data, which would provide a truer picture of insolvency proceedings in the Czech Republic, the current legislation can neither be appropriately reformed, nor can we appropriately adjust the judicial structure. Data collected via the Ministry of Finance and published on its website are too general and do not encompass a number of important aspects and features of insolvency proceedings. This is also the reason why the effects of a fundamental modification of insolvency law, implemented via new legislation (most key provisions of the Insolvency Act became effective as of 1 January 2008), cannot be thoroughly analysed. This paper looks at some proposals for modifying the process of collecting statistical data as well as opportunities that these proposals could present for scientific work and everyday business operations. Special attention is given to possible application of data within financial economy as well as on the potential benefits that a successful modification of data collection and analysis could have within the banking industry.

Key-Words: bankruptcy, debtor, insolvency, the Insolvency Act, reorganization, default, statistics, creditor,

1 Current situation (2012) in the Czech Republic

Complex systems may be managed only with a degree of difficulty where information is incomplete. We wholeheartedly agree with the thesis and believe that only few people would actually challenge it. Despite this, businesses and even political institutions at various levels adopt decisions without first examining the topic subject to their decision-making, without having a sufficient amount of information on its characteristics and without having precise knowledge of its historical development. Logically, the result of such an undertaking is failed attempts at reforms (whether concerning business procedures or legislative and government systems), with businesses becoming less economical and profitable, legislation not having the desired social impact and government systems being less effective.

Expert literature provides a plethora of examples that poorly planned and ad-hoc investment decisions, which are not based on knowledge of the market and business potential, have led to decreased profitability and other adverse effects [1]. If this is often true for private business entities then we have to expect that this also applies, at least as often, to decision-making processes of state bodies or municipalities.

We are now faced with the same situation: the Ministry of Justice of the Czech Republic, acting as the expert guarantor of legislation in question, currently prepares extensive amendments to existing insolvency-related laws; however, upon examining statistical outputs that are available for insolvency proceedings, we have to necessarily conclude that the available information concerning these economic processes is fragmented and far from perfect. The imperfection is manifested in the lack of information on aspects perceived as problematic that we think are in need of improvement.

While we are able to say where the new legislation demonstrates insufficiencies based on the current practice and case studies, we are unable to generalize our findings and compare them to overall statistical data, i.e. we are unable to assess the relevance of these findings. This means that we see the problems and how they are manifested but we are unable to verify whether we correctly understand the mechanisms behind their occurrence.

Continuing the reform efforts along the lines of Insolvency Act no. 182/2006 Coll., as subsequently amended, would be like shooting at a target blindfolded. While we would have a relatively exact idea of the target’s location, including its size, shots would be marked by a high degree of misses compared to shooting with unobstructed vision. If a
discussion is to take place in 2012-2013 concerning legislative modifications of the insolvency law and the actual Insolvency Act, it would seem logical to embark on this journey equipped with information that, however, is beyond our reach at this point. And the reason why it is not available is the currently applied system of collecting statistical data which is insufficient and does not enable us to map insolvency proceedings with the desired degree of detail.

2 Statistical problem viewed from different angles

It is natural that upon claiming data for various areas, we cannot support our claims by arguing that these data are useful for researchers or, simply, that they are interesting. If private entities or state administration were to be subjected to additional requests for data that would go beyond those currently defined, they should be provided with solid arguments justifying why they need to be charged with new obligations. In this respect, we need to consider the following two questions:

Firstly, we need to determine the current structure of insolvency-related statistical data, their availability, accuracy, thoroughness and to what extent they meet our needs. The second question that ensues is whether the change in the method of collecting data leading to an increase in their volume and informative value will be measurable or quantifiable in any way, i.e. whether we will be able to assess benefits of such measures against their cost.

If we fail to provide answers to these two questions then, understandably, we cannot justify our requests for new data. By the same token it is true that there is a lack of information on insolvency proceedings in the Czech Republic (as well as in other developed countries), with the structure of available data being insufficient and hindering three vital activities.

The first of them is the scientific processing of data and their macroeconomic analysis. The second one is the use of the available data to assess to what extent the Insolvency Act and the entire insolvency procedure are functional and comply with the public interest of maximizing enforceability of law (recoverability of claims) while minimizing costs of enforcement. The third activity is the provision of trustworthy reference information to creditors, especially those recruited from the banking industry, so that they could correctly assess the development of the entire insolvency system while also comparing their results in order to optimize their own activities.

