Regulating collection of receivables

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American Chamber of Commerce in Croatia Američka gospodarska komora u Hrvatskoj

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Introduction

Collection of receivables is a prerequisite for normal functioning of any enterprise, regardless of its size. Debt defaults have negative effects, often causing creditor companies themselves to become debtors because of debts owed to them. This leads to frozen accounts preventing normal business and infrequently causing bankruptcies and striking of enterprises from appropriate registries.

The position paper will point out negative consequences of defaults on delinquent debtors themselves, as well as on non-delinquent debtors, companies, the economy as a whole and ultimately on the rating of the Republic of Croatia in the EU and globally. The position provides examples taken from other European countries where the issue is perceived differently and where the problem of debt defaults is kept under control as well as methods employed to achieve and maintain that. An additional emphasis is placed on collection of receivables as a method helping the entire economy to maintain its stability and performance in the long run.

In regular operation, companies perform their individual activities and they normally do not have the time to tend to their outstanding receivables. The situation is helped by the secondary market of receivables which might allow the companies to free up their staff and premises for performance and development of their core activities.

According to the Croatian National Bank[1] 2019 data, banks in the Republic of Croatia sold HRK 4,244,165,000 of their claims at the price of HRK 2,666,987,000 in 2019, and HRK 5,392,930,000 of claims were sold at the price of HRK 2,221,900,000 in 2018. By selling their receivables, the banks released their provisions in the amount of the receivables sold and they additionally generated income in the amount of the selling price. This is a significant multiple benefit for the banks ultimately resulting in lower interest rates and higher availability of credit placements to their users. According to available information, the European Central Bank (ECB) imposed the European Union (EU) banks, including the Croatian National Bank (CNB), obligation to sell as large portfolio of non-performing loans (NPL) as possible. By selling receivables, i.e. by collecting them successfully, national credit rating is also improved, and this certainly points out the importance of claims management in the macroeconomic context.

[1] https://www.hnb.hr/statistika/statisticki-podaci/financijski-sektor/druge-monetarne-financijske-institucije/kreditne-institucije/pokazatelji-poslovanja-kreditnih-institucija

Moreover, it is economic necessity recognized by European experts of key economic institutions.

Several things are essential for a successful system for collection of receivables:

- Good regulations and support and awareness of the legislature regarding the issue of collection on national and global levels and in both retail and corporate segments.
- Raising awareness and level of knowledge of the media.
- General development of the entire system for collection of receivables which is primarily affected by the regulations and support of the legislature.

State of play in Croatia

Even though a large number of unpaid debts (which cannot be collected) in the Republic of Croatia stems from financing of consumption not meant to satisfy the basic needs of living, enforcement of collection of such debts is still by large perceived unfavorably in the Republic of Croatia. Creditors are predominantly perceived unfavorably even though the creditors delivered products or performed a service to fulfil their contractual obligations towards the debtors and received no consideration in return. Such unfavorable perception is exacerbated by the image portrayed by the media.

Creditors found themselves in an unenviable position following the Amendments to the Financial Assets Enforcement Act of 18 April 2020 as well as the Intervention Measures in Enforcement and Bankruptcy Proceedings During Special Circumstances Act which took effect on 01.05.2020 and remains in force until 18.10.2020. The Amendments to the Financial Assets Enforcement Act concerns suspension of enforcement proceedings against financial assets in accounts of natural persons while the Intervention Measures in Enforcement and Bankruptcy Proceedings Act pertains to suspension of all enforcement proceedings in the Republic of Croatia regardless of the object and means of enforcement or if the debtor is a legal or natural person. This Act prevents institution of new bankruptcy proceedings. Both of the acts also suspend charging of penalty interest, representing a permanent loss in balance sheet of each creditor. Even though those regulations govern enforcement and bankruptcy proceedings, according to available interpretations of the competent ministry, in addition to the suspension of penalty interest in proceedings that are already in progress, charging of penalty interest is suspended in all legal relations where payment defaults occur and this may lead to an interpretation that debtors are not required to pay on time for goods or services supplied while those acts are in force

because no penalty interest is charged, i.e. there are no consequences of default. Non-delinquent debtors are thereby in unfavorable position.

