

COVID-19 and Non-Performing Loan Resolution in the Europe and Central Asia region

Lessons learned from the global financial crisis for the pandemic



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Glossary

Asset Management Company	A public, private, or joint entity that manages non-performing assets with the goal of maximizing the recovery value of these assets.
Asset Quality Review	A detailed, point-in-time assessment of the accuracy of the carrying value of banks' assets.
Balloon payment	Interest paid regularly together with only small repayments of principal so that the bulk of the loan is payable upon maturity.
Bullet payment	Principal and interest paid at maturity.
Collateral enforcement	The exercise of rights and remedies with respect to collateral that is pledged against a loan.
Conditional debt forgiveness	A bank forfeiting the right to legally recover part or the whole of the amount of an outstanding debt upon the borrower's performance of certain conditions.
Cooperative borrower	A borrower which is actively working with a lender to resolve a non-performing exposure.
EBITDA (earnings before interest, taxes, depreciation, and amortization)	An accounting measure calculated using a company's earnings, before interest expenses, taxes, depreciation, and amortization are subtracted, as a proxy for a company's current operating profitability.
Forbearance (see also Loan Restructuring)	Concessions towards a debtor that is experiencing or about to experience difficulties in meeting its financial commitments.
Interest rate coverage ratio	A ratio expressing how many times a company can cover its current interest payment with its available earnings.
Loan to value ratio	Financial ratio expressing the value of the loan compared to the appraised value of the collateral securing the loan.
Management information systems	Risk management information systems to gather and report relevant data at the unit and bank-wide level.
Moratorium (enforcement)	A legal provision prohibiting creditors to enforce collateral or to initiate other legal actions against a debtor, when the debtor has defaulted as a result of the crisis.
Moratorium (payment)	A provision allowing borrowers to temporarily defer all debt service obligations, after the commencement of the crisis.

Non-cooperative borrower	A borrower which is not showing signs of cooperation with a bank to resolve a non-performing exposure.
Non-performing assets (NPAs)	In addition to non-performing exposures, this definition includes foreclosed assets.
Non-performing exposures (NPEs)	In addition to non-performing loans, this definition includes advances and debt securities.
Non-performing loans (NPLs)	Loans that are either more than 90 days past due, or that are unlikely to be fully repaid without recourse to collateral.
Reorganization	A procedure that permits the rehabilitation of distressed but potentially viable borrowers through financial and operational restructuring.
Restructuring plan	A document containing the measures to be taken in order to restore a borrower's viability.
Risk management system	A centralized system that allows a bank to holistically monitor bank's risks, including credit risk.
Servicing platform	Infrastructure necessary for effective monitoring and collection of NPLs. It includes the IT system to manage data, call center, restructuring unit, and back-office. The infrastructure may be housed either in the bank or in an independent service provider.
Unlikely-to-pay (UTP)	Evidence that full repayment of principal and interest is unlikely without making use of collateral, regardless of whether a loan is in arrears.
Viability analysis	An assessment of borrower's ability to generate adequate cash flow in order to service outstanding debts.
Willful defaulters	Borrowers that have the financial capacity to meet their debt service obligations but choose not to.
Workout unit	A bank's operational unit in charge of handling problematic exposures.
Zombie borrowers	Borrowing companies that are unable to cover debt servicing costs from current profits over an extended period.

Abbreviations

AMC	Asset Management Company
AQR	Asset Quality Review
BCBS	Basel Committee on Banking Supervision
BRRD	Banking Recovery and Resolution Directive
CESEE	Central, East- and South-Eastern Europe
DPD	Days-Past-Due
EBA	European Banking Authority
EBITDA	Earnings before Interest, Taxes, Depreciation, and Amortization
ECA	Europe and Central Asia
ECL	Expected Credit Losses
EU	European Union
FASB	US Financial Accounting Standards Board
GFC	Global Financial Crisis
IASB	International Accounting Standards Board
ICR	Insolvency and Creditor Rights
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IT	Information Technology
LTV	Loan-to-Value
MSME	Micro, Small and Medium-Sized Enterprises
NPA	Non-Performing Asset
NPE	Non-Performing Exposure
NPL	Non-Performing Loan
NPV	Net Present Value
PV	Present Value
SICR	Significant Increase in Credit Risk
SSM	Single Supervisory Mechanism
UTP	Unlikeliness to Pay

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Executive Summary and Key Conclusions

The outbreak of the COVID-19 pandemic in the first quarter of 2020 has prompted a series of unprecedented emergency measures – including travel bans, mandatory closure of non-essential business, limitations on gatherings, and mandatory home-based work. The crisis has severely impacted economic activity with output losses often exceeding those observed during the global financial crisis (GFC) that started more than a decade ago. Many borrowers quickly saw their income flow drastically reduce or dry up altogether due to COVID-19. Against the backdrop of a highly uncertain economic recovery, renewed spikes in caseloads, and a reintroduction of emergency measures, borrower distress has been on the increase ever since.

Policymakers have been quick to roll out borrower relief programs. In the case of Europe and Central Asia (ECA), these programs have primarily taken the form of temporary payment moratoria, where decisions on which borrowers qualify are usually left to banks, combined with short-term legal measures to flatten the bankruptcy curve. Aggregate non-performing loan (NPL) ratios have generally remained stable while these measures are in place, but policymakers and bankers anticipate that rising levels of borrower distress will inevitably translate into fresh pressures on asset quality in the banking sector that will become increasingly apparent in banks' earnings, capital, and financial statements.

Experiences in the aftermath of the GFC, which left many ECA countries with a persistent legacy of high NPLs, underscore the need for a quick and comprehensive policy response. The GFC initially hit the region through a sudden stop in capital flows, exposing the vulnerabilities that had built up. In the worst-affected countries in Central, East- and South-Eastern Europe (CESEE), credit growth went into reverse, asset and real estate booms went bust, and economic growth stalled. Reflecting widely held views that the downturn would be short-lived and

transient losses would be naturally recuperated over time, policymakers and bankers were slow off the mark in responding to the rising pressures on asset quality.

