



Special Series on COVID-19

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Private Debt Resolution Measures in the Wake of the Pandemic

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The COVID-19 pandemic has exacerbated corporate, SME and household over-indebtedness in many countries around the world and affected the functioning of the private debt resolution system. This note proposes a strategy to address the special challenges posed by the pandemic and its economic consequences by identifying key measures for effective debt resolution in three potential phases. Countries will need to take swift and determined actions to adopt specific solutions to tackle the economic shocks from the pandemic and improve their legal mechanisms to resolve debt overhang and prevent long-run economic scarring.

BACKGROUND

The combination of high levels of corporate and household debt and the sudden shock of COVID-19 creates an unprecedented economic challenge for many countries. According to the IMF Global Debt Database, overall global debt stood at 226 percent of GDP in 2018, of which corporate and household debt comprised three-fourths. Given the unprecedented levels of debt pre-crisis, the pandemic is widely expected to trigger extensive debt distress in the corporate sector—particularly in SMEs—as well as in the household sector in many countries, which in turn could affect the financial sector through an increase in NPLs.

Private debt resolution strategies must be implemented in line with fiscal and financial policies. Private debt resolution does not operate in a vacuum: in the context of generalized debt distress, debt resolution strategies will have to be coordinated with fiscal and financial policies. This note elaborates on the elements of private debt resolution, which must be integrated within the overall thrust of national economic policies.

This note discusses the need to adapt and strengthen national private debt resolution frameworks in the wake of the COVID-19 shock. The note identifies three potential phases of the crisis and the key measures for effective corporate and household debt resolution during each phase: a first phase, where there is a need for *interim measures* to halt insolvency and debt enforcement activity; a second phase, in cases of severe crisis, where *transitional measures* may be required to respond to the wave of insolvency cases, including special out-of-court restructuring mechanisms; and a third phase in which countries strengthen their *regular debt resolution tools* to address the remaining debt overhang and support economic growth.

The sequencing of phases and the transition from one phase to another are determined by country circumstances. The first phase corresponds to the health emergency, which has disruptive effects not only on

the economy, but also on the insolvency and debt enforcement system (courts, justice administration, and other institutions and professionals in charge of carrying out insolvency and debt enforcement activities). Once emergency measures are lifted, insolvency and debt enforcement can resume (phase 3), but there may be a need for an intermediate phase (phase two) to address the wave of defaults and insolvencies that could come after the health emergency measures are lifted.

PHASE ONE – FREEZE

Interim measures are urgently needed to help distressed businesses and households tackle the economic shocks from COVID-19.¹ These measures need to be clearly limited to a specific emergency period -which can be linked to the restrictions affecting economic activities and the courts- to avoid creating moral hazard and undermining credit and contractual relationships. The design and calibration of these measures depend on the country's circumstances (for instance, importance of mortgage lending, as opposed to renting, in the residential market). Key interim measures include:

- **Moratorium on debt enforcement:** A legally binding moratorium on debt enforcement, foreclosures, evictions and debt collection gives breathing space to debtors and prevents social disruption. Many countries (e.g. Australia, Germany, Spain, Turkey) have already imposed broad moratoria on all debt enforcement, while others (e.g., Portugal) have implemented more targeted measures (e.g., foreclosures of primary residences or suspension of evictions). Moratoria may also cover evictions for lack of payment of rent. A moratorium on *debt enforcement* must be distinguished from a moratorium on *loan payments*, which raises different issues pertaining to financial regulation.² Even in the absence of a legal moratorium on debt enforcement, activities of the courts and enforcement agents are heavily impacted by the health crisis restrictions.
- **Rental agreements and essential utility contracts:** Utility contracts (energy, water, telecommunications) should not be terminated for lack of payment during the pandemic (e.g., France and Spain). This minimizes economic disruption and avoids negative impacts on the living conditions of households, complementing any special support measures adopted by states. Likewise, rental agreements should not be terminated if the lack of payment is due to the pandemic.
- **Credit information systems:** Some countries (e.g., US and Colombia) are excluding the failure of consumers to pay financial or commercial obligations because of the pandemic from the reporting to credit bureaus, to avoid unnecessary negative effects on the credit history of consumers. Another option would be to separate these defaults in the credit information files and lessen their impact on the credit rating.
- **Reducing and suspending insolvency cases:** The regular application of insolvency law can also have negative effects during the pandemic. For this reason, and depending on the system, it may be advisable for countries to suspend certain insolvency law rules that could otherwise prompt insolvency filings during the crisis. These could include, e.g., the suspension of the rules prohibiting trading while insolvent and the rules establishing a duty to file for insolvency, which give rise to personal liability implications for those managing distressed companies (Australia, Germany, UK). Other measures restrict the number of insolvency cases, such as by increasing the thresholds for involuntary bankruptcy cases or rejecting insolvency applications unless the criteria for insolvency were met before the date of the pandemic (India, Singapore, Germany). The courts can extend deadlines in ongoing insolvency proceedings (e.g., the deadline to present a reorganization plan), while the emergency conditions last ("*mothballing*"). Legal amendments can also delay deadlines in insolvency proceedings (Italy, India).

