Handbook for Effective Management and Workout of MSME NPLs in Slovenia

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Vienna, 15-16 May 2018
Credit quality

• NPE (EBA) in Dec.17 declined to 6.0% or €2.5bn (-2.2 pp and -€1bn compared to Dec.16).

• NPL (EBA) in Dec.17: 8.6% or €2.4bn (-3.2 p.p. compared to Dec. 2016).

• The largest volume of NPE remains in non-financial corporates with €1.7bn, representing 69% of remaining NPE in the banking sector.

Source: Bank of Slovenia

NPL, NPE according to EBA definition

NPL according to MDS definition
NPE development and activities for reduction

1. State intervention:
   1. recapitalisation of banks
   2. transfer of NPLs to BAMC
   3. orderly wind-down of 2 banks

2. Insolvency legislation upgraded

3. Slovene Bank Association issues
   Restructuring Principles
   (for large enterprises)

4. BoS guidelines and
   recommendations
   Additional supervisory measures

5. Handbook for NPE management of
   MSME published
SME NPE development and main factors of reduction

Main developments:
- Reduction from EUR 3.5 yard down to EUR 1.1 yard.
- Decline in relative terms is even higher than in total.
- Main reason of decrease is "sale and other".
- Write-offs and forgiveness in SME portfolio represent relatively higher proportion than in portfolio of large exposures.
- Repayment ratio is lower in comparison to non-performing large exposures.
TECHNICAL ASSISTANCE – EUROPEAN COMISSION and WORLD BANK

GOAL: Tool for Management of SMEs non-performing exposures (NPE)
SCOPE OF WORK: Establishment of a systematic (best practice) approach for SME NPE restructuring

- TA PROVIDER: World Bank

- SPECIFIC DELIVERABLES
  - A handbook for SME NPL workout.
  - A toolkit for SME NPL workout.
  - Workshop for banking community organized by World Bank and BoS.

- MAIN ACTIVITIES & TIME TABLE:
  - Kick-off meeting: 10 May - 11 May 2016
  - Data gathering and Analysis: June – August 2016
  - Project team work: 06 Sept – 05 Oct 2016
  - Workshop for banking community: 13 January 2017
  - Handbook published: 14 March 2017
Lessons learnt from SME data analysis

- Number of small MSME NPL exposures was high
- Substantial buildup of exposures in D,E categories or 90 DPD
- Evidence of systemic “evergreening” of NPLs
- Average and maximum DPD indicator is high
- Multiple exposures from different banks to one borrower
- Small number of legal actions initiated, relative to age of NPLs
Brief overview of the Handbook

- Chapter I - Early Warning System
- Chapter II - Internal institutional arrangements for managing MSME NPLs portfolio
- Chapter III - Methodology for early segmentation, including the initial assessment of borrower’s viability
- Chapter IV - Essential preparations for workout process
- Chapter V - Methodology for in-depth financial and business viability assessment
- Chapter VI - Potential workout strategies and the methodology for choosing the strategy that would lead to the maximum recovery value
- Chapter VII - The negotiations process and the documentation of restructuring process
- Chapter VIII - The monitoring of restructuring process
Brief overview of the Handbook - Appendices

- **Appendix 1:** Financial ratios by sector
- **Appendix 2:** Estimated time and cost of legal solutions
- **Appendix 3:** Sample Forms and Templates
  - Checklist for MSME Borrower
  - SSA Template
  - Restructuring Process Timetable
- **Appendix 4:** Case studies
KEY RECOMMENDATIONS

• EWS should be an effective tool in the **timely** identification of potential problematic borrowers
• Bank should have **adequately resourced workout units** with specific KPIs for NPL resolution linked to the bank’s overall NPL resolution strategy
• Need for **standard timeline** with indicative deadlines for each step in NPL management process
• NPL segmentation should build on two pillars – **cost effectiveness and initial viability assessment**
• Collateral analysis should be done on **prudent** basis using qualified appraisers
• Select resolution route based on **comparison of NPVs** of recoveries expected under various workout options: forbearance, sale, collateral enforcement, and insolvency – taking into account **all costs** to the bank
Chapter 1: EARLY WARNING SYSTEM

**Signal Identification**
- Responsibility for establishing parameters for signals and monitoring resides in separate unit or function within risk management, middle or back office.
- Upon identification of a signal, EWS unit notifies account officer and his manager that action is required.

**Action**
- Account officer contacts the borrower and identifies source and magnitude of potential payment difficulty.
- After analysis and in consultation with risk management, a corrective action plan is put in place.
- Exposure is added to the watch list for the purposes of further monitoring.

**Monitoring**
- Risk management approval required to remove exposure from watch list.
- Exposure can remain on watch list for a maximum of twelve months. After that period, exposure must be either returned to originating unit or transferred to workout unit.
- While on the watch list, exposure should be classified with lower risk rating compared to the one prior to moving to the watch list.
Chapter 3: Proposed methodology for portfolio segmentation

Segmentation consists of two stages:

- **In stage I**, exposures in legal procedures, exposures outside Slovenia, and exposures below 10,000 EUR are separated from the main NPE pool.
- **In stage II**, initial viability assessment is done using Debt/EBITDA and LTV.
- Focus should be on cost efficient process.