Consequently, when NPL levels started increasing across the board, the problem quickly spun out of control. Banks, that often had thin capital buffers, were frequently reluctant to recognize and provision for their true exposure to problem loans. This, in combination with weaknesses in regulatory and supervisory frameworks, caused reported asset quality indicators to drift away from economic realities and impeded timely supervisory follow-up vis-à-vis weak banks. In addition, profound weaknesses in insolvency and creditor right environments and in banks' operational readiness to work out rapidly rising volumes of NPLs prevented a resolute handling of non-viable borrowers. These borrowers were often kept afloat with questionable loan restructuring practices, breeding allocative inefficiencies as banks' credit stocks became locked up in underperforming economic sectors at the expense of more dynamic ones. Paradoxically, the lack of exit of non-viable borrowers coincided with significant missed opportunities in terms of salvaging distressed but potentially viable borrowers, that due to an absence of a rescue culture and inefficient insolvency systems were frequently pushed towards liquidation.

These experiences demonstrate the dangers of a delayed initial policy response, that allowed the underlying problems to fester, compromised the capacity of the banking sector to finance the real economy, and ultimately left countries trapped in a bad equilibrium of low growth and lackluster financial sector performance. Avoiding a repetition of the post-GFC scenario should be top priority for policymakers in the region. This will require an alignment of three sets of policies that are discussed in detail in this policy note, including (i) robust banking

regulation and supervision to ensure the proper identification of NPLs and provisioning for credit losses, (ii) strengthening of banks' operational readiness to work out rising volumes of problem assets, and (iii) a legal environment that enables banks to work out bad loans and that avoids unnecessary losses by steering distressed but potentially viable borrowers towards liquidation.

Most ECA countries entered the COVID-19 pandemic from a stronger starting position than the GFC. Banks in the region generally have more robust liquidity and capital buffers, while many regulators have introduced more stringent regulatory definitions for the identification of problem assets that are aligned with international standards. Following the GFC, policymakers across the region have also embarked on sweeping reforms to strengthen creditor rights and insolvency regimes, while banks' relatively recent experience with NPL resolution has left them better prepared to work out high volumes of bad debt.

Nonetheless, in the face of potentially the worst economic crisis since the Great Depression in the 1930s, there is no room for complacency. The challenges associated with rapidly rising NPLs require a prompt, proactive, and comprehensive policy response. The mere passage of time only makes a bad situation worse. It is therefore imperative that policymakers and bankers rise to the challenge and start preparing now. Failure to respond quickly and comprehensively significantly increases the chances of a repetition of the post-GFC scenario. Experiences in the region over the last decade point to some important lessons for the COVID-19 era.

First, effective NPL resolution requires the availability of economically meaningful data about banks' exposure to problem assets. Regulators and supervisors need this information to gauge the

magnitude of the problem, inform their NPL resolution strategies, ensure that banks provision appropriately for credit losses, and follow up with banks with a high NPL exposure. Softening regulatory definitions and supervision only increases opacity without addressing the underlying problem. Strong regulatory definitions, including the qualitative "unlikeliness to pay" (UTP) criterion and forbearance, are key for transparency and comparability amongst banks and jurisdictions. Past reforms, wherein countries adopted internationally harmonized regulatory definitions, need to be preserved. These regulatory definitions need to be underpinned by robust supervisory enforcement, particularly in an environment where pressures on asset quality may incentivize banks to disguise the true extent of their difficulties to banking supervisors. Weak banks that are short of capital space to fully recognize their exposure to problem loans may be particularly inclined to engage in questionable practices to present an overly optimistic picture on asset quality. These challenges may be exacerbated by industry and political pressures on the operational independence of regulators.

Second, an orderly exit from the current exceptional borrower relief measures and short-term legal measures, aimed at flattening the bankruptcy curve, needs to be engineered. With borrowers still struggling to meet their debt-service obligations there is considerable pressure to perpetuate these schemes. Prolonging exceptional borrower relief and short-term legal measures carries hidden costs, including a weakening of repayment discipline, allocative inefficiencies associated with zombie borrowers, and a possible adverse impact on banks' liquidity. The temporary and extraordinary nature of these measures needs to be well understood by banks and by the general public to avoid that these measures are perceived as a new normal and become permanent fixtures. While the

question when and how to phase out the measures does not have a simple answer, the general principle should be to unwind them as soon as circumstances permit, and with careful consideration for the financial impact on banks. Instead of phasing out borrower relief measures altogether when reaching the closing date, measures can also be gradually wound down. Expiring schemes can be replaced with a set of more targeted and better designed measures, including by ruling out borrowers whose financial difficulties predated the pandemic and borrowers whose difficulties are likely to evolve into longer term repayment difficulties. In addition, while these measures are in place, banks should be expected to provide banking supervisors with reliable, frequent, up-to-date, and comparable information regarding loans that have benefitted from borrower relief measures.

Third, it is vital that banks get operationally ready for resolving high volumes of bad loans. The task at hand requires dedicated workout units, separate from loan origination departments, endowed with adequate human and financial resources, and underpinned by robust information systems and bank-specific policies regarding the management and resolution of NPLs. Banks will need to make the necessary investments in human and financial resources to ensure that workout units are fully functional. Banks' own efforts may be complemented by regulatory requirements that banks with high NPLs articulate NPL reduction strategies (that are embedded in their risk and capital strategies and approved by the bank's management body) and agree with the banking supervisory agency on quantitative NPL reduction targets.

