

Consumer Insolvency in the Czech Republic

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Abstract—The Czech Republic is a country whose economy has undergone a transformation since 1989. Since joining the EU it has been striving to reduce the differences in its economic standard and the quality of its institutional environment in comparison with developed countries. According to an assessment carried out by the World Bank, the Czech Republic was long classed as a country whose institutional development was seen as problematic. For many years one of the things it was rated most poorly on was its bankruptcy law. The new Insolvency Act, which is a modern law in terms of its treatment of bankruptcy, was first adopted in the Czech Republic in 2006. This law, together with other regulatory measures, offers debt-ridden Czech economic subjects legal instruments which are well established and in common practice in developed market economies. Since then, analyses performed by the World Bank and the London EBRD have shown that there have been significant steps forward in the quality of Czech bankruptcy law. The Czech Republic still lacks an analytical apparatus which can offer a structured characterisation of the general and specific conditions of Czech company and household debt which is subject to current changes in the global economy. This area has so far not been given the attention it deserves. The lack of research is particularly clear as regards analysis of household debt and householders' ability to settle their debts in a reasonable manner using legal and other state means of regulation. We assume that Czech households have recourse to a modern insolvency law, yet the effective application of this law is hampered by the inconsistencies in the formal and informal institutions involved in resolving debt. This in turn is based on the assumption that this lack of consistency is more marked in cases of personal bankruptcy. Our aim is to identify the symptoms which indicate that for some time the effective application of bankruptcy law in the Czech Republic will be hindered by factors originating in householders' relative inability to identify the risks of falling into debt.

Keywords—bankruptcy law, household debt, consumer bankruptcy, business bankruptcy

I. INTRODUCTION

CURRENT research focuses primarily on analysing the dynamics and stability of the financial potential of the people, and on revealing the factors which significantly influence this potential. This trend is also corroborated by theoretical and applied reports and articles presented at the international level, such as the work of Paapa [1], Di Prete and McManus [2], and Lillard and Willis's publication [3], while an assessment of the stability of the financial potential of people in EU countries can be found in the works of Longford and Pittau [4]. In the Czech Republic there is still no adequate methodological and analytical apparatus which is both able to provide us with a good, structured characterisation of the

financial potential of the populace and how this potential changes and develops and also makes appropriate use of the very latest modelling methods. Research of this area in the Czech Republic is being carried out at the University of Economics, Prague, headed by Bartošová [5]. There is also still a lack of adequate analysis of the quality and effectiveness of the institutional framework which affects the financial potential of the populace during the insolvency phase. In this respect there has still been no proper analysis of the formal and informal institutions and how they influence people's behaviour. The Czech Republic used to be a transitive country whose institutional standards were well below those of more developed countries, especially as regards bankruptcy law.

The causes of this lie in the fact that the expert public and economic policy itself are focused primarily on the macroeconomic aspects of bankruptcy cases and the role of the law is underestimated. The institutional quality of the Czech Republic's economy has been reviewed over the last decade primarily from the viewpoint of its impact on boosting the economic activity of businesses and on the performance of the economy as a whole. This is evident in the works published by, for example, Kouba [11 6], Mlčoch [7], Holman [8], and Šíma [9], amongst others. These authors explore the relationship between institutions and economic growth in the Czech Republic, while they are based on the theories put forward particularly by North [10], and Alston [11]. New findings concerning the links between institutions and organisations in the Czech Republic were presented by Vymětal and Žák [12]. The specialised studies carried out by these authors highlight the importance of formal institutions and the rule of law for the further development of the Czech Republic. Their standpoints and theory are based on a new institutional economy. They have brought a new insight into how institutional quality should be gauged and assessed to the lively ongoing discussions regarding the institutional environment of the Czech Republic and its impact on social development. Žák and Vymětal particularly emphasise the importance of a quality rule of law for the creation of a comprehensive network of contractual relations between businesses. In addition to this, they also stress that the law must be accompanied by an adequate system able to enforce the observance of such contracts. They see that the role of formal institutions, including the law, lies in the fact that they can reduce transaction costs as well as the risks involved in searching for new information. The work of Bortel [13] (2005, p. 661) links the system of law and the enforcement of the law with allocative efficiency from the perspective of businesses and the economy as a whole. These authors refer to the conclusions drawn by North [14], which imply that in

