EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 14 September 2012

on measures relating to personal insolvency

(CON/2012/70)

Introduction and legal basis

On 25 July 2012, the European Central Bank (ECB) received a request from the Irish Minister for Finance for an opinion on the Personal Insolvency Bill 2012 (hereinafter the 'draft law').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and the sixth indent of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[1], as the draft law relates to rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose of the draft law

1.1 The draft law introduces wide-ranging measures which seek to deal with the issue of personal debt and to modernise Irish bankruptcy law. The draft law provides alternatives to court-administered bankruptcy proceedings for insolvent debtors (individuals) by introducing three new debt settlement processes to lessen the difficulties insolvent debtors face in discharging their debts whilst enabling creditors to recover debts owed them by insolvent debtors to the extent that the means of such debtors reasonably permit. The new processes, while being under the jurisdiction of the Irish Courts, are predominantly non-judicial based processes. Briefly, these debt settlement processes are: (a) Debt Relief Notices (DRNs)[2], which apply to unsecured debts of up to EUR 20 000; (b) Debt Settlement Arrangements (DSAs)[3], which apply to unsecured debt greater than EUR 20 000; (c) Personal Insolvency Arrangements (PIAs)[4], which apply to both unsecured debt (of any amount) and secured debt of up to EUR 3 000 000 (hereinafter collectively referred to as the 'insolvency arrangements').

1 OJ L 189, 3.7.1998, p. 42.

2 Part 3, Chapter 1 of the draft law.

3 Part 3, Chapter 3 of the draft law.

4 Part 3, Chapter 4 of the draft law.

1.2 To oversee the insolvency arrangements and to provide the necessary infrastructure, the draft law establishes the Insolvency Service of Ireland[5]. The Insolvency Service is a new State-funded, independent corporate body responsible for performing the functions under the draft law for the operation of the insolvency arrangements.

1.3 Applications for insolvency arrangements are made to the Insolvency Service. To qualify, the debtor must be insolvent with no likelihood of becoming solvent within five years and must meet certain other specified criteria depending on the type of insolvency arrangement sought[6]. The DRN lasts three years and the DSA and PIA can last up to five and six years respectively, during which time the debtor will be protected from creditors' claims provided the debtor meets the terms of the insolvency arrangement. At the end of the applicable period, as prescribed by statute, the debtor is discharged from the debts specified in the insolvency arrangement. Insolvent debtors may make a proposal to enter into a DSA or PIA with their creditors via a personal insolvency practitioner who is authorised by the Insolvency Service and makes the proposal on behalf of the debtor[7]. Before entering into effect, the proposed DSA or PIA must be agreed by the prescribed supermajority of creditors[8].

1.4 As regards reforming bankruptcy law and procedure, the draft law[9] provides, amongst other amendments, for a reduction of the automatic discharge period from bankruptcy under the Bankruptcy Act 1988 from 12 to 3 years. Combining these reforms with the introduction of the insolvency arrangements, the draft law aims also to mitigate the negative impact of personal insolvency on economic activity in Ireland.

1.5 The publication of the draft law was a financial sector reform foreseen under the EU-IMF Financial Support Programme for Ireland[10].

2. General observations

2.1 The ECB generally supports the reform of personal insolvency and bankruptcy laws in Ireland as proposed by the draft law.

2.2 The ECB notes that the EU-IMF Financial Support Programme for Ireland requires the introduction of the draft law[11]. The ECB supports the draft law's aim of lowering the cost and increasing the speed and efficiency of personal insolvency proceedings while at the same time mitigating moral

5 Part 2 of the draft law.

6 Section 23 for DRNs, Section 52 for DSAs and Section 87 for PIAs of the draft law.

7 Section 50 for DSAs and Section 85 for PIAs of the draft law.

8 Section 67(8) for DSAs and Section 105 for PIAs of the draft law.

9 Part 4 of the draft law; especially Section 143 amending section 85(1)(automatic discharge from bankruptcy) of the Bankruptcy Act 1988.

10 Ireland: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding of 30 May 2012 in the context of the EU-IMF Financial Support Programme for Ireland.

11 Ireland: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding of 10 February 2012 in the context of the EU-IMF Financial Support Programme for Ireland, structural reforms, p. 12.

hazard and maintaining credit discipline. The draft law provides for debt relief in appropriate cases. It contains provisions which aim to protect the interests of creditors by applying strict eligibility criteria to the availability of the insolvency arrangements, providing for oversight by the Insolvency Service and the Courts[12] and requiring creditor approval by supermajority of the insolvency arrangement in appropriate cases. The ECB considers that the provisions strike a reasonable balance between the interests of creditors and debtors in coming to an insolvency arrangement.

2.3 The ECB notes, however, that the reforms are unprecedented, particularly as regards the scope of the PIA, which is the only insolvency arrangement applying to both unsecured and secured debt and hence risks impacting credit institutions that have lent to the debtor against security, e.g. mortgage loans in arrears. In addition, the reforms are being introduced without the benefit of a thorough economic impact assessment[13]. The ECB considers that the insolvency arrangements and the supportive administrative infrastructure, whilst ambitiously conceived, should above all be workable and that these measures should not result in blanket mortgage debt forgiveness and should be geared to minimising the risk of abuse. In the absence of an impact assessment, however, it is difficult to be confident that the objectives set by the draft law will be achieved[14]. In particular certain features of the proposed PIA regime may have negative implications for credit institutions in their capacity as creditors and even for the wider functioning of the financial system. In that regard, the ECB invites the authorities to consider the following points.