The above measures will affect creditors from all sectors and industries as well as the secondary market for collection of receivables, small companies and natural persons who are also creditors to natural persons. Despite the fact that this measure is introduced to relieve economic problems affecting citizens during the crisis caused by the COVID-19 pandemic, it does not distinguish those affected by the epidemic from those who are capable of performing their obligations and did not, for example, lose their job as the source of their livelihood at the time when those acts came into force. Furthermore, the measure restricts economic rights of entrepreneurs including the rights acquired upon investment of capital. Lack of justification and disproportionality of the measure affecting constitutional rights of entrepreneurs is also reflected in the fact that people who lost their jobs due to the epidemic are not the ones benefiting from the moratorium because, in this period, they have no income which might be seized anyway. As regards those citizens whose income is reduced, the existing Enforcement Act determines that only a portion of the income may be seized and the reduction of their income also reduced that portion, while economic standing of the third category of people, comprising those who work for an unchanged salary, is not threatened. This is just one example of generalization of the imposed measure without any social analysis and it does not provide any economic benefit to the citizens.

Furthermore, in relation to the circumstances occurring due to the COVID-19 crisis, it is important to note that an extension of duration of the special circumstances prescribed in Article 25.a of the Financial Assets Enforcement Act until 18 October 2020 is not followed by a write-off and delay of payment of tax prescribed by the Regulation on enforcement of the General Tax Code (Official Gazette 115/16, 106/18, 121/19, 32/20, 42/20, 43/20) bringing private entities and the government in the role of a creditor in an inferior position in collection of receivables.

Examples of good practice from the EU

Interest rates in Europe

In the Republic of Croatia, there are no legal or practical limits applicable to statutory penalty and contractual interest in relation to principal. Most European countries do not have any legal or practical obstacles to charging of statutory penalty and contractual interest in the amount exceeding principal. Those are generally West European and Scandinavian countries (the United Kingdom,

Sweden, Slovenia, Slovakia, Portugal, Norway, Luxembourg, Italy, Ireland, Germany, Finland and Belgium).

Countries with no clear regulations or those where practice supports the idea that the amount of statutory penalty interest should not be restricted, even though the situation is subject to practical and judicial decisions and the above restrictions are possible, are largely East European countries (Albania, Czech Republic, Estonia, Iceland, Lithuania and Russia).

Countries where regulations restrict the amount of statutory penalty interest in relation to the amount of principal entirely or with minor exceptions are generally Balkan countries or East and South European countries with a number West European countries (Austria, Bosnia and Herzegovina, Belarus, Montenegro, Kosovo, Latvia, Malta, Romania, Switzerland and Spain).

As regards penalty interest rates in other countries, they exceed 20% in Estonia and Finland, but the rate in other countries (where data exist) is about 8%. These penalty interest rates are higher than the ones in force in Croatia.

Slovenia

In the Republic of Slovenia, collection of receivables is regulated by the Enforcement Act and additional secondary regulations. The Slovene system is based on systematic digitalization whose introduction was in preparation for 5 years in cooperation with and in accordance with recommendations of German legal and economic experts. Good preparation resulted in impeccable technical and operational functioning of the system from day one. The basic characteristic of the system is that it allows creditors to perform collection through an advanced and nearly fully automated enforcement system. The creditors are allowed to enter, using a special platform, predefined data in proposed enforcement templates individually or in batches and the system consisting of linked platforms associated with courts, the Tax Administration, the Ministry of the Interior, the Pension Insurance Institute, the Land Registry and similar institutions automatically verifies the entered data and predefined costs of proceedings depending on amount of the debt. This prevents any accidental or intentional manipulation of data or data accuracy and therefore no additional verification or correction by the enforcement procedure authority is needed. Because of this, the entire Slovene enforcement system rests on a single court (Okrajno sodišće v Ljubljani), specifically a single department of the court – COVL (Centralni odelek za verodostojno listino), employing 5 judges, about 40 court assistants and about 20 recording clerks. Therefore the system rapidly produces and dispatches enforcement decisions which become final within no more than 2 months. The system is inexpensive for both creditors and debtors because it is fast, efficient

and simple to use. On the other hand, once the enforcement decisions become final, further collection procedure is managed through local courts potentially leading to slowing down of further course of the proceedings, but it could be expedited by its automation.

As regards the creditor-debtor relationship, in Slovenia, perception of creditors is significantly different than the one found in Croatia. The creditors are perceived as the party who sold a product, rendered a service and therefore its right to compensation is not questioned. Effects of this type of system and social climate are also apparent in Slovenian economic outlook.

Germany and Austria

Germany and Austria have mutually similar, well-developed and partially electronic collection system distinguished by high quality organization. Rate of blocked entities relative to the total number of citizens and legal entities in both those countries is roughly equal to that found in the Republic of Croatia. Also, in those countries, the reasons for defaults are the same as those unofficially listed in Croatia[2], but the number of intentionally delinquent debtors is far lower than in the Republic of Croatia. In spite of similarities in terms of percentages, public awareness concerning creditor-debtor relations is completely different, i.e. the social climate of Austria and Germany is such that paying and collection are encouraged rather than brought into question.