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situations where society veers away from the use of formal institutions, more extensive use is made of informal institutions, which results in increased transaction costs, a lesser degree of cooperation and the division of labour, and an underachieving economy. Kouba [15] concludes that the poor enforcement of the law in the Czech Republic has, moreover, led businesses to consider more, particularly in the short term, and to strive for self-sufficiency and independence.

II. ASSESSMENT OF THE QUALITY OF BANKRUPTCY LAW IN THE CZECH REPUBLIC

For a long time the Czech Republic was famed for its long-lasting, described as interminable bankruptcies [16]. Czech bankruptcy law did not meet the standard requirements of the market economy and, according to the World Bank's indices, was one of the least effective laws.

From the beginning of the transformation in the early 1990s the institutional conditions in the Czech Republic were hampered by the non-existence of private enterprise. Unlike other Central European countries, such as Poland, Hungary, and Germany, the Czech Republic had no sizeable entrepreneurial community, nor did it have the corresponding legal standards, any apparatus in place to enforce such standards, or any informal business relations. [17] According to Klvačová [18], the Czech economy performed best at the regional level, although was one of the worst from an institutional viewpoint. The lack of private ownership misshaped the way businesses thought and behaved, and established informal institutions that were incompatible with the market economy. All these factors were enhanced by the unenforceability of the law. According to Havel [19], the inability to enforce formal institutions means they are not used, as businesses have an aversion to uncertainty. In this uncertain environment businesses rely predominantly on informal relations, which require them to obtain information about their partners and invest money in enforcing those relations.

In our opinion this thesis has been confirmed in the Czech Republic and, all these years after the 1989 revolution, is reflected in an ineffective concept of bankruptcy law. The bankruptcy law is unsuitable for the following reasons:

- Inadequate standing of creditors
- Limited satisfaction of secured creditors and reduced credit availability
- Increased powers of the court and bankruptcy administrator
- Higher level of corruption (trend of Corruption Perception Index in the Czech Republic [21 20]).

In 2006 the Czech Republic adopted a new Insolvency Act [21], which, together with its amendment in 2008, brought about fundamental changes in this area not only for businesses, but also for non-entrepreneurs. According to an assessment carried out by the World Bank [22], the Czech Republic has moved up the insolvency law quality rankings from 115th to 32nd place. This huge step forward was the

result of major institutional changes which have cut the duration of insolvency proceedings by half and have enabled creditors to recoup an average of 56 percent of their receivables instead of a mere 20 percent. Similar conclusions regarding the improvement in the quality of insolvency law are also evident from the assessment performed by the London EBRD [21]. With respect to the impacts the global financial crisis has had on households' financial stability, the adoption of the new insolvency law has also helped to make the resolution of household debt more effective. This law introduced the completely new institute of personal bankruptcy. Prior to this the people of the Czech Republic did not have recourse to this means of resolving bankruptcy cases.

That paradigm shift in the evolution of bankruptcy law in the Czech Republic has motivated us to analyze:

- the factors which have had a marked influence on qualitative changes to Czech insolvency law between 2006 and 2010
- the factors which have so far prevented more effective enforcement of insolvency law in the Czech Republic and which can be seen as a potential risk to the future growth of the Czech economy.

Our aim is to identify factors which could hinder the future enforcement of insolvency law in the Czech Republic to the extent and standards common in developed market economies.