3. Eligibility criteria for the PIA

3.1 *Threshold of debt*

The ECB notes that the PIA will apply to an arrangement which, *inter alia*, has satisfied the criterion that the aggregate of a debtor's debts which are secured debts is less than EUR 3 000 000[15]. In the ECB's view, the potential inclusion of such large amounts of secured debt in the PIA, including debt relating to a debtor's quasi-commercial transactions, i.e. 'buy-to-let' mortgage loans, is unprecedented and may have significant financial implications for creditor banks if it results in deteriorating payment morale of debtors. The ECB notes that the threshold of EUR 3 million represents by many times the average amount of secured borrowings by customers of Irish banks. If made use of by large numbers of debtors, the PIAs could significantly increase

12 For example, the court is responsible under the draft law for approving the issue of the protective certificate, which will protect the debtor under the insolvency arrangement against creditor claims being enforced against him during the period that the protective certificate is in force. Another important role for the courts is reviewing appeals or notices of objection to approved insolvency arrangements.

13 See the explanatory memorandum to the draft law.

14 See also Opinions CON/2012/40 and CON 2010//34. All ECB opinions are published on the ECB's website at www.ecb.europa.eu.

15 Section 87(1)(a) of the draft law.

default rates and thus impact on both the capital adequacy and liquidity position of credit institutions at a time when they are still undergoing restructuring[16].

The ECB, therefore, invites the authorities to take into account such considerations in the draft provisions on the PIA and to carry out an impact assessment of these provisions on creditor banks. The authorities should also consider lowering the eligibility threshold to an aggregate of secured debt of no more than EUR 1 million.

3.2 *Insolvent debtor's cooperation with creditors*

Furthermore, in order to qualify to make a proposal for the PIA, insolvent debtors must, *inter alia*, declare that they have cooperated for at least six months with their secured creditors as respects their principal private residence[17]. It is not clear to the ECB why the evidence of good cooperation by debtors with their creditors should only be relevant when it concerns secured debt relating to a debtor's principal private residence and not to other debts which are owed to creditors and which could be more significant. The ECB considers there is a case for debtors to be obliged to show that they have engaged in *bona fide* debt negotiations for a reasonable period of time with a majority of their creditors.

4. Security valuation

The draft law provides the framework for the determination of the value of security in respect of secured debt in a PIA[18]. This is initially an issue to be agreed by the insolvency practitioner and the creditors who are parties to the PIA. The ECB notes that the draft law contains complex provisions on the protection of secured creditors in a PIA and that the valuation of security is of central importance for the protection of their rights in that respect. This is because the draft law precludes PIAs which include terms involving retention by a secured creditor of its security and a reduction to a specified amount of the principal sum outstanding in respect of the secured debt from specifying the amount of the reduced principal sum at an amount less than the value of the security as determined in accordance with the draft law[19]. The ECB considers that there should be legal certainty as to how such security is to be valued for the purposes of the PIA.

5. Other issues

The ECB notes that there are a number of issues which are not regulated in the draft law but which are crucial to its effective operation. For example, the authorisation regime and compensation

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16 For instance, the restructuring plan for Permanent TSB is currently being assessed by the European Commission. See Ireland: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding of 20 August 2012 in the context of the EU-IMF Financial Support Programme for Ireland.

17 Section 87(1)(g) of the draft law. Those criteria will further not apply in the circumstances set out in Section 87(3) of the draft law.

18 Section 100 of the draft law.

19 Section 98(1) and (2) and Section 100 of the draft law.

mechanism for the personal insolvency practitioners is not specified in the draft law but will have to be regulated subsequently[20]. The ECB also reminds the authorities of their commitment to establish a professional financial advisory service for overburdened borrowers[21].

6. Review period

The draft law currently provides for a mandatory review of the PIA regime[22] after five years[23] from the date of its commencement. The ECB believes that for such a major reform the review period should be shorter. A reasonable period for reviewing the overall operation of the PIA regime could be after one to two years from the commencement of the regime. The review report could usefully cover such matters as the level of take up of PIAs, cases of abuse and the experience of the courts in exercising the PIAs, e.g. related competences that have been assigned to them under the draft law, including dealing with any appeals by creditors.

7. Bankruptcy law reform

The ECB also invites the authorities to further consider reforming Irish bankruptcy law and procedure to make it more effective and also to make it easier for secured creditors to repossess mortgaged properties upon default by the debtor[24]. No matter how successful the insolvency arrangements turn out to be, there will always be debtors who default on their specific arrangement and who will need to enter into formal bankruptcy proceedings.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 14 September 2012.

[signed]

The President of the ECB

Mario DRAGHI

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20 Part 5 of the draft law on the regulation of personal insolvency practitioners.

21 See Ireland: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding of 20 August 2012 in the context of the EU-IMF Financial Support Programme for Ireland; financial sector reforms, p. 10.

22 Part 3, Chapter 4 of the draft law.

23 Section 84 of the draft law.

24 There have been only a handful of applications for bankruptcy filed with the courts under the current bankruptcy legislation. See the Law Reform Commission Report on Personal Debt Management and Debt Enforcement of December 2010.