¹ This note does not analyze the fiscal, financial and macro-prudential measures adopted in response to the pandemic crisis. The references to country measures included in this note are provided merely by way of example.

² See IMF Special Note, 2020, *Banking Sector Regulatory and Supervisory Response to Deal with Coronavirus Impact*.

The measures adopted during phase one are just the consequence of the physical constraints imposed by the health emergency. During this phase, authorities could prepare the transition to the other phases by:

- Monitoring data on the economic distress suffered by enterprises and households to form predictions on the potential surge of insolvencies;
- Assessing the state and adequacy of the legal regime for insolvency and debt enforcement, in order to prepare reforms, if necessary; and
- Enhance or introduce modern technology in the insolvency and debt enforcement system.

PHASE TWO: TRANSITION

After the pandemic subsides and economic activity resumes, an effective debt resolution framework is essential to resolve debt overhang and support growth. During this period, debt resolution activity that has effectively been “frozen” during the interim period will resume, but there will also be an increased need for insolvency and debt enforcement due to the worsening economic situation. In this phase, countries should expect high numbers of insolvent enterprises and households. Countries could directly move to phase three in cases where the economic situation is less severe and the capacity of the insolvency and debt enforcement system is sufficient to handle the uptick of cases. However, in situations of crisis that could overwhelm the capacity of the insolvency and debt enforcement system, there is a need to include a phase two to “flatten the curve” of insolvencies and minimize the permanent damage to the economy. This potential phase two would complement the regular debt resolution regime with special measures, including the administrative and financial support of the state for debt restructuring procedures. The measures in phase two are *temporary* - their duration will depend on the severity of the crisis in the country and on the relative strength of the standard debt resolution regime – yet critical to avoid potential long-run economic scarring. The second phase should start with a triage of business cases – the rest of the measures would follow, operating in tandem with the restart of the debt resolution activity at the courts:

- **Triage:** A triage distinguishes between businesses that cannot be restructured, those which can recover their viability with restructuring measures, and those which can recover without assistance. Following the pandemic, it may be necessary in those countries more heavily affected by the crisis, to implement a risk-based approach, analyzing the prospects of entire economic sectors, and not just the situation of individual enterprises, and focusing on the cases with the biggest economic impact. Limited legal and financial resources should concentrate on those sectors and enterprises that have better prospects of recovery and that perform essential economic functions. Restructuring “zombie enterprises” should be avoided.³ The triage can be conducted by the authorities, supported by specialists from the private sector, based on transparent criteria, and can be based on financial data prior to the pandemic, as well as on new business projections. The purpose of the triage is to provide access to special out-of-court debt restructuring mechanisms for those cases considered of highest priority and to set the parameters for standardized debt restructuring solutions.
- **Special out-of-court restructuring frameworks:** The use of special out-of-court solutions can provide solutions for the high number of over-indebted enterprises and households, avoiding overload of the court system. Separate tracks for corporates, SMEs and households are desirable. Out-of-court debt restructuring can be supported by the state—including through a dedicated restructuring agency or office, in some cases—or can be organized by the private sector; in either case, effective opportunities for ongoing public/private coordination would be critical. The experience of special out-of-court restructuring mechanisms in the wake of the Asian crisis (Korea, Indonesia, Malaysia, Thailand) would be relevant.

³ Zombie enterprises are defined as those who cannot generate enough income to service the interest of their debt (see for instance McGowan et al., 2017; Banerjee and, Hofmann, 2018). Although the problem of zombie enterprises had already been identified, the COVID-19 crisis will likely exacerbate it.

- **Incentives and penalties to encourage restructuring:** Temporary restructuring mechanisms will be more effective if there is a set of incentives that encourages both debtors and creditors to restructure the debt. These incentives (“carrots”) need to be designed in accordance within the space allowed by fiscal and financial regulatory policies. They can be combined with penalties or disincentives (“sticks”) to encourage cooperation in restructuring negotiations, such as fines for not complying with the deadlines for the negotiation, or the threat of liquidation for the debtor. The experience in the Asian crisis is also relevant in this context.
- **Standardized restructuring solutions:** Standardized solutions (i.e. restructuring plans adjusted to basic characteristics of all relevant debtors) also help accelerate the resolution of business and household cases (Iceland, 2010-2011). Standardized solutions broadly adapt to the circumstances of the case but offer a simple, less precise and less costly solution than a tailor-made restructuring plan. These measures could include, for small businesses, predetermined restructuring solutions based on the value of the firm. With respect to households, mortgage loans can be written down to a percentage of the reassessed value of the property. If the crisis affects the real estate sector, the state can provide support by designing mortgage modification programs, which can extend maturities, change the amortization schedule or reduce interest rates (US, after the GFC). Although these solutions are not customized, and thus could be over- or under-inclusive, they may be justifiable in the context of a generalized crisis.
- **Financing of distressed businesses:** Restructured business will often need working capital to continue or resume operations, and this can only happen if there are rules that protect interim and post-petition financing, and entities ready to support distressed enterprises. In some cases, however, the size of the financing needs may require a public support program, which can be articulated through guarantees, loans or equity injections, backed by a specialized analysis of the viability of restructured businesses, and including exit plans for public investment. The government can also provide guarantees for companies who were solvent and profitable before the crisis and appear to need only liquidity support. All public support measures need to be subject to adequate safeguards and controls.⁴
- **Simplified administrative proceedings and no-asset cases:** Simplified court proceedings can reduce the cost and use of judicial resources for micro/small enterprises (US) and for no-asset cases (UK). The law and the court rules should recognize the possibility of quickly resolving no-asset cases (including a quick discharge of debt for natural persons).
- **Use of insolvency and debt enforcement proceedings:** During this phase, insolvency and debt enforcement activity needs to be maintained, as it is crucial to uphold payment discipline and to incentivize debt restructuring. Special plans to strengthen the court system may be necessary, although their effects will normally be appreciated only in the medium term. Therefore, the ordinary operation of the insolvency system (phase 3) overlaps with the temporary measures included in phase two.