First of all we will clarify what we mean by the term "quality insolvency law". We assume that the quality of insolvency law must be assessed according to whether and to what extent it takes account of informal institutions, other formal institutions, and the overall conditions and economic aspects of the country in question. It is also necessary to consider whether the resulting compatibility of the institutional framework makes the law more enforceable and whether the consistency and complementarity of formal and informal institutions are reflected in the insolvency effectiveness indicators [23], [24]. We agree with the conclusions drawn by the World Bank, which document the impact that the nature of insolvency law has on economic performance. Therefore, we base our assessment of the effectiveness of insolvency law on the indicators of the World Bank [25] and on the assumption that insolvency law, when set up properly, can have a positive impact on economic activity and performance indirectly through the credit market, where the effectiveness of the insolvency law improves credit conditions and interest rates. The methodology applied by the World Bank [26] to assess the quality of insolvency law shows that the factors that play a crucial role in "defining the concept" of insolvency law are the standing of creditors, the effectiveness of the courts, and provision for the informal institutions of the country in question [27]. We also consider these factors to be of fundamental importance in assessing Czech insolvency law, as well as in assessing the impact of the Czech Republic's institutional framework as a whole on the resolution of corporate and private bankruptcy cases.

TABLE I

NUMBERS OF BUSINESS FILINGS IN CENTRAL AND EASTERN EUROPE, RUSSIA AND SELECTED COUNTRIES OF WESTERN EUROPE. SOURCE: CREDITREFORM [28]

*) Including liquidations

**) Change in statistics in Commercial Register – since 2006 bankruptcies are company branches are not included

***) Since 2008 including deletion and dissolution of companies through bankruptcy as per Article 731b CR

	2010	2009	2008	Change 2009/2010 in %
Estonia	504	693	423	-27.3
Latvia	2,428	2,322	1,296	+4.6
Lithuania	1,496	1,168	731	+28.1
Croatia	1,300	1,050	875	+23.8
Poland	631	702	425	-10.1
Romania	5,430	4,543	n.a.	+19.5
Slovakia	830	900	582	-7.8
Slovenia	510	414	657	+23.2
Czech Republic	4,852	4,570	2,913	+6.2
Hungary*)	17,600	14,832	11,322	+18.7
Great Britain	17,690	19,908	16,268	-11.1
Switzerland ***)	6,255	5,215	4,222	+19.9
Luxembourg	918	698	590	+31.5
Italy **)	10,923	8,354	6,498	+30.8
France	631	702	702	-10.1
Germany	32,100	32,930	29,580	-2.5
Norway	4,480	5,013	3,637	-10.6
Greece	355	355	359	0
US	56,282	60,837	43,546	-7.4
Russia	16,600	15,473	n.a.	+7.3

III. BANKRUPTCIES IN THE CZECH REPUBLIC IN 2008-2010 AND COMPARISON WITH SELECTED EU COUNTRIES

The trend in the number of corporate bankruptcy cases from 2008 to 2010 in the Czech Republic and in selected countries of the EU, US, and Russia, is shown in Table I. These figures show that in the Czech Republic there was a sharp rise in the number of bankruptcy cases in 2009 as a result of the global financial crisis. In 2010 the number of corporate bankruptcy cases increased at a lesser rate. We assume that these bankruptcy dynamics were the result of a more than 10-percent growth in industry and, thanks to a strong pro-export policy, the rise in foreign trade, which increased by 19% in 2010. Another positive factor was evidently the trend in the number of bankruptcies in the Czech Republic's more prominent foreign trade partners, such as Germany, followed by China, Poland, Russia, and Slovakia. None of these partners saw any major rise in the number of bankruptcies in 2010 as compared to 2009 (Germany -2.5; Poland -10.1; Russia +7.3; Slovakia -7.8) [28].