2.1 Availability of data in the Czech Republic

The issue of insolvency legislation has been subject to intensive debate among Czech economists and lawyers, especially after the former Bankruptcy and Composition Act (Act no. 328/1991 Coll.) proved insufficient. Somewhat paradoxically, the shortcomings of the Act adopted in the 1990s were so obvious that not much proof, such as statistics on bankruptcy proceedings or other forms of reorganization, was necessary to initiate the debate. As a result, calls for suitable data gave way to other issues and those wanting to analyse the Bankruptcy and Composition Act were left empty-handed.

At that time we were completely in the dark as to the actual course and outcome of insolvency proceedings (and continue being so even today). However, the insolvency practice was so deterrent and shortcomings so abundant that no general evidence was essentially needed.

Today the situation is very different. Over the last years, following the effectiveness of the Insolvency Act, there have been clear and undeniable changes that have improved the legality of insolvency proceedings, boosting the position of creditors and improving the transparency of court decisions. However, we are not capable now to assess whether the changes have been enough to bring the quality of insolvency proceedings to a level habitual in developed countries or whether it still lags behind.

2.1.1 Current data structure

Today, data on the course and outcome of insolvency proceedings are essentially provided exclusively by the Ministry of Justice. Besides that, there are a number of private entities that analyse insolvency proceedings and interpret data provided by state bodies. Unless asked directly to provide the latest data, the Ministry of Justice surprisingly only discloses quarterly data. Moreover, this information is published with a significant delay on a separate website (www.insolvencnizakon.cz) [2]. These statistical overviews include, without limitation, the following information:

- number of filed insolvency petitions by individual regions, information on the initiator of the petition (debtor vs. creditor), and whether the petition is a general one or includes a proposal for a specific solution;
- the number of completed cases and the number of cases where a decision has been adopted - e.g. on whether bankruptcy (konkurz) or another method will be chosen as the outcome of insolvency.

It is apparent that the official statistics do not offer any data suitable for analysis, except for information on the number of submitted petitions at the national or regional levels.

The website of the Ministry of Justice alone does not offer any relevant data concerning insolvency proceedings. The Czech Statistical Office does not equally collect any such data.

It is worth noting in this respect that there is no information on the actual value of claims, value of sold assets, costs of insolvency proceedings, etc.; it is mostly financial information that is missing.

All this information is naturally available in the Insolvency Register [3]; however, there it is filed separately under individual companies or physical entities. If we were to extrapolate this information from the insolvency documents on file, we would be faced with an immensely laborious task. This makes the information available in the Insolvency Register, such as the outcome (financial solution) of insolvency, creditors’ costs, etc., very difficult to use for statistical purposes as the number of insolvent companies and individuals is substantial.

Companies that use data provided by the Czech Statistical Office include most notably Creditreform [4] and the Czech Credit Bureau (CCB) [5]. On quite a regular basis, the CCB publishes analyses of the development of the number of insolvency cases, getting some of its data directly from the Ministry of Justice, while mining others from the Insolvency Register. As the CCB only works with very rough numbers in its reports, including the number of insolvency petitions for individual types of entities or the number of insolvencies ordered or approved by courts, in terms of assessing the effectiveness and quality of the entire insolvency system the CCB-produced analyses are of a very limited value. The same goes for regular monthly reports delivered by Creditreform.

The answer to the first question on whether insolvency data are readily available, accurate, thorough and meeting our objectives is thus obvious: the data are not easily accessible as the website where they are located (www.insolvencnizakon.cz) is not sufficiently promoted on the Ministry of Justice’s website www.justice.cz. In fact, the data may even be considered as almost unobtainable as their location within the structure of the website www.insolvencnizakon.cz does not correspond to prevailing standards and is, to a large degree, illogical. While the data are most likely accurate, we have to bear in mind that different sources cited in literature often provide different information on what may be considered the most basic information: the number of insolvency petitions, with individual discrepancies attaining as much as five per cent of petition totals. However, the discrepancies among individually reported numbers may be in part due to the degree of diligence of those working with the data, including a certain amount of methodological inconsistencies on their part.

To answer the question of whether the data meet our needs is trivial: no, they do not as the available numbers only deal with the type of insolvency and may be divided by the time and region, however, they fail to cast light on any other aspects that are material in insolvency proceedings. So, while the data show that (and where) the number of insolvency petitions decreases or increases, they do not convey anything in terms of the actual insolvency proceedings, including costs of proceedings, recovery rates, size of debtor businesses, etc.

We therefore need to answer the second question as well: would a change in the method of data type and method of data collection, which would involve additional burden on state administration as well as private entities who would be subjected to additional reporting obligations, achieve such improvement in the general level of awareness that would offset the costs involved?