PHASE THREE: FIGHTING DEBT OVERHANG

After the situation stabilizes, temporary measures will lapse and countries should move to the exclusive use of the standard tools in the debt resolution framework. Countries that do not need a transitional phase two will move directly from phase one to phase three. Countries need to assess their debt resolution systems and identify the areas that require strengthening. In contrast to the temporary nature of the measures under phases one and two, the measures under phase three are permanent, and include the fundamental elements of an effective debt resolution strategy under international standards. Although this note has placed them in the “after stabilization” phase, some of these elements will often also be helpful to facilitate phase two of the crisis. The core elements of the debt resolution framework are as follows:

- **Robust debt enforcement system:** Creditors must have expedient and effective means to collect on unpaid debts. Many advanced economies have developed strong enforcement regimes; more recently, other

⁴ See IMF Special Note, 2020, *Public Sector Support to Firms*.

countries have introduced mechanisms to overcome delays in debt enforcement, especially for secured credit (Brazil, India, Italy). The use of extrajudicial enforcement mechanisms, especially for commercial mortgages, shortens the time to recover secured claims and can help to maximize value for all parties.

- **Corporate insolvency regime:** Reforms in this area should focus mainly on facilitating timely rehabilitation of viable enterprises and swift liquidation of non-viable ones, as decided by the creditors based on a viability assessment. The insolvency regime should allow for comprehensive restructuring of all types of claims, including tax debts and other arrears to the state. Concerning large corporations and enterprise groups, cross-border recognition and cooperation mechanisms are fundamental.
- **Hybrid and out-of-court debt restructuring mechanisms:** After the most acute phases of the crisis, there is still a need for mechanisms that allow informal debt restructuring by agreement between the debtor and its creditors. In addition, hybrid frameworks, that combine informal debt restructuring with limited court intervention, represent a useful tool to accelerate the restructuring process, by way of pre-packaged reorganizations (US) or preventive insolvency procedures (EU).
- **Personal insolvency regime:** Most advanced economies have adopted personal insolvency laws that allow individuals a fresh start and their return to the productive economy. The need for effective personal insolvency regimes will increase as the crisis develops. Countries considering the introduction of personal insolvency frameworks need to ensure that certain preconditions are in place, such as a functioning debt enforcement regime, payment discipline, and effective registries and credit information systems.
- **Adequate institutional framework:** Any improvements to the legal regime for debt enforcement and insolvency must be coupled with reforms to improve the capacity and integrity of the institutional framework, in particular, the judiciary and insolvency administrators. These reforms take a long time to be completed but starting them early can bring tangible benefits, including positive signaling effects.
- **Use of modern technology:** Countries are increasingly recognizing the value of technology to increase the effectiveness and efficiency of insolvency and debt enforcement. For example, numerous countries are increasingly moving towards the conduct of auctions online, especially in Europe. Electronic case management, organization of electronic voting, automated proceedings, and video hearings contribute to the efficiency of insolvency and debt enforcement proceedings. Electronic filing of insolvency and debt enforcement cases allows better data to be collected on the use and the bottlenecks in the system, allowing policy makers to diagnose problems in their systems to inform policy changes and to measure the effectiveness of reforms. The use of technology should inform the response to the crisis, taking into account the time needed to implement technological change.

CONCLUSION

The unprecedented shock of COVID-19 requires specific solutions to tackle the resulting over-indebtedness of large and small enterprises and households. In that context, national authorities should take a proactive approach in spearheading reforms to achieve a seamless operation of the three phases described in this note. Sustained political commitment and close coordination among all stakeholders are essential for the effective implementation of reform measures, as part of a comprehensive strategy. Given that some of the above reforms can take considerable time to bear fruit, it would be important that they are planned and implemented at an early enough stage to maximize their impact.

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