<table>
<thead>
<tr>
<th>Stage I</th>
<th>Stage II</th>
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<tbody>
<tr>
<td>Exposures already in legal procedures</td>
<td>Viable borrower</td>
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<tr>
<td>Exposures originated outside Slovenia</td>
<td>LTV ≤ 80</td>
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<tr>
<td>Exposures below EUR 10,000</td>
<td>Debt/EBITDA ≤ 5</td>
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<tr>
<td>Automatic transfer to legal workout unit</td>
<td>Marginally viable borrower</td>
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<td>LTV ≤ 80</td>
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<td>Debt/EBITDA ≤ 8 ≤ 5</td>
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<td>Non-viable borrower</td>
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<td>LTV ≤ 80</td>
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<td>Debt/EBITDA ≥ 8</td>
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- Write-off (after provisioning) and/or sale of portfolio

- Automatic transfer to legal workout unit

- Transfer to workout units in respective jurisdictions or divestment

- Viable borrower
  - LTV ≤ 80
  - Debt/EBITDA ≤ 5

- Marginally viable borrower
  - LTV ≤ 80
  - Debt/EBITDA ≤ 8 ≤ 5

- Non-viable borrower
  - LTV ≤ 80
  - Debt/EBITDA ≥ 8
Chapter 4: Preparations for workout process

KEY ISSUES

- Gathering information about the borrower
- Determining bank's legal rights and remedies
- Collateral analysis (valuation)
  - Frequency of valuation
  - Valuation Methodology
    - individual property valuation (market value)
    - use of indexing (residential RE, value below EUR 300K, GURS - Ministry of the Env. and Spatial Planning)
- Requirements for Appraisers
  - internal or external
  - objectivity
  - avoidance of conflict of interest
Chapter 5: In-depth viability assessment

In-depth viability assessment

• Key financial ratios
  • Liquidity
  • Solvency and leverage
  • Profitability
  • Efficiency
• Balance sheet analysis
• Cash-flow analysis

Note
BS will continue to publish key financial ratios annually

Business viability assessment

Example of leverage analysis

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<tr>
<th>Viable borrower</th>
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<td>LTV ≤ 80</td>
<td>LTV ≥ 80</td>
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<td>Debt/EBITDA ≤ industry average +20% with cap at 5</td>
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<td>Marginally viable borrower</td>
<td>Marginally viable borrower</td>
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<tr>
<td>LTV ≤ 80</td>
<td>LTV ≥ 80</td>
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<tr>
<td>Debt/EBITDA ≥ industry average +40% with cap at 8</td>
<td>Debt/EBITDA ≥ industry average +40% with cap at 8</td>
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Average debt/EBITDA ratios of specific Slovenian economic sectors

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<tr>
<td>Manufacturing</td>
<td>2.51</td>
<td>3.39</td>
<td>3.92</td>
<td>3.68</td>
<td>3.4</td>
<td>3.45</td>
<td>3.26</td>
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<td>Construction (rhs)</td>
<td>5.08</td>
<td>5.9</td>
<td>9.41</td>
<td>29.79</td>
<td>25.67</td>
<td>17.27</td>
<td>12.23</td>
<td>118.07</td>
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<td>Wholesale and retail</td>
<td>3.96</td>
<td>4.39</td>
<td>5.27</td>
<td>5.44</td>
<td>5.79</td>
<td>6.21</td>
<td>5.67</td>
<td>4.43</td>
<td>3.81</td>
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<td>Transport and storage</td>
<td>8.16</td>
<td>9.84</td>
<td>15.58</td>
<td>9.05</td>
<td>7.55</td>
<td>6.66</td>
<td>6.27</td>
<td>5.57</td>
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<td>Hotels</td>
<td>6.24</td>
<td>8.5</td>
<td>9.4</td>
<td>12.01</td>
<td>12.27</td>
<td>12.68</td>
<td>11.88</td>
<td>16.34</td>
<td>7.82</td>
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<tr>
<td>Real estate (rhs)</td>
<td>10.17</td>
<td>12.12</td>
<td>15.97</td>
<td>14.18</td>
<td>18.19</td>
<td>31.06</td>
<td>53.59</td>
<td>76.14</td>
<td>16.22</td>
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Source: Chamber of Commerce & Industry of Slovenia, based on data from Ajpes.
Chapter 7: Negotiating and Documenting

**MAIN TOPICS**

- Developing the negotiating strategy
- Documenting the restructuring agreement
- Communication to the borrower
- Management of disputes
Chapter 8: Monitoring the Restructuring Plan

MONITORING TASKS

- Monitoring arrangements
- When restructuring fails
CONCLUSIONS

- EXTREME CIRCUMSTANCES CALL FOR EXTREME MEASURES
- TIME (SWIFT REACTION) IS MONEY
- NPE TOPIC IS NOT "ONE-OFF EVENT"
- NPE (MANAGEMENT) IS A QUESTION OF CYCLES - WE NEED:
  - CURATIVE MEASURES and
  - PREVENTIVE MEASURES
- INCORPORATION OF NPE MANAGEMENT IN ONGOING OPERATIONS OF A BANK IS A "MUST"
- IMPORTANT ROLE OF SUPERVISOR
- ESSENTIAL COOPERATION OF ALL STAKEHOLDERS
- "NPE AWARENESS" OF BORROWERS
THANK YOU FOR YOUR ATTENTION

DISCUSSION