First of all we need to pose the question of whether the need for better insolvency data is there. The answer here is clear: yes, we do, since insolvency proceedings are among significant economic phenomena that have serious implications across the board and influence the overall competitiveness of economy. The high costs on the part of creditors of insolvency proceedings as well as of other recovery-related processes linked to debtors’ defaults are reflected in prices at which lenders offer loans to borrowers. This means that an ineffective system of insolvency procedures or commercial justice increases the price of loans or demands of investors purchasing corporate bonds, etc. This situation may be compared to “financial poison” that works slowly yet tirelessly, eventually plaguing the entire economy with its effects.

So if we are currently unable to express what sort of changes the insolvency procedure has undergone, we are equally unable to detect the areas in need of a reform. In situations such as this one, the work is then usually performed by highly expert teams that (provided that experts in both theory and everyday
business practice are represented) may to a certain degree make up for the lack of statistical data.

However, recommendations delivered by such teams are inevitably limited by the personal experience of its members, including their individual character and skills. Thus, even if the composition of the teams is appropriate, with high likelihood even the combined skills and knowledge of their members will not be as representative as statistical data describing individual aspects of insolvency procedures.

Even more important is the fact that as of now we have but a hazy idea of what type of companies become subject to insolvency proceedings, what percentage of total claims is recovered by creditors, how high the recovery costs involved are, etc. We could therefore say that while we discuss amendments to insolvency law, we have merely a very incomplete idea of how the procedure looks in reality.

This is where insolvency data come into play. Without them, we would be unable to bring about improvements in parameters such as the usual duration of insolvency proceedings, usual costs of insolvency proceedings on the part of creditors and recovery rates for claims presented by creditors within insolvency proceedings. Based on international statistics, the Czech Republic has achieved significant improvements in these parameters since 2008, apparently following the effectiveness of the new Insolvency Act. But even given these advancements, the quality of insolvency proceedings still lags behind that of OECD; more specifically, the Czech Republic still continues to significantly lag behind the OECD average. This fact has been subject to previous analyses [6, 7] whose conclusions could hardly be challenged.

Authors of the analyses express their suspicion as to the statistics published by the World Bank and International Finance Corporation (IFC) [8] not providing an accurate picture of the situation. We feel the same way as, in many cases, the actual data structure is somewhat stiff and, apparently, cannot provide a true image of the reality: “It is worth noting that there are certain doubts about the accuracy of the statistical data that are published by the World Bank and IFC based on their research of the quality of individual economies. As the time series reveal, the presented numbers are obviously not the average values for real cases, but rough estimates derived from partial documentation. Despite this fact, the data cannot be taken lightly as with certainty they show the trend, if there is one, and there is no doubt that, providing for error, they are as accurate as possible, enabling comparisons to be made over time as well as among individual states or territories. As far as OECD data are concerned, these are quite distorted by the relatively scary numbers from Italy where local commercial disputes last for 1,400 days and also the duration of insolvency proceedings significantly exceeds the habitual length.” [6, page 67]

2.1.2 Potential for reform

Another question we need to consider is whether a change in the method of collecting statistical data could create an environment that could significantly contribute towards substantial reform of the insolvency system, thus positively affecting the economy. Answering this question, we understandably cannot but speculate as realistic assessment of such potential is impossible. We may nevertheless have a look at how Czech insolvency proceedings par with the OECD average (notwithstanding that we have just challenged these statistical data [8] in previous paragraphs).

<table>
<thead>
<tr>
<th>Tab. 1: Selected data on insolvency proceedings</th>
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<tr>
<td>Source: OECD, IFC [8]</td>
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<tr>
<td>duration of proceedings (years) CR OECD Finland</td>
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<tr>
<td>3.2</td>
</tr>
<tr>
<td>Cost of proceedings (% of claim) CR OECD Finland</td>
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<tr>
<td>17</td>
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<tr>
<td>Investment recovery rate (% of the investment) CR OECD Finland</td>
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<td>56.0</td>
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The table summarizes data for the Czech Republic, OECD average and Finland that shows some of the best values worldwide. And it is not a coincidence that Finland enjoys this position. In similar comparisons, Finland also scores some of the best values in many other parameters, with the improvement being the result of a reform following the collapse of the USSR in the early 1990s. At that time Finnish economy was to a large degree dependent on the relationship with the Soviet economy whose collapse forced the former to adopt extensive structural and legislative modifications.