Fourth, this time around, banks need to aim for quality in undertaking long-term loan restructuring. Distressed but potentially viable firms will need proper restructuring, not the extend-and-pretend

practices often observed in the aftermath of the GFC. Proper loan restructuring entails rearranging the borrower's liabilities and matching future repayment obligations with expected cashflows. Loan restructuring should not be used as a tool to merely delay the recognition of inevitable credit losses related to exposures to non-viable or uncooperative borrowers, that should be steered towards an orderly exit. Pressures to keep these borrowers afloat with low quality loan restructuring measures should be resisted, to avoid locking up the credit stock in underperforming economic sectors at the expense of more dynamic borrowers as occurred in the aftermath of the GFC. Similarly, it is important that despite the highly uncertain economic outlook, banks make reasonable efforts to distinguish borrowers with transitory liquidity difficulties from those with deeper rooted solvency problems, which has far-reaching consequences for the type of restructuring measures that banks should consider. While the distinction can be challenging, particularly under the current circumstances, this should not discourage banks from making efforts in this direction.

Fifth, while unviable and uncooperative borrowers need to be dealt with resolutely, the depth of the recession puts a high premium on efforts to ensure that distressed but potentially viable borrowers are given an opportunity to rehabilitate. Their rehabilitation entails not only loan restructuring, but also operational restructuring, i.e. fundamental changes in a company's operations aimed at restoring the commercial viability of ailing companies. Encouraging out-of-court workouts for these borrowers is a top priority. Legal frameworks need to enable debt reduction and should be supported by tax regimes that do not unduly disincentivize restructuring. In addition, consideration can be given to the introduction of time-bound regimes that give debtors and creditors special one-off benefits in exchange for an agreed workout plan.

Sixth, while ECA countries overall have made good progress in overhauling legal frameworks, continued efforts are needed to bridge the gap that has emerged between modernized insolvency frameworks and actual practices. This will require continued investments in the institutions that underpin the functioning in practice of these overhauled legal frameworks, and which have often struggled to keep up with legal reforms. These institutional capacity constraints may become acute when faced with renewed pressures on asset quality, with the corresponding increase in debt and litigation cases stretching the capacity of creditors, debtors, advisors, and the judiciary. Where significant gaps have emerged between legal frameworks and practices, policymakers may prioritize upgrading the institutional framework over embarking on a fresh round of complex and time-consuming legal reforms.

Lastly, given the many stakeholders involved, policy coordination is a critical element of any strategy to address high NPLs. Nationwide NPL reduction strategies, designed and implemented with the active participation of private and public sector stakeholders, can help to accelerate the rate of NPL reduction. Key actors include banks and other private sector representatives (such as institutional investors and services) as well as a wide range of national authorities, including central banks and banking supervisory agencies, as well as finance and justice ministries, and civil society representatives, including consumer organizations. A successful strategy must build on robust coordination and interaction among these actors to ensure that timely actions are taken, and measures are well-aligned. Government-initiated coordination mechanisms, including high-level working groups with senior representatives from participating agencies, can play a useful role in assessing obstacles to NPL resolution, setting reform priorities and ensuring that all stakeholders are clear on their role in implementation.

1. INTRODUCTION

The COVID-19 pandemic poses unprecedented health, economic, and financial stability challenges. Protecting lives and allowing health care systems to cope have required isolation, lockdowns, and closures to slow the pandemic. The pandemic prompted a series of unprecedented emergency measures – including travel bans, mandatory closure of non-essential businesses, limitations on gatherings, and mandatory home-based work – that resulted in sharp falls in levels of economic activity, household income, and enterprise revenues and thus loan repayment capacity. Output losses in advanced economies are expected to dwarf those observed during the GFC, and there is continued uncertainty about the economic recovery trajectory.

Policymakers have introduced a variety of exceptional short-term relief measures in response to rising levels of borrower distress.

Borrowers ranging from large corporates to households quickly experienced serious difficulties in staying current on their debt obligations. Against the backdrop of a highly uncertain economic recovery, borrower distress has continued to increase ever since. The magnitude of the economic shock combined with limited macroeconomic policy space prompted most ECA countries to introduce borrower relief measures to provide breathing space to distressed borrowers, as well as short-term legal measures to flatten the bankruptcy curve. Borrowers have been supported with temporary payment and enforcement moratoria, as well as through temporary reductions in borrowers' repayment obligations (e.g. through a temporary switch to interest-only payments).

Looking ahead, rising borrower distress will inevitably translate into fresh pressures on asset quality in the banking sector. With borrower relief measures still in place in many countries, pressures on asset quality are yet to be fully reflected in reported asset quality indicators. Although there is uncertainty as to which borrowers will be permanently affected and how debtors will adjust to the “new normal”, it is evident that many borrowers, ranging from households to large corporates, are facing financial difficulties that go well beyond liquidity stress. It is therefore imperative that policymakers and banks prepare for the complex challenges of resolving increasing volumes of NPLs. ECA has extensive recent experience in this respect. The GFC hit the region particularly hard, leaving a persistent legacy of high NPLs that set the stage for a near-decade of lackluster financial sector performance and low economic growth.

These developments give a renewed relevance to the NPL resolution agenda that is discussed in this policy note. This note draws on ECA region's experiences in NPL resolution in the aftermath of the GFC, with an emphasis on the lessons most relevant for the current circumstances facing policymakers in ECA countries and beyond. Section 2 focuses on ECA's post-GFC experiences in NPL resolution, highlighting the importance of a timely and comprehensive policy response. This note then takes a holistic perspective on NPL resolution by discussing three mutually reinforcing components: regulatory and supervisory policies relevant for the timely identification of NPLs (section 3), bank-led and systemwide measures for resolving large volumes of NPLs (section 4) and -lastly- the enabling legal environment (section 5).

2. ECA REGION POST-GFC AND PRE-COVID-19

ECA stands out as the World Bank region that was worst affected by the GFC that hit the region through financial and trade channels.

A sharp reduction in the availability of external funding set the stage for a reduction in bank lending, limiting access to finance for businesses and households. In addition, with most advanced country trade partners experiencing deep recessions, countries faced a negative trade shock. The situation was exacerbated in some countries by unsustainable current account deficits and a high exposure to foreign currency loans at a time when many national currencies suffered substantial devaluations.