From a comparison of the trend in the number of bankruptcy cases in the Czech Republic and selected countries, it is evident that the Czech Republic has managed to maintain its business bankruptcy rate at an acceptable level, despite the adverse impact of the global financial crisis. The positive trend in the number of bankruptcy cases has evidently been supported by fundamental institutional changes. In our

opinion, these changes owe a lot to the adoption of the new concept for the insolvency law and the ongoing reforms in the judicial system of the Czech Republic [28]. This has led to the welcome introduction of formal institutions that are new in qualitative terms and which are aimed at resolving corporate debt. We assume that the decisive turn-around will come when creditors come to play a greater role, when the standing of secured creditors changes, when more ways are introduced of resolving debtor bankruptcy, and when the role of the courts and bankruptcy administrators in bankruptcy proceedings changes. More details of the new bankruptcy law and a comparison of this law with that of other countries can be seen via the Doing Business database of the World Bank [29] and from the assessment of the Czech Republic's bankruptcy law published by EBRD [3]. If we take account of the formal and informal institutions and their importance in shaping the quality bankruptcy law as described above in Section I., we come to the conclusion that the quality of formal institutions in the Czech Republic can continue to improve to a level [28] comparable with that of developed market economies. In our opinion, the problem lies in the fact that so far these formal institutions have not been accompanied by compatible informal institutions. In the Czech Republic neither companies nor individuals have experience or established rules governing the conduct needed for the enforcement of ownership rights in market conditions. We believe that this problem is particularly serious as regards household debt. Considering the dynamics of household debt over the last 10 years and the rise in the number of personal bankruptcy cases in the Czech Republic from 2008 to 2010, in the next few years we can expect this to have an adverse impact on the financial stability of households.

TABLE II

INSOLVENCY PETITIONS FILED BY NON-ENTREPRENEURS IN THE CZECH REPUBLIC FROM 2008 TO 2010. SOURCE: CREDITREFORM [6 28].

	2010	2009	2008	Change 2008/2010 in %
Personal bankruptcy FO (?consumer)	1,936	4,237	10,559	-81.6
Business bankruptcy	4,852	4,570	2,913	66.5

Therefore, next we will be focusing on the factors which currently affect the dynamics of household debt and means of dealing with the adverse impact such debt has on households through personal bankruptcy.

IV. LIMITS ON THE EFFECTIVENESS OF BANKRUPTCY LAW IN THE CZECH REPUBLIC

As mentioned above, if there is no conclusive solution to household debt, the Czech Republic allows non-entrepreneurs to file for personal bankruptcy on the basis of the new Insolvency Act [30]. This means of settling a debt is subject to strict controls by the bankruptcy administrator and registration in the Insolvency Register. The law allows two different procedures for personal bankruptcy:

- a) the sale of all assets,
- b) debt write-off – life for a period of 5 years on minimum subsistence.

Of these, the most common procedure in the Czech Republic is to have a debt written off through the insolvency court [31], [32]. Having a debt written off allows the debtor to reduce the debt by as much as 70%, thus allowing a “new start” in life with no debts. In this respect, debt write-off is also convenient for creditors. The advantages of this new legal institution can particularly be enjoyed by large companies strong on capital in the role of creditors. In the Czech Republic these are primarily banks, with if the debtors are clients of theirs. As creditors, banks have the motivation to mediate the writing off of their clients’ debts rather than seeing them go bankrupt. If debtors are declared bankrupt, they usually lose the motivation to make money, and cease to be consumers (clients of the bank). When a debt is written off, the creditor does not recover all the money, but does get its client back. It is because of this advantage that this legal institution is becoming more and more widely used in the Czech Republic. Unfortunately, the positive effects of debt write-off are also accompanied by less favourable circumstances, one of the most serious of which is the enormous rise in Czech household debt. The increasing dynamics of debt have raised fears as to whether the current improvements to the bankruptcy law will be sufficient to successfully cope with household financial instability. Certain symptoms already indicate that household debt in the Czech Republic carries risks which could have serious consequences not only for household financial stability, but also for the macroeconomic stability of the Czech Republic.

