INVESTMENT CLIMATE

Creating specific insolvency regimes for SMEs

Andres Martinez, Private Sector Development Specialist
Vienna, January 16, 2012

International Finance Corporation World Bank Group | THE WORLD BANK | World Bank Group Multilateral Investment Guarantee Agency

Roadmap

- Why WBG Investment Climate group in the area of insolvency reform?

- Why MSME insolvency? Specific WBG data on MSME that may justify a special treatment in the insolvency terrain

- Specific cases where MSME require a different treatment

- Difficulty of obtaining evidence on *impact* of insolvency reforms in the MSME terrain

IFC and Insolvency

- The biggest development organization, part of World Bank Group, focused on private sector development through investment and advisory services

- As a global investor understands that reliable business exit and solid restructuring frameworks are crucial to a good credit environment

- Since 2009 developing a robust practice focusing on development of insolvency TA around the world, at the request of governments

- Worked in over 20 countries, some of them post-conflict and fragile

Different approaches to a definition of MSMEs

- Different definitions used from country to country usually based on number of assets, total net assets, sales and investment.

Table 1: World Bank definitions of MSMEs (enterprise must meet at least 2 of 3 characteristics)

Firm size	Employees	Assets	Annual sales
Micro	<10	<$100,000	<$100,000
Small	<50	<$3 million	<$3 million
Medium	<300	<$15 million	<$15 million
	Loan size proxies		
Micro	<$10,000		
Small	<$100,000		
Medium	<$1 million (<$2 million for some advanced countries)		

Source: Ayyagari, Beck, and Demirgüç-Kunt (2005)

Table 2: Average sales ranges for bank definition of SMEs

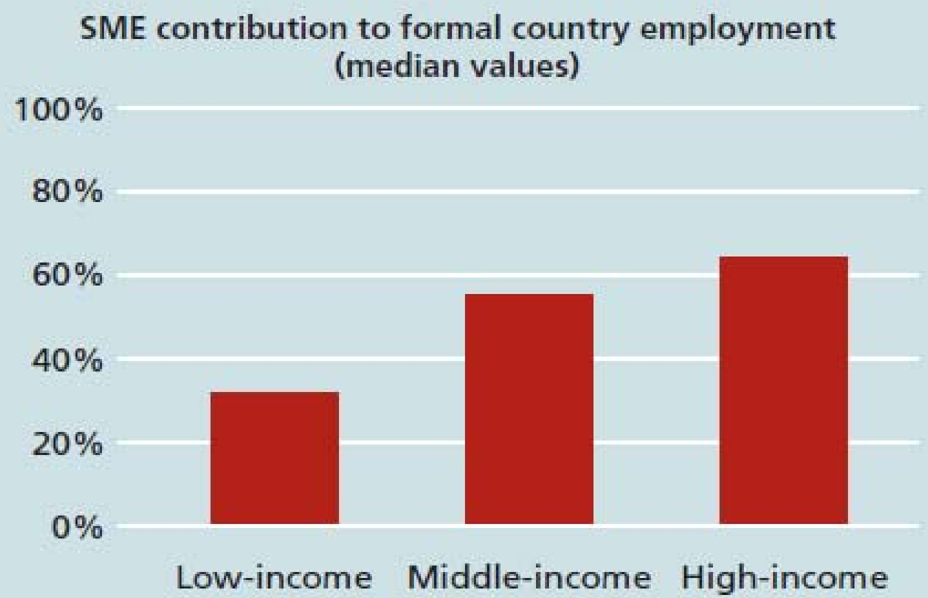
Firm size	Minimum sales	Maximum sales
Small	$200,000	$4 million
Medium	$2 million	$16 million

Source: Beck, Demirgüç-Kunt, and Martínez Pería (2008)

Why should there be tailored insolvency regimes for MSMEs? SMEs are the backbone of growth and entrepreneurship

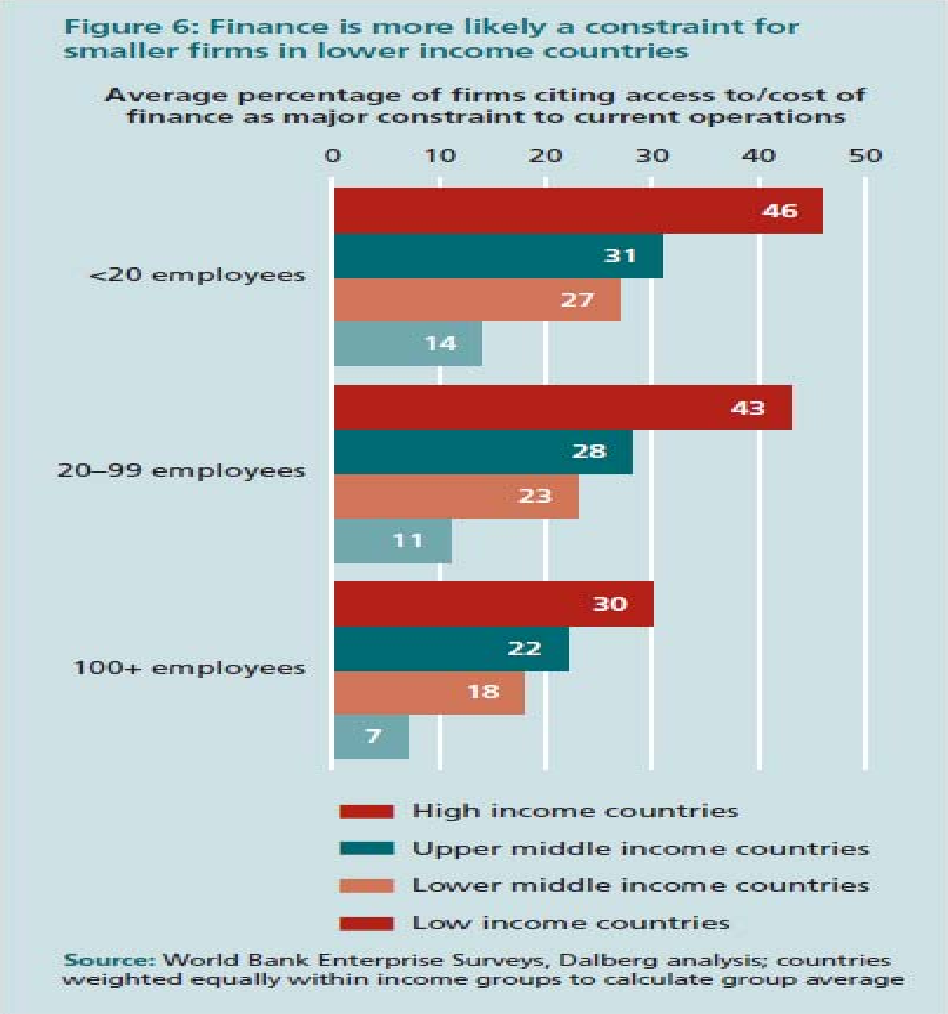
- SMEs provide a significant portion of formal jobs worldwide:

Figure 4: SMEs provide a significant portion of jobs worldwide



Source: Ayyagari, Beck, and Demirgüç-Kunt (2003)

Why should there be tailored insolvency regimes for MSMEs? Finance is often a severe constraint



Why should there be tailored insolvency regimes for MSMEs? Time and cost effectiveness

- Insolvency typically leads to lengthy and complex legal proceedings

- This is in itself counter productive as, the more time goes by, the more value is destroyed by the debtor.

  → While larger companies are usually better suited to cope with this inherent cash flow issue, MSMEs need alternative insolvency regimes that are :
    - Shorter
    - Less cumbersome
    - More cost-efficient

OHADA: concern that West Africa needed to ease business exit, and if possible, rescue for its many micro businesses

- OHADA is an organization of 17 West and Central African countries whose purpose is to harmonize business law.
- Uniform Acts adopted at the OHADA level become immediately applicable in every OHADA country.
- IFC/World Bank assisted in modernizing the Uniform Act on insolvency (pending finalization)

Tailored MSME Insolvency Regime in draft OHADA Law 2013

- Simplified Procedures for Reorganization and Liquidation for MSMEs pre insolvency:

  Règlement Préventif Simplifié

  - Qualifying threshold is 5 or less employees within the six months preceding court referral
    - Easier evidentiary requirements to open proceedings
    - No appeal against settlement
    - Duration of proceedings reduced from 3 months (+1 month extension) to 2 months (+ 15 days extension)
    - Option for the judge to appoint an independent expert to ensure execution of the settlement agreement (concordat).

Tailored MSME Insolvency Regime in draft OHADA Law 2013 cont…

- After MSME debtor is insolvent:
  - ***Redressement Judiciaire Simplifié :*** Simplified **reorganization** proceeding for SMEs with 5 employees or less (in the six months preceding court proceedings) AND with an annual turnover not exceeding USD 100,000.
    - Period to prepare reorganization plan shortened from 9 months to 4 months (+ 15 days)
    - Court may impose rescheduling up to 2 years on creditors (with their consent)
  - ***Liquidation des Biens Simplifiées:*** Simplified **liquidation** proceeding for SMEs with 1 employee or no employees (in the six months preceding court proceedings), and no real estate.
    - Expedited proceeding: contractual sale of assets instead of public auction process
    - Only claims that are likely to be paid are checked for admissibility
    - Liquidation process may not exceed 9 months

Summary of changes in MSME framework compared to “general” framework

- Broadly, the differences for MSMEs are that:
  - Time-frames are shorter;
  - Evidentiary requirements are lighter;
  - Fewer procedural steps;
  - There are fewer or no appeals permitted; and
  - The court has the discretion to refuse to apply the simplified procedure and can use the “general” framework if it so chooses.

India: the problem of outdated personal bankruptcy legislation

- According to the 2001-2002 census of Small Scale Industries (SSI), proprietorships or partnerships constitute 97.3% of all units in India, leaving a tiny minority of business units, and a very tiny proportion of small units, that are incorporated

- India follows a Common Law model where unincorporated businesses are subject to personal bankruptcy laws.

- India's personal bankruptcy laws are outdated: The Provincial Insolvency Act 1920 and The Presidency Towns Insolvency Act 1909. For instance:
  - Severe criminal penalties including imprisonment
  - Benchmark amounts such as 500 Rs (about $10) for the minimum amount of debtor's debts, etc.

Solutions in India

- Some States are updating their personal bankruptcy laws at a state (rather than federal) level. Need to consider:
  - Simple arrangements to avoid bankruptcy
  - Fresh Start Concept;
  - Removing criminal penalties and reducing stigma; and
  - Easier procedural requirements.

- RBI has promoted a Debt Restructuring Scheme for viable SMEs:
  - This mechanism is applicable to all borrower who have funded and non-funded outstanding up to Rs. 10 crores under multiple/consortium banking arrangement.
  - Restructuring package is worked out and implemented within 90 days from the date of receipt of request for restructuring from the borrower.

Final question: How will we know if MSME new insolvency system works? – Impact measurement challenges

- How to measure the success of an insolvency reform?

- How to quantify such success?

- How to attribute success specifically to the insolvency reform and not to, for example, market factors

- Would “baseline surveys” (capturing data pre and post reform) be an adequate tool? If yes, what content

- Should data be captured on specific cases or globally?

- Other questions…

Thank you

Questions?

amartinez3@ifc.org