On average, costs of enforcement and civil proceedings in Austria and Germany are higher than the ones in Croatia and the situation is the same in the entire West Europe. This, in part, makes cross-border collection by creditors from the Republic of Croatia from debtors located in, for instance, Germany more difficult. This leads to the conclusion that Germany and Austria presume that, if the cost of enforcement proceedings imposes no additional financial burden on the debtor, there is no incentive for the debtor to voluntarily pay before enforcement proceedings are instituted. Furthermore, Austria and Germany have a developed secondary market for collection of receivables. It is interesting to mention that Croatia adopted the German model which is frequently more profitable financially to creditors than investing in enforcement and civil proceedings.

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[2] http://hr.n1info.com/Vijesti/a333896/Svaki-cetvrti-gradjanin-i-tvrtka-kasni-s-placanjem-racuna.html
https://www.poslovni.hr/hrvatska/cak-petina-tvrtki-u-hrvatskoj-namjerno-ne-placa-racune-252340

Austria and Germany, together with other EU Member States, also implement legitimate enforcements against debtors' accounts and income. When the same debtor's income is affected, according to available information, intention exists to

abolish such enforcement through a new Enforcement Act, while in e.g. Germany it is used in as many as 41% of cases. In Germany, threshold for enforcement against real property is EUR 750 (about HRK 5,600), while the applicable threshold in Croatia is HRK 20,000 and the new Enforcement Act contemplates an additional increase the amount of principal to HRK 40,000, far above the amount applicable in Germany, Austria and other EU Member States. The simple consumer bankruptcy introduced on the Republic of Croatia on 1 January 2019 does not exist in the EU Member States which apply the standard consumer bankruptcy in somewhat greater extent than it is used in Croatia. As regards statutory limitation, applicable time-limits are longer than the ones in effect in Croatia. For example, statutory limitation of telecommunication company receivables in Croatia is 1 year, while in Germany it is 3 years. Statutory limitation of bank receivables in Croatia is 3 or 5 years and, in Germany, it is 10 or 13 years. Switzerland, for instance, applies statutory limitation of telecommunications company receivables of 5 years and 10 years for bank receivables while there is no lower limit for enforcement against real property.

It is clear from the above that the West European approach to collection of receivables facilitates collection to creditors in spite of high percentage of blocked entities. Its fluctuations are high – i.e. the existing cases are closed more rapidly, new ones arrive in order and are successfully closed before further influx of new cases. It could be claimed that the systems are faster and more efficient, more creditor friendly and this also demonstrates that efficient collection of receivables is a factor related to successful economy.

Recommendations

Inclusion of business community in the legislation process

In order to create long-term, efficient, sustainable and mutually useful legislation on collection, we propose inclusion of representatives of the business community, i.e. the creditors in the process of development of the legislation.

Raising awareness on long-term consequences of defaults

It is necessary to raise awareness and level of knowledge among citizens, entrepreneurs, and media about long-term consequences of defaults on the economy and the society as a whole.

Debt write-off procedure

We propose an option to review the provision of the Financial Assets Enforcement Act requiring deregistration of the basis from the Financial Agency (FINA) if collection

did not commence for 3 years. We propose extending the time-limit to 5 years or revoking the provision itself.

Digitalization and automation of implementation of the Enforcement Act

The Enforcement Act currently in force in the Republic of Croatia is a high-quality piece of legislation and, in practice, it functions exceptionally well in terms of enforcement against financial assets and we can say that it is more effective than most EU Member States' enforcement systems. Namely, by conducting enforcements through notaries, 40% of enforcement decisions become final and enforceable within a month after commencement of the proceedings and as many as 95% of decisions become final within 3 months. Such speed of implementation of enforcement proceedings greatly helps creditors and debtors because it shortens the period in which statutory penalty interest is accrued. Enforcement is performed through the Financial Agency (FINA) promptly and transparently and it is automated and quick with good results also achieved in practice in enforcement of income implemented through employers. This part of the system is recognized even by Germany. It is possible to additionally upgrade and improve the existing system through systematic digitalization and automation of all segments of the system by taking cue from Slovenia in order to network the entire system ranging from courts to the notaries and the public administration system and minimizing the possibility of manipulation or error. It is also necessary to additionally **improve the system for enforcement against real property, vehicles and movable assets** by, for example, **introducing electronic bulletins announcing seizures of movable assets and vehicles** thus contributing to simplification of sales and raising awareness of potential buyers regarding the process itself. At the time of seizure, such items would be photographed and announced at publicly available site foreseen for the purpose along with a description and technical specification of the item without indicating any information on the debtor and debt and such items would be available for a specific period for purchase at a fixed price or as auctionable items. This would ensure complete anonymity of the debtor and the buyer while a large portion of movable assets would be sold and creditors would collect at least a part of their claims.

