



Insolvency Abuse: An Economic Impact Analysis Discussion Material

Strictly Private and Confidential

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Why should we analyze insolvency abuse?

Problem statement

Motivation

Insolvency abuse results in large losses not only for the banks, but also for all the other key stakeholders of the economy – businesses, investors, employees and the Latvian State.

Issue

General public appears to be unconcerned due to the common perception that this is a “banks’ problem”.
Thus the responsible politicians continue to refer to “few isolated cases” and feel little pressure to act.

How to address the issue?

Our approach

In order to clearly quantify **the full cost of insolvency abuse** to the Latvian economy, we propose to carry out **an independent, scientific research study** in cooperation with leading banks and State institutions.

In order to credibly demonstrate that this problem can be fixed, we propose to carry out **a cost-benefit analysis** for the required investment from the State.

Phase I

> Collecting the Data

Phase II

> Modelling the Impact

Phase III

> Developing the Solution

Phase IV

> Presenting the Results

Phase I

Collecting the Data

Phase I: Collecting the Data

Direct & indirect costs/losses

In order to quantify the direct & indirect costs and losses incurred by all involved parties, we will build a fact base from the following sources:

Source	Information
Leading banks	<p>For all defaults involving insolvency abuse:</p> <ul style="list-style-type: none">• <u>Direct costs</u> such as abnormal losses in the recovery process due to lost rights to real estate collateral, external legal costs, etc.• <u>Indirect costs</u> such as additional time (and attributable overheads) spent in the recovery process by the bank's employees (loan managers, credit analysts, restructuring officers, lawyers, the management, etc.)
Insolvency Administration	<p>Statistics about all insolvency cases, including the insolvent company's total assets, decrease in value due to revaluation and write-off, the compensation received by the administrator, etc.</p> <p>Statistics about all claims from the Employees' Guarantee Fund.</p>
Database of enterprises "Lursoft"	<p>Historical financial position and performance of insolvent companies before the insolvency process.</p>
State Revenue Service	<p>Detailed information about tax debt recovery from insolvent companies.</p>
Prosecutor General's Office, Economic Police	<p>Statistics about the number of criminal and civil cases, court utilization, external costs, additional time and attributable overheads spent on cases involving insolvency abuse.</p>

Phase I: Collecting the Data - continued

International benchmarks

In order to benchmark the losses due to insolvency abuse, we will obtain comparative information about insolvency in other countries:

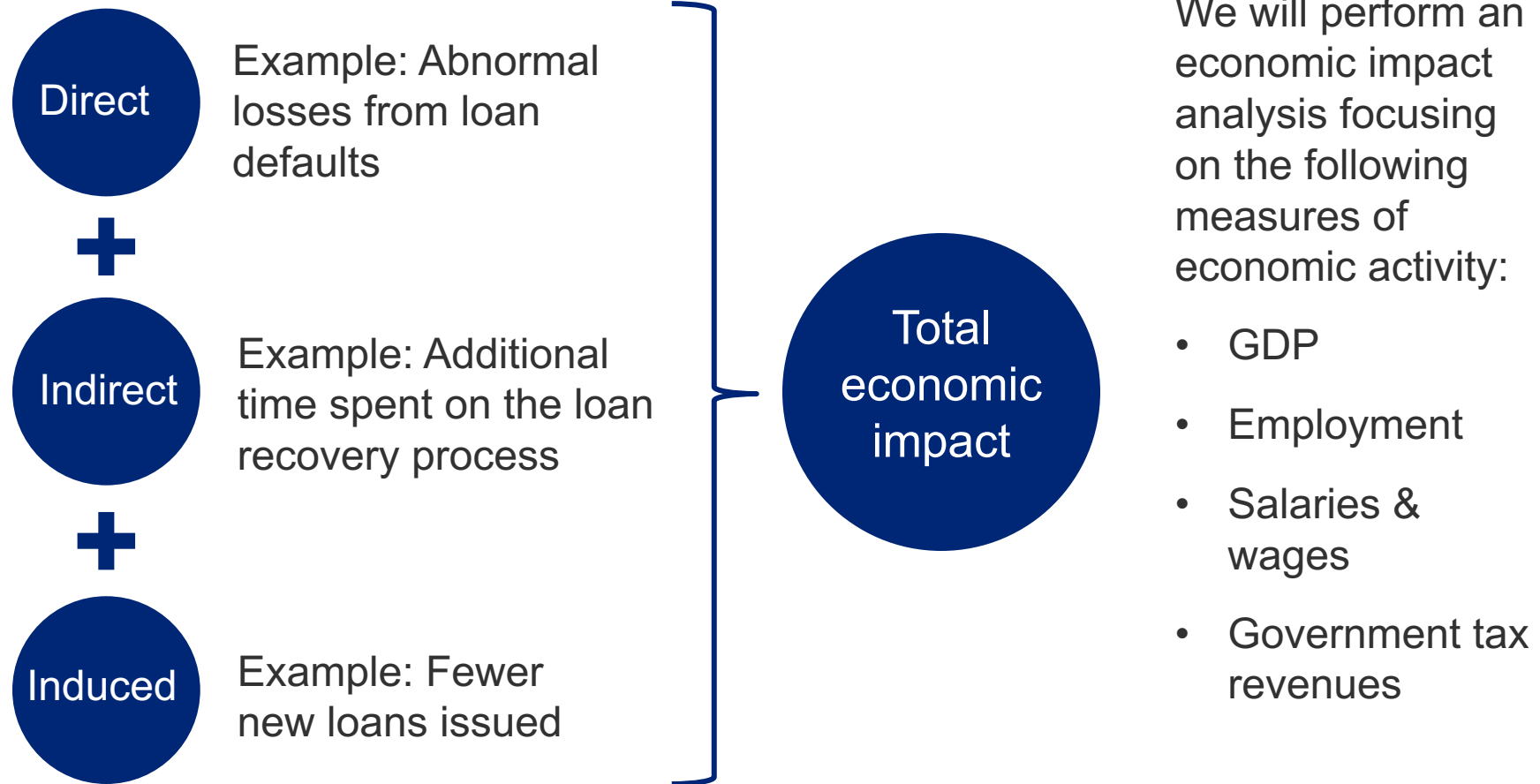
Source	Information
The Scandinavian/Baltic Network on Insolvency	Data about insolvency abuse and its economic impact in the Baltic States and Scandinavia.
Ministry of Justice, Estonia	Statistics about the number of criminal and civil cases, court utilization, external costs, additional time and attributable overheads spent on cases involving insolvency abuse.
Ministry of Economics, Lithuania	Statistics about the number of criminal and civil cases, court utilization, external costs, additional time and attributable overheads spent on cases involving insolvency abuse.
INSOL Europe, Eurostat, IMF, World Bank, etc.	Comparative information about insolvency, corruption and economic crime and their impact on the economy

Phase II

Modelling the Impact

Phase II: Modelling the Impact

Economic impact analysis



Phase II: Modelling the Impact

Capturing all costs and losses

In order to accurately and completely capture the costs due to insolvency abuse, we will review data quality, perform cross-checks across different sources of information and extrapolate to the rest of the economy.

Type of cost/loss	Overview of methodology
Direct	Data quality check, aggregation and extrapolation of the direct costs incurred by the banks, businesses, the State, employees and other stakeholders.
Indirect	Estimating the indirect costs incurred by the banks, businesses, State, etc. Estimating the “dead-weight loss” to the economy as a whole.
Induced	Macroeconomic model demonstrating the impact of insolvency abuse on the economy via the following channels: <ul style="list-style-type: none">• Decrease in crediting (as banks are issuing fewer loans)• Decrease in investment (as foreign investors are reluctant to invest)• Decrease in business activity (as companies are more cautious)

Phase II: Modelling the Impact

Past vs. future, scenarios, litigation

Costs and losses incurred in the past are just one part of the story. In order to assess the future impact, we need to take into account the growth of the insolvency abuse “industry” and the impact of possible international litigation.