Within ECA region, several CESEE countries were hit particularly hard.¹ In the years before the GFC, when financing from eurozone-based parent banks was plentiful and cheap, the CESEE countries experienced credit booms. European Union (EU)-based banks had entered CESEE domestic markets in the early transition years through the purchase of local banks, establishing subsidiaries and in some cases branches. The rapid growth of cross-border banking coupled with a lack of domestic savings set the stage for a banking model characterized by a heavy reliance of local subsidiaries and branches on parent bank funding and built-in currency mismatches, as lending was predominantly provided in foreign currency including to mostly unhedged domestic borrowers. Rapid credit growth was accompanied by booming asset and real estate prices and steep

increases in household and corporate debt, with aspirations of reaching EU living standards running ahead of borrowers' debt-shouldering capacity (EIB, 2019).²

The cross-border banking model prevalent in the CESEE countries played an important role in the transmission and subsequent amplification of the GFC. In the immediate aftermath of the collapse of Lehman Brothers in 2008, external financial markets largely closed for banks (euro bonds, wholesale funding, and syndications). This represented a major problem for local subsidiaries and branches that relied on the continued availability of foreign funding to meet their refinancing needs. Subsequently, credit growth went into a steep decline, asset and real estate booms went bust, and economic growth slowed down sharply, setting the stage for steady increases in NPL ratios across the region. Currency mismatches between the denomination of loans (e.g. euro, Swiss franc, and Japanese yen) and the borrower's income source led to the emergence of forex-induced credit risk. The depreciation of local exchange rates caused repayment difficulties for borrowers with local currency incomes and with debts denominated in foreign currencies in countries that had floating exchange rate regimes. Elsewhere, the combination of low growth and minimal currency depreciation created a challenging macro environment for a swift reduction of NPLs, putting a heavy premium on structural reforms that took time to introduce and take effect.

1 This section focuses on the experiences of the worst affected countries in the CESEE, rather than on ECA region as a whole.

2 https://www.eib.org/attachments/efs/10years_vienna_initiative_en.pdf

A delayed policy response

For a variety of reasons, policymakers and bankers did not respond immediately to the rising pressures on asset quality. In part, this was due to weaknesses in underwriting practices, as illustrated by the buoyant growth of unsecured personal loans, upbeat expectations of corporates' future revenues, and lofty collateral valuations following a long period of steadily increasing real estate prices.³ In addition, policymakers and bankers initially had optimistic expectations regarding the economic recovery trajectory. The prevalent attitude among policymakers and bankers at the time was that the crisis would be short-lived. Banks would just have to navigate through a few challenging years, after which borrowers' repayment capacity and collateral values, which had often depreciated significantly, would recover. In this vein, aggressive efforts to recover, e.g. by foreclosing on loans that had become non-performing, would likely be counterproductive by forcing banks to acknowledge transient losses that would naturally be recuperated over time.

Another factor that contributed to the delay in the initial policy response were widespread weaknesses in legal frameworks for the enforcement of creditor rights and insolvency proceedings, that translated into low expected recoveries. Weaknesses in the enforcement of creditor rights introduced significant uncertainty regarding ultimate recovery prospects due to the unpredictability of court decisions, as well as a limited or non-existent business rescue culture and frequent procedural delays. Even if banks were to aggressively push for recovery, eventual recovery prospects would be low and highly uncertain due to the poor functioning of the overall credit enforcement environment. Rather than forcing such borrowers towards an orderly exit, banks often

resorted to questionable loan restructuring practices, keeping non-viable borrowers afloat with a mixture of low interest rates, long grace periods, bullet payments, and frequent rescheduling. Conversely, distressed but potentially viable borrowers often did not receive the loan restructuring necessary to restore their commercial viability. Banks were frequently reluctant to provide debt relief, while the absence of a rescue culture combined with inefficient insolvency systems meant that many of these borrowers were pushed towards a formal or informal liquidation process.