More accurate determination of social criteria

A more accurate determination of social criteria in the Enforcement Act is needed regarding exemptions from enforcement, potentially addressing them through other regulations.

Development and establishment of a central register of debtors

Apart from measures aimed at development of successful collection of receivables, prevention of citizens' excessive debt is of exceptional importance as well as devising mechanisms deterring already indebted citizens from incurring new debts. Even

though everyday life is associated with many challenges and uncertainties and there are justified situations leading to inability to perform obligations assumed through a contract, it is certainly important, if a citizen finds himself/herself in such situation, that the citizen assumes no new liabilities which may lead to a default.
In order to avoid precisely such potential situations, we propose **establishing of a central register of debtors** which would allow verification of (excessive) indebtedness and/or creditworthiness of private persons allowing determination of any risk of default on future liabilities, for example, at the time of conclusion of a subscription agreement. Such a register would include all citizens with a record of delinquency in payment of their liabilities, enforcements on the basis of unpaid bills, frozen accounts etc. The above exists in banking sector as the Croatian Registry of Credit Obligations (HROK). We hold that such a register would contribute primarily to protection of natural persons against potential excessive debts (we would like to remind that, for example, there are legal restrictions regarding overdrafts of current accounts). It would protect creditors and assist in better business decision-making while also allowing rewards and better conditions for non-delinquent payers and it would also provide the government with mechanisms for reduction of overall indebtedness of population and a clearer and more nuanced social policy. Such unique legislative framework allowing exchange of information on debtors regardless of type of service associated with the claim would protect citizens and thereby ameliorate consequences of inability to settle debts and thus significantly facilitating collection of receivables.

Amendments to the Consumer Bankruptcy Act

In the part regulating the simple consumer bankruptcy, the Consumer Bankruptcy Act contains legislative presumptions which largely hinder collection in practice such as presumption of agreement to participate in proceedings if the debtor does not respond and presumption that the debtor has no property if one provides no response regarding its existence. Furthermore, the Act does not allow control of debtor's property by the creditor. It provides only for control by courts, but there are no legislative controls for that. Practice indicates that the ranks of the debtors whose debts were written off by this Act include very few who incurred excessive debts due to justified social reasons (e.g. inability to cover costs of utilities). On the other hand, creditors having a large number of low-value receivables, which normally do not stem from social reasons, are potentially brought into a position where they will not be able to settle their obligations because they cannot collect their receivables from numerous debtors who have been subjects of the simple consumer bankruptcy proceedings. This situation is particularly reflected on operation of small enterprises for whom even a small number of receivables which cannot be collected due to the simple consumer bankruptcy proceedings might be financial burden capable of jeopardizing sustainability of their future operation. Aiming to balance rights of debtors and creditors, we propose to amend the part of the act regulating the simple consumer bankruptcy as follows:

- Introducing social criteria in the act – at this time, the simple consumer bankruptcy procedure is instituted equally for all debtors regardless of their social situation.
- Balancing rights of all creditors - the simple consumer bankruptcy procedure is instituted against all debtors where one Basis (e.g. enforcement decision, judgment, debenture bond etc.) has been submitted to the FINA for more than 3 years and thereby creditors who are at the FINA for even a short period when the basis previously activated at the FINA against such debtors matures to the age of 3 years are equally added to the bankruptcy proceedings. This brings new creditors in less favorable position than the earlier ones while preventing collection (if the basis is written off after only a month it may not be argued that the creditor had the opportunity to collect its claim from the debtor's account). If it is not possible to balance the creditors' rights, we propose at least to allow the creditors to inspect data held by the FINA before activation of a basis thereby allowing them to conclude that their basis might be written off soon.
- Abolishing presumption that the debtor consents to simple bankruptcy proceedings unless the debtor expressly declares otherwise (if the debtor remains silent). Namely, most debtors who responded whether they preferred to institute the proceedings or not declared that they did not wish to institute the proceedings. At the same time, this infringes upon the debtor's property rights even against the debtor's will.
- Abolishing presumption that the debtor has no property if the debtor did not expressly declared otherwise. Namely, such presumption is not found in Croatian legislation or legislation of other countries. Also, since most debtors in practice fail to declare if they would like to institute the proceedings or not and they do not participate in the proceedings at all or appear inactive, it is unjustified to assume for most debtors that they have no property. This also brings those debtors who declared having some property but failed to provide an accurate list of the same, in less favorable position than debtors who did not respond at all. Sanctions are foreseen for the former, but not for the latter. In other words, debtors who acted honestly and actively participated in the proceedings are worse off than those who remained silent and inactive.
- Imposing an obligation on the court regarding control of debtor's property in proceedings and/or accuracy of the list of property submitted by the debtor. In practice, the property is largely controlled through public registers which only offer insight into ownership of vehicles and vessels while property kept in debtors' homes is not controlled even though it is often of considerable value.
- The law does not permit creditors to enter real property of their debtors and take inventories of movable assets. Therefore, creditors are unable to submit evidence on debtors' assets for those debtors who are not registered