In other words we may say that structural reforms in Finland, which have led to a significant flexibility of Finnish economy and influx of foreign capital, assuring that the economy is now capable of withstanding unfavourable geographic and other conditions and continues being among the economies posting some of the best growth results worldwide, have also been to a large degree based on Finland having one of the most efficient...
insolvency systems. Comparing three key parameters featured in Table 1, the difference between efficiency of the system in the Czech Republic and Finland is so obvious that no further comments are necessary. What is important is that the Czech Republic also lags behind the OECD average values. This means that the low-efficiency insolvency system in the Czech Republic reduces the competitiveness of the entire Czech economy.

This leaves us with one logical conclusion: as far as the potential for reform in the Czech economy is concerned, insolvency law and the entire insolvency system obviously offer an abundance of opportunities. By fulfilling this potential, the competitiveness of the Czech economy as a whole could be increased. Thanks to reducing transaction costs borne by creditors, the level of risk across the economy would be reduced as well. This, in turn, would reduce the price of loans offered by lenders to borrowers.

3 Directing the reform
In what direction should the reform of collecting data within insolvency proceedings go? This depends most importantly on what type of information is missing that would enable us to considered insolvency proceedings a well-chartered territory.

In essence, the scope of information that would have to be reported by parties to insolvency proceedings or by courts could be divided as follows [9]:

- Value of claims raised by creditors and recognized by trustees in insolvency, including those rejected yet subsequently recognized following a lawsuit for determining their existence;
- Number and duration of lawsuits for determining existence of claims and other judicial litigations that would influence insolvency proceedings one way or another;
- Costs of insolvency proceedings charged by trustees in insolvency, expressed in absolute terms as well as a percentage of total claims registered and total claims actually recovered by creditors;
- Amounts recovered by individual groups of creditors within insolvency proceedings that would be expressed in absolute terms as well as a percentage of total raised and recognized claims;
- Debtor data, most significantly those concerning the average number of employees in the debtor business, business revenues and other information linked to the course of bankruptcy, e.g. at whose proposal bankruptcy is filed and the value of claims that are registered and recognized. Providing information on regional distribution of data would equally be very beneficial;
- Creditor data, number of creditors for each specific group (by size) of debtor businesses measured via number of employees, revenues as well as the value of registered and recognized claims. Division of debtors by their respective groups based on number of creditors, value of claims raised by creditors for each group;
- Data on the outcome of insolvency proceedings, including amount of claims received for each debtor group, duration of proceedings measured from the insolvency filing date until the commencement of asset sales and the pay-out of their proceeds to creditors.
- Information on the value actually recovered through realization of collateral vs. percentage of debt thus secured.

4 Reporting scenarios
If we look at the system of insolvency proceedings in an attempt to identify the most suitable method that would provide for collecting relevant information as defined above, while keeping the cost of collection at its minimum, the best solution seems to be charging trustees in insolvency with the obligation of preparing the information overviews within individual stages of insolvency proceedings.

The most important of these stages would be the final report that is prepared by the trustee in insolvency and subsequently approved by court. In essence, a form inserted as a part of the final report would merely require completion of information that the report already includes anyway.

Following the final report being approved and the proceedings completed by the court, court clerks would enter the data on the course and outcome of insolvency in electronic forms. Further processing would in fact be a matter of applicable software.

Alternatively, the mechanism could be used within certain key moments of insolvency proceedings, e.g. when deciding on the best solution of a particular insolvency case. The main advantage of this method would be the quick availability of data that would not otherwise be disclosed until the final report. However, in terms of mapping the
insolvency system, such data would not bring any additional information.

We have a reason to assume that this method would not constitute a major burden on trustees in insolvency or courts whose agenda would not significantly outgrow their current obligations. As far as data confidentiality acts and related legislation are concerned, this method does not put confidentiality at risk as it merely works with publicly accessible data available in the Insolvency Register.

We may thus say that while requiring marginal investments, the method would bring significantly larger and publicly available amount of information on the course of insolvency proceedings, enabling, most importantly, a thorough analysis of their efficiency and quality.

5 Conclusion

Improving the availability of information on the course of insolvency proceedings is a prerequisite for a continuing reform that would make these proceedings more accurate and less costly. This would enable insolvency proceedings to better play their economic function for which they have been established and defined. It becomes apparent that procurement of additional statistical data and their processing would not entail any significant costs nor would it present an unjustifiable burden on state administration or private entities. On the contrary: it is apparent that a relatively simple setup would enable professional and lay public to obtain information on the course of proceedings that could be used by economic entities during other decision-making processes, thus making these decision more rational. For example, banks today assess costs of insolvency proceedings and recovery of debts from defaulted entities predominantly based on their specific knowledge and data, compared to whatever information they have available from other banks. Introducing new statistical procedures and disclosing their outputs could enable banks to confront their results with those attained within the entire market.

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