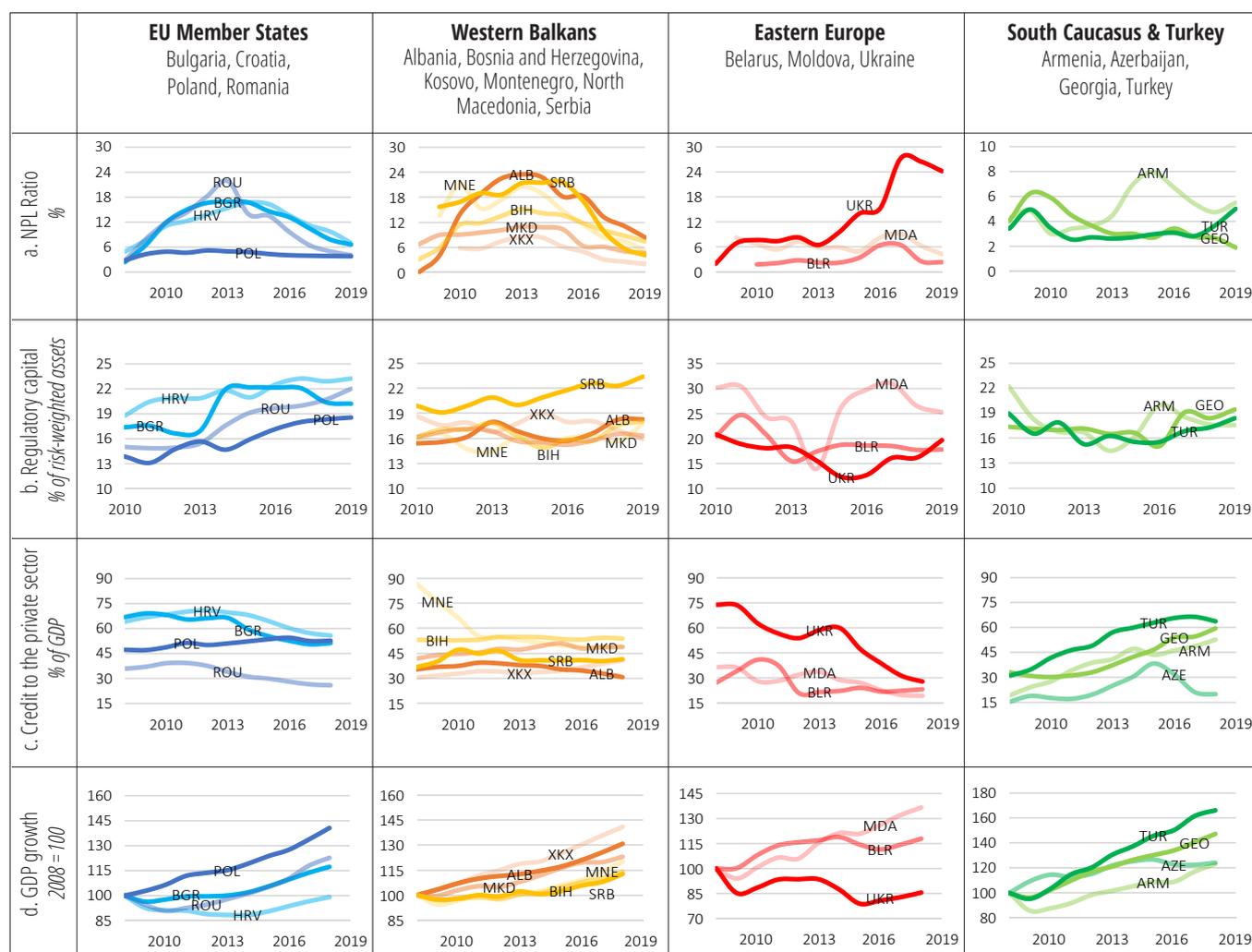
Banks often lacked the capital space and skills to respond proactively to deteriorating asset quality. Banks in the region often had thin capital buffers. The concern was that full and proactive acknowledgment of NPLs could thus reveal capital shortfalls (which would be difficult to replenish as parent banks were facing their own financial difficulties and risk aversion spooked financial markets) and trigger regulatory scrutiny. In addition, banks often opted to constrain total risk-weighted assets to strengthen the capital adequacy ratio, collectively reducing the availability of credit and exacerbating the economic downturn. In addition, banks were generally operationally poorly prepared to deal with an increase in NPL volumes across the board. During the GFC, many countries in the region experienced the first turn in the financial cycle since the start of the transition. The significant increase in NPLs across the board was thus the first serious test of people, systems, and procedures. While in some cases adequate frameworks were in place for dealing with incidental NPLs, banks in the region generally lacked dedicated workout units and did not have the skills needed to respond effectively.

³ Currency mismatches exacerbated the situation. With loans often denominated in foreign currency, the depreciation of local currencies implied a lower value of real estate collateral expressed in the foreign currency of denomination of the loan.

In hindsight, the delay in the initial policy response allowed the problems to fester, with steadily rising NPL volumes ultimately weighing heavily on financial sector performance and economic growth. In the years following the GFC it became increasingly evident that the mere passage of time would do little to improve the situation. On the contrary, the problem was progressively worsening as rising NPL volumes set in motion a negative feedback loop between lackluster financial

sector performance and a weakening real economy. A large stock of unresolved NPLs made it difficult for banks to fulfill their intermediation function in the bank-dominated financial sectors in the region, compromising their capacity to finance new and dynamic sectors, reducing the availability of fresh credit (as illustrated by decreasing or stagnant credit-to-GDP ratios observed in most countries in the region), driving up the cost of finance, and weakening economic growth.

Graph 2.1 NPL ratios, bank capital adequacy, financial intermediation, and economic growth in ECA region, 2008-19



Source: World Development Indicators.

Note: NPL ratio data for 2019 are supplemented with statistics from national central banks, where available.

Policy reforms

Policy reforms in the CESEE mirrored those in the EU, which was facing NPL resolution challenges of its own. The GFC and the subsequent sovereign debt crisis led to soaring NPL ratios in several EU member states, including Cyprus, Greece, Ireland, Italy, Portugal, Slovenia, and Spain. Among the key reforms initiated in the EU was the European Banking Authority's (EBA) 2013 implementing technical standards, which sought to establish uniform regulatory definitions of non-performing and forborne exposures. The introduction of internationally agreed regulatory definitions by banks and supervisors was an important step to enable policymakers to monitor and assess banks' asset quality in a more consistent manner, both within and across jurisdictions, as well as to facilitate timely action to address rising asset quality problems. The introduction of common EU regulatory definitions motivated many countries in ECA region to adopt the harmonized definitions in updated loan loss classification regulations.⁴

The establishment of the Single Supervisory Mechanism (SSM) in 2014 contributed to greater transparency in asset quality problems, that were not always recognized in reported NPL ratios. Euro area heads of state agreed in 2012 to create a European banking union, with European banking supervision through the SSM established within the European Central Bank (ECB) as one of its main building blocks. As part of the transfer of banking supervision to the supranational level, a comprehensive assessment was undertaken of 130 euro-area based banking groups, involving a detailed, point-in-time assessment of the accuracy of the carrying value of banks' assets, with similar exercises taking place in several ECA countries.⁵

Gradually, the notion settled in CESEE countries that accelerating the rate of NPL reduction would require more ambition. A strong case advocating an ambitious NPL resolution agenda was presented in a report prepared by the Vienna Initiative's Working Group on NPLs. It concluded that the resolution of problem loans by individual banks was proceeding too slowly, and that a more comprehensive and concerted approach was urgently needed, with distinct roles for the various stakeholders. The relevant country authorities should press ahead with removing burdensome regulatory, tax, and legal impediments to NPL resolution identified in the report; regulators should tighten supervision to eliminate incentives to let NPLs linger; banks should step up their collective effort to speed up NPL resolution; and avenues for out-of-court debt restructuring and corporate rehabilitation negotiations between debtors and creditors should be explored (Vienna Initiative Working Group on NPLs in CESEE, 2012).⁶

ECA countries embarked on much-needed reforms to strengthen the enabling environment for resolving large volumes of NPLs. With various degrees of success and ambition, countries across ECA have undertaken steps to strengthen creditor rights, improve the functioning of the judiciary, establish or strengthen insolvency and collateral enforcement frameworks, set up frameworks for out-of-court workouts for financially distressed but viable borrowers, and fostered the development of markets for portfolios of NPLs. Countries have also taken steps to improve collateral enforcement and to establish a tax environment that is more conducive to NPL resolution, including by facilitating tax deductibility of loan provisions and write-offs and exempting asset sales from VAT.