The causes and consequences of rapid household indebtedness are currently hard to foresee.

We assume that the dynamics of household debt in the Czech Republic are primarily influenced by the following factors:

- Household debt statistics and the structure of household debts in the Czech Republic, implying that in the very near future households will become a major contributor to debt in the Czech Republic. Neither Czech society nor the Czech economy has ever faced this before.
- The ability of households to recognise the risks involved with falling into debt as well as companies can. Economists have long focused on investigating corporate indebtedness and the optimal variants of the amount of debt owed to other partners, while the question of household debt in the Czech Republic tended to be seen more or less as a popular topic rather than a scientific one.

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The question is whether households are able to discern the risks associated with debt as well as companies are. Economists have long focused on investigating corporate indebtedness and the optimal variants of the amount of debt

owed to other partners, while the question of household debt in the Czech Republic tended to be seen more or less as a popular topic rather than a scientific one [for more, see 30].

V. CONCLUSION

Up to now, research and analysis of the effectiveness of bankruptcy law in the Czech Republic has focused more on corporate (business) bankruptcy law. Personal (consumer) bankruptcies are still fairly new in the Czech Republic. There has still been no analysis of the institutional prerequisites for resolving household debt and for the effective application of personal bankruptcy and other regulatory means available to the state. With the impact of the global financial crisis on the Czech economy and subsequently on the financial potential of household, there is even more of a need to focus research on this area.

From what has been said above we can draw the following conclusions:

- So far Czech society has had no experience with such a high level of debt as Czech households are currently experiencing. We agree with Smrčka, the economist [33], when he claims that for the first time in the history of Czech society, household debt in the Czech Republic is reaching a level comparable with that of businesses.
- The Czech Republic has no experience with real-estate crises, nor can it draw on the experience of more developed societies. No reliable conditions have yet been postulated in which such crises arise.

From the conclusions of an analysis of the behaviour of Czech households since the social changes of 1989 [5], it is difficult to say whether Czech households are able to work seriously with a debt service, whether they are capable of properly assessing facts about their own finances, and whether they are able to see the red light that warns of the risks of their debts. From this viewpoint, the crucial question is whether Czech households get into debt purely on the basis of intuition or through rational consideration. According to the conclusions of the research carried out by Smrčka [33], when assessing how families act when they fall into debt in the conditions of the Czech Republic, we can only work with the assumptions and analysis of current events. This is because we do not know either the macroeconomic potential of the symptoms of a crisis or the microeconomic potential symptoms. There is not yet sufficient information about how developed economies behave during a crisis as regards family finances. High household debt is a phenomenon we have not seen until the last few decades.

There have been several signals and hints that a certain proportion of the Czech populace is not managing to cope with the credit expansion [33], [5].

These include:

- the dynamic rise in the number of executions in recent years [34],
- the increase in the number of registered loan contracts,

- the reduction in the number of people able to re-enter the credit market and resolve the problems they have on that market,
- high household commitment to mortgage loans [35] in circumstances where there is a low likelihood that the dangers of the crisis will be recognised. The Czech Republic has never gone through a mortgage crisis and has no experience of one,
- increased risk of global crises having an impact on the Czech economy due to its openness to the rest of the world as a result of its level of advancement and its economic dimension. These risks are hard to identify and describe. This is especially serious for the Czech Republic if it is households which are particularly affected by the severe impact of a global crisis,
- the dynamics of growth in the ratio of final household consumption to GDP. This ratio is currently 60% [36]. This trend can be described as problematic unless in the future there is a fundamental change in consumer behaviour.

The facts above indicate that Czech household debt is accompanied by a whole range of potential risks which could have a fundamental impact not only on households' financial standing, but also on the macroeconomic standard of the Czech Republic. All these unanswered questions concerning the influence the institutional environment has on household debt and on the effective enforcement of bankruptcy law pose a challenge for expert research and discussion.

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