as vehicle owners because the law does not permit them to do so (the principle of inviolability of home). On the other hand, the law requires the creditors to submit the above evidence, otherwise the debtors are deemed to have no property. The above is illogical from the legal standpoint.

- Determination of value of property – in practice, for example, vehicles older than 10 years are valued at HRK 0.00 regardless of the type, brand and type. Since the information required to determine actual value of vehicles is available from the Tax Administration, we propose using this source in determination of actual value of property.
- Since the simple bankruptcy procedure is conducted through a year, we propose taking into account aggregate salary/other income of debtors in the one-year period. Namely, since it is prescribed that the proceedings shall not be conducted if the determined value of the debtor's assets is lower than HRK 10,000 (which means that the proceedings are opened and closed and the debtor is released from remaining liabilities). In this way, only those debtors whose salary amounts to HRK 10,000 or more (there is an exceptionally small number of such citizens, let alone debtors in the Republic of Croatia), unless they have a vehicle newer than 10 years old as well, are deemed not to have property worth more than HRK 10,000.

Extending statutory limitation period

We propose amendments to the Civil Obligations Act by extending statutory limitation period for intermittent contributions, primarily telecommunications company invoices made to consumers (debtors) affording the operator (creditor) more time for the option of amicable resolution of matured receivables with the debtor before instituting enforcement proceedings. Even though the above is not a measure of change of default culture, it would certainly influence all negative aspects of a coercive model of collection such as enforcement and help reduce freezing of accounts held by citizens and commercial entities along with costs of such procedures.

Introduction of strict deadlines for each step of court proceedings

AmCham proposes introduction of strict deadlines for each step of court proceedings, in particular enforcement proceedings, and simplification of procedures in enforcement proceedings. Enforcement proceedings based on an 'authentic document' (notaries make and submit a writ of execution) are quick and enforcement decisions become final and enforceable within a short time from the initiation of proceedings. However, enforcement proceedings based on enforceble instruments conducted before the courts, as well as in proceedings regarding objections to the enforcement decision based on a authentic instrument, are in practice much slower. The courts' proceedings until the final court decision take much longer (about a year or two). Therefore, we propose faster proceedings and simplification of court

procedures in enforcement and civil proceedings, in order to achieve the basic determinant of enforcement proceedings, which are speed and efficiency.

Establishing a secondary market of receivables regulated by law

AmCham considers that establishment of secondary market of receivables regulated by law is needed. Taking cue from more developed economies of the EU Member States, we propose enactment of legislation to regulate operation of a secondary market for collection of receivables. The secondary market for collection of receivables may help collection as follows: In case of a greater recorded amount of non-performing loans (NPL) within a bank, its associated risks grow and this leads to increases of its interest rate as well as fees for use of products and services of the bank. Furthermore, in case of reduction of a part of enforceable income, the number of citizens with good creditworthiness is reduced (annuity amount is related to creditworthiness and ability to repay loans by the client). Instead of transferring the risk to non-delinquent payers, the risk (i.e. the risk of potential loss) may be mitigated by using the secondary market.

Conclusion

Development of a successful receivables collection system requires enactment/adoption and implementation of an adequate set of regulations providing incentive for collection of matured liabilities as an important function of a successful economy. It is additionally possible to influence a change of the culture of defaulting by raising awareness and increasing knowledge on actual and long-term consequences of non-payment for the economy and the society as a whole. It is also necessary to create a positive climate in relation to creditors at all levels through action of all involved stakeholders and decision-makers in the claims management process in order to avoid a chain reaction of failures of small and large enterprises as a potential consequence every social and economic system wishes to avoid.

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