Work step	Description
Future costs/losses	Estimating future costs/losses due to insolvency abuse based on the key drivers.
Scenario analysis	Estimating the likely range of future losses due to insolvency abuse for different macroeconomic scenarios.
Litigation review	As it is likely that a number of cases involving insolvency abuse will be brought to the international courts for settling investment disputes, we need to assess the potential legal costs to the claimants and the Latvian State.

Phase III

Developing the Solution

Phase III: Developing the Solution

Prevention of insolvency abuse

Our work we will not end with the finding that insolvency abuse, on yearly basis, generates huge losses to the Latvian economy. Based on the collected data, we will propose a concrete set of solutions that, if implemented by the State, would prevent insolvency abuse and finance themselves via increased tax revenues.

Work step	Description
Insolvency analytics	Data-based identification of “suspicious” parties (administrations, judges, etc.) Internal controls review & recommendations to address weaknesses
Feasibility and options analysis	Performance review (KPIs analysis) Review of remuneration & motivation package Required competency model for fighting economic crime Gap analysis Implementation plan
Cost-benefit analysis	A cost-benefit analysis (e.g. discounted cash flow model) demonstrating the return on investment in prevention of insolvency abuse, prepared in accordance with the European Commission Guidelines.

Phase III: Developing the Solution

Cost-benefit analysis

We will perform a cost-benefit analysis consisting of the following:

Financial analysis

- Total investment costs
 - Total operating costs and revenues
 - Financial return on investment
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Economic analysis

- Monetization of non-market impacts
 - Inclusion of indirect effects
 - Social discounting and calculation of economic performance indicators
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Risk assessment

- Sensitivity analysis
- Probability distributions for critical variables
- Risk analysis

Phase IV

Presenting the Results

Phase IV: Presenting the Results

What do we expect to find out?

Our work will result in concrete findings of the following nature (an illustration):

- *Total cost of insolvency abuse for the Latvian economy is MEUR [XXX] per year, or EUR [XXX] per capita.*
- *Insolvency abuse has resulted in a loss of MEUR [XXX] over the last four years (2011-2014). Its expected cost over the next four years (2015-2018) is MEUR [XXX].*
- *The stakeholders that are losing the most and their respective costs are:*
 - *The Latvian State – MEUR [XXX];*
 - *Businesses (including banks) – MEUR [XXX];*
 - *Employees – MEUR [XXX];*
 - *The rest of the Latvian economy – MEUR [XXX].*

Phase IV: Presenting the Results

Making it count

We will go all the way in order to bring our findings to the attention of the responsible politicians, State institutions and the general public.

Deliverable	Description
Report	We will prepare a detailed report, documenting the information gathered, the procedures performed and the results obtained in a clear and understandable way.
Presentations	We will present our report to the responsible politicians, relevant State institutions and any other interested parties.
On-going support in communication	We will provide an on-going support in communication with the various stakeholders in the fight against insolvency abuse.

Team



Rafal Antczak
Director
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Rafal is a macroeconomist with more than 20 years of professional experience in carrying out research, consulting and advisory projects. He has extensive training in applied macroeconomics, including economic modelling, monetary policy, banking sector, public finance, tax policy and public governance.



Helmut Jauja
Manager, Legal
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Helmut's specialization areas are insolvency law, corporate law and public law. He has more than 14 years of experience working for Government authorities: Ministry of Finance, the Company Register and Insolvency Administration.



Jānis Kauliņš
Manager, Advisory
Latvia

Janis has extensive experience in assurance services, specializing in the financial audits of banks, investment funds and securitization vehicles in Luxembourg and Latvia. Janis has also held the position of a Head of Department at a leading Latvian bank. Janis is a holder of CFA and ACCA charters.



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