4 Note that the EBA's implementing technical standards do not set uniform standards for provisioning percentages, treatment of collateral, write-offs, nor for credit grading systems and internal rating systems for performing exposures (D'Hulster et al, 2014). <http://pubdocs.worldbank.org/en/314911450690270267/FinSAC-LoanClassification-Provisioning-Paper.pdf>

5 Together with national supervisory authorities, the ECB regularly carries out comprehensive assessments of banks, that consists of an AQR and a stress test.

6 https://ec.europa.eu/economy_finance/articles/governance/pdf/2012-03-28-ebci-npls_en.pdf

Reform dividends and unresolved challenges

Eventually, these measures, together with an improving economic outlook in the EU and an acceleration in credit growth, helped to set the stage for a gradual reduction in reported NPL ratios. NPL ratios peaked around 2013-2014 in the CESEE and started improving thereafter, as the economic recovery in the EU lifted economic activity in local economies and against the backdrop of a gradual recovery in credit growth. The picture in Eastern Europe and the South Caucasus is more diffuse. Some countries escaped the worst of the GFC but experienced rising NPL ratios later due to domestic factors, including losses from hitherto disguised related party lending (e.g. Moldova and Ukraine) and post-GFC state-sponsored credit booms (e.g. Belarus and Turkey). With the notable exception of Ukraine⁷, reported NPL ratios in most ECA countries were at single digit levels at the end of 2019. In most cases, reported NPL ratios were close to pre-GFC levels, although in a few countries (notably Turkey) NPL ratios were on the increase in the run-up to the pandemic.

Reforms in the enabling legal and taxation environment helped banks to dispose of NPLs through write-offs, and – increasingly – through sales of NPL portfolios. Banks in the CESEE countries have often managed to aggressively reduce the reported NPL ratio through write-offs of fully provisioned problem loans. This was made possible by reforms aimed at removing various obstacles, including onerous legal requirements to fully exhaust collection efforts through the legal system and the absence of tax deductibility for write-offs. In addition to helping reduce the stock of NPLs through write-offs, reforms also promoted the development of NPL markets. These have been most successful

in larger ECA countries, as the development of markets for NPLs requires a sufficient pool of distressed assets to recoup the significant upfront investments to conduct market due-diligence and develop local servicing platforms.

Although most banks significantly reduced their reported NPL ratios, oftentimes borrowers were left trapped in debt. Write-offs and sales allowed banks to reduce their reported NPL ratios but did not necessarily imply debt forgiveness. Consequently, borrowers were often left with an unaffordable debt burden. The absence of efforts to work out such exposures, including a reduction of debts consistent with the borrower's debt-shouldering capacity and a rearrangement of repayment obligations matched with future cash flows, deprived the affected borrowers of a clear pathway out of a situation of debt overhang.⁸

In addition, there were indications of a disconnect between banks' improving asset quality indicators and the financial condition of particularly large corporate borrowers. The World Bank and the International Finance Corporation (IFC) commissioned several corporate health studies in the region in 2018 and 2019. These highlighted that large corporates (which typically account for the bulk of the outstanding credit stock in the economy in these countries) continued to suffer from high levels of indebtedness and a generally weak financial condition. This outcome needs to be seen against a backdrop of relatively few liquidations of distressed corporates. Financially weak companies were often kept afloat with a combination of low interest rates and questionable loan restructuring practices (including long grace periods and bullet

7 Ukraine experienced a severe banking crisis in 2014 – 2016 when more than half of the country's 180 banks had their license revoked. The aftermath of a cumulative 16 percent real GDP decline in 2014-2015, lingering security tensions, and downward pressure on the national currency continued to drive up the NPL ratio, which reached 55 percent of gross loans at the end of 2017. The crisis exposed the fundamental flaws in the Ukrainian banking sector, including non-transparent ownership structures, oligarchic banking (focusing on channeling resources to insiders), a high level of disguised problem loans, ineffective corporate governance arrangements, and distorted financial statements. Thanks to concerted government action and support from international financial institutions, there have since been moderate improvements.

8 Note that investors that have acquired portfolios of NPLs subsequently significantly step up collection efforts.

payments). In addition, despite frequent rounds of loan restructuring, operational restructuring aimed to restore the commercial viability of distressed but potentially viable borrowers was far less common. The sharp economic slowdown in the aftermath of COVID-19 can thus be expected to bring these unresolved problems to the fore again.

Lessons from the GFC for COVID-19

In conclusion, experiences in the ECA region following the GFC have highlighted the complexity of the NPL resolution agenda, and the importance of a quick and comprehensive policy response. The experiences of CESEE countries illustrate how a delay in the initial policy response can allow underlying problems to fester, undermining the capacity of the banking sector to fulfill its basic function of financing the real economy. Consequently, NPLs in the CESEE continued trending upwards in the five years following the GFC, only to come down slowly afterwards. Failure to address rising NPLs head-on can leave economies trapped in a persistent bad equilibrium of low growth and lackluster financial sector performance.

Avoiding a repetition of the post-GFC scenario should thus be a top priority for policymakers in the region. Economic downturns generally show up in NPL ratios with a lag. With various unprecedented borrower support and regulatory relief measures in place (that are discussed in detail in chapter 3), the pressures on banks' asset quality are not yet visible in reported NPL ratios, which by and large have remained stable. Nonetheless, banks and prudential supervisors across the world are anticipating an inevitable increase in credit risk and rising NPL volumes.⁹ It is critical that bankers and policymakers respond to the challenges early on, and proactively, to contain financial stability risks,

enable banks to fulfill their basic intermediary function, and to avoid that the economic recovery from the pandemic is jeopardized by a dysfunctional financial sector that is mired in problem debt.

This requires the alignment of three sets of policies (further elaborated in the sections that follow). First, it requires a robust regulatory and supervisory framework so that banks properly identify NPLs and provision for credit losses, which is the starting point for any NPL resolution strategy. Absent a robust regulatory and supervisory framework, banks' reported asset quality and financial strength indicators risk becoming disconnected from economic realities, obscuring policymakers' efforts in gauging the magnitude of the problem and hindering a timely policy response. Second, banks need to get operationally ready for resolving rising volumes of bad loans. This requires fully functional workout units, endowed with the necessary human and financial resources. Banks will also need to develop internal policies for the management and resolution of NPLs, and methodologies for comparing expected recoveries under various resolution scenarios and for assessing distressed borrowers' viability. The latter is vital for ensuring a resolute handling of borrowers considered non-viable and for avoiding low-quality, extend-and-pretend loan restructurings that merely delay recognition of the inevitable credit losses. Lastly, experiences in the region have highlighted the critical role of insolvency frameworks and credit rights for NPL resolution. Weaknesses in these areas can translate into unpredictable and low recoveries, inadvertently incentivizing banks towards low-quality loan restructurings and causing unnecessary economic losses by steering distressed but potentially viable borrowers towards liquidation. In the decade following the GFC, most ECA countries embarked on comprehensive reforms. The prospect of rising NPL volumes will put these overhauled legal systems, and the institutions that support them, to the test.

⁹ As an illustration, the EBA (2020) mentions that the combined effect of an economic downturn and a second wave could lead to a sudden and significant increase in the level of NPLs in the future.

3. RECOGNIZING PROBLEM ASSETS: REGULATORY AND SUPERVISORY CONTEXT

The availability of reliable, up-to-date, and economically meaningful data about individual banks' exposure to problem assets is a necessary first step towards NPL resolution.

Policymakers need this information to understand the magnitude of the problem, and to be able to articulate a well-informed NPL resolution strategy. This information is also required to ascertain whether banks are provisioning appropriately for credit losses, to evaluate banks' true financial condition, and to undertake appropriate supervisory action vis-à-vis banks with a high or increasing NPL exposure.

Weaknesses in regulatory definitions and a lack of effective supervisory enforcement can lead to situations where reported NPL ratios drift away from economic realities. With a significant mass of uncaptured credit risk, banks' provisions for credit losses fall short of what is needed given their true exposure to problem assets. The resulting provisioning gap inflates banks' capital, obfuscating their true financial position and impeding the timely identification and remediation of problem banks. Following the GFC, many CESEE countries have taken encouraging steps to address this by adopting best-practice regulatory definitions, strengthening supervision, and – in some cases – asset quality reviews (AQRs) to bring much-needed transparency of banks' exposures to bad assets. Outside the CESEE, progress is uneven, with some countries (particularly in Central Asia) yet to establish the basics of proper credit risk supervision. Going forward, it is critical that past gains be preserved in the face of political

and industry pressures to dilute regulatory definitions and soften supervision that may increase as the pandemic's impact on banks' balance sheets becomes apparent.

This section focuses on the regulatory and supervisory context relevant for the timely identification of NPLs. It discusses international initiatives towards greater harmonization of regulatory definitions, and their implementation in ECA countries. This section also explores the regulatory, supervisory, and accounting treatment of the moratoria and other borrower relief measures introduced across the ECA region in the early stages of the COVID-19 pandemic. Lastly, this section discusses priorities for regulatory and supervisory policy in the near to medium term.

Regulatory definitions – NPLs and forbearance

The use of internationally agreed definitions of non-performing and forborne exposures is critical for monitoring and assessing banks' asset quality in a consistent and rigorous manner. The GFC exposed a striking heterogeneity in terms of regulatory definitions of key concepts with significant differences as to how banks and jurisdictions recognize and report asset quality. The outcomes of a FinSAC study in 2014 were fully consistent with this observation. The study documented important differences within a group of 24 surveyed ECA countries with respect to the criteria for recognizing

problem assets (D'Hulster et al, 2014).¹⁰ The absence of an international standard for categorizing problem loans impeded meaningful cross-country comparisons of asset quality, increased opacity and uncertainty at the height of the crisis, and hindered investors' efforts to assess banks' performance and risk. To address this situation, the EBA issued harmonized regulatory definitions for the EU in 2014¹¹, followed by the Basel Committee on Banking Supervision (BCBS) in 2017.¹² Although many of the criteria embedded in the harmonized regulatory definitions were already in use, their adoption helped to promote greater consistency across jurisdictions. The EBA standards have motivated policy-makers in CESEE countries to revise regulations on loan classification and provisioning and adopt the harmonized definitions.

The harmonization of regulatory definitions comprises the introduction of a uniform set of quantitative and qualitative criteria. At the core of the harmonized definition for NPLs is the hard quantitative 90 days past-due (dpd) backstop, and a qualitative "unlikeliness to pay" (UTP) criterion where there is evidence that full repayment of principal and interest is unlikely without resorting to collateral, regardless of whether a loan is in arrears. Banks are expected to establish and implement UTP indicators throughout the banking group, and continuously assess the creditworthiness of borrowers, including their repayment capacity. In addition, a so-called "pulling effect" applies to borrowers with multiple loans. If a bank has a significant exposure¹³

to a borrower that is non-performing, then all exposures (on- and off-balance sheet) should also be considered non-performing regardless of actual repayment status. Lastly, the EBA and the BCBS also recommended that regulators and supervisors consider a broader range of problem assets than loans only.¹⁴

Collateral is not considered when assessing whether an exposure is non-performing. The sole factors determining whether an exposure is non-performing are the presence of arrears and evidence of UTP. Although the availability of collateral affects the amount that banks need to provision, it does not influence the assessment whether a loan is non-performing. This marks an important break from the past. Until recently, many jurisdictions allowed banks to delay the classification of collateralized exposures as non-performing. Under the new standard such exposures are to be classified as non-performing, even if the estimated value of collateral significantly exceeds the loan amount outstanding.

Another key definition in managing problem assets is forbearance. Forbearance takes place when banks grant their clients concessions in situations where the debtor is already facing repayment difficulties, or preemptively to loans still considered to be "performing" but for which repayment difficulties are anticipated. According to the BCBS guidelines, forbearance is "a concession granted to a counterparty for reasons of financial difficulty

10 <http://documents1.worldbank.org/curated/en/721281468249702176/pdf/928310WP0P143704Box385375B00PUBLIC0.pdf>

11 The standards were issued in 2013 and endorsed by the European Commission and published in 2014. <https://eba.europa.eu/sites/default/documents/files/documents/10180/449824/a55b9933-be43-4cae-b872-9184c90135b9/EBA-ITS-2013-03%20Final%20draft%20ITS%20on%20Forbearance%20and%20Non-performing%20exposures.pdf>

12 BCBS Guidelines - Prudential treatment of problem assets - definitions of non-performing exposures and forbearance <https://www.bis.org/bcbs/publ/d403.htm>

13 In the case of the EBA, the criterion is exceeding 20 percent of the gross carrying amount of all on balance sheet exposures to that borrower

14 The EBA and BCBS have advocated the use of the term Non-Performing Exposures (NPEs) that covers a broader range of problem assets than the term "NPLs". NPEs comprise NPLs, as well as non-performing debt securities and other amounts due (including interest and fees) as well as select off-balance sheet items (such as loan commitments and financial guarantees). In addition, the term Non-Performing Assets is used to include foreclosed assets.

that would not be otherwise considered by the lender". The EBA technical standard, in similar fashion, states that "forbearance measures consist of concessions towards a debtor that is experiencing or about to experience difficulties in meeting its financial commitments".

In granting forbearance, banks can take several types of measures. Concessions encompass a wide range of measures, including extending maturities, changes in the schedule of payments, granting of grace periods, changes in interest rates, and any other modifications made on the structure of the loan(s) in order to relieve pressure on the borrower, with the expectation that such concessions will result in full repayment of the new loan(s). Forbearance can also include consolidating all exposures from a borrower in a single suitable schedule, granting additional loans, releasing/lowering collateral, forgiving, deferring, or postponing principal, interest, and fees, as well as converting debt to equity, among others. In practice, concessions do not necessarily result in a reduction of the amount owed (lower net present value - NPV) although in practice they often do. While the term forbearance is commonly used by regulators and supervisors, banks usually refer to these concessions as loan restructuring.¹⁵

Forbearance should not be used to merely postpone the recognition of inevitable losses. Selectivity is a first principle for sound forbearance. As explained in more detail in the next section, forbearance should only be considered for borrowers that are cooperative and that are distressed but potentially viable, and provided that banks assess forbearance will result in lower losses than collateral enforcement, portfolio sales, or legal measures. This highlights the importance of a proper viability

assessment aimed at filtering out borrowers that should not be considered for forbearance measures. These borrowers should be steered towards an orderly exit through collateral enforcement or legal measures instead. A second good practice in forbearance is to undertake a rigorous assessment that the borrower will be able to meet the revised payment schedule (i.e. taking into consideration the concessions that have been granted). To minimize the risk of the occurrence of new arrears, the bank needs to thoroughly understand the borrower's financial position, matching the revised repayment schedule with the borrower's expected cash flows.

Loans that have benefitted from forbearance measures need to rebuild a solid repayment track record before they cease to be identified as forborne. It is considered good practice that banks provide up-to-date information about forborne exposures as part of their reporting requirements. Banks are expected to conduct a detailed assessment and continue monitoring borrowers who were granted forbearance. Loans benefitting from forbearance measures need to rebuild a solid track record before banks can cease to classify them as forborne. In case the loan was non-performing prior to the granting of forbearance measures, a solid track record needs to be rebuilt to permit reclassification as performing. The probation regime consists of a minimum number of months of timely payment of principal and interest¹⁶ (12 months for the BCBS and 24 for the EBA), the absence of other impaired or defaulted exposures, as well as the existence of no concerns regarding the borrower's ability to pay the forborne loan in full.

¹⁵ Therefore, in section 4, which discusses the various manners in which banks can dispose of NPLs, the term loan restructuring is used instead.

¹⁶ The EBA requires that payments of more than an insignificant aggregate amount of principle and interest have been made during at least half of the probation period.

Accounting standards

ECA countries have also been taking steps to introduce a more forward-looking approach towards provisioning for credit losses. The adoption of International Financial Reporting Standards (IFRS) 9 by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) marked a transition from accounting losses based on incurred losses to expected credit losses (ECL), hence promoting an earlier recognition of credit losses. The new standard came into force in 2018, and financial sector regulators in ECA have been taking steps to ensure its implementation by banks.

IFRS 9 introduces new classification and measurement requirements. Assets are classified based on (i) how the bank manages the financial assets in order to generate cash flows (with three possible categories: hold to collect, hold to collect and sell, and other) and (ii) the contractual cash flow characteristics. The latter require banks to monitor the change in credit risk over the life of their loans and compare this to the credit risk at initial recognition to determine the amount of provisions recognized. The loss allowance for those exposures whose credit risk has not increased significantly – “stage 1” or “performing” exposures – is based on 12 months ECL. The allowance for those exposures that have suffered a significant increase in credit risk (SICR) – “stage 2” or “underperforming” and “stage 3” or “impaired” exposures – is based on lifetime ECL. The shift towards forward-looking assessments of credit risk over the life cycle of a loan can result in potentially significant increases in provisions, while the requirement that banks already make some provisions for performing loans can help in weathering credit shocks.

The introduction of an intermediate category of underperforming stage 2 loans has several

advantages. The category underperforming exposures (i.e. stage 2) did not exist previously. Its introduction helps to address banks’ inclination to classify exposures that have suffered a SICR but that are not yet impaired as performing (which is the likely outcome in an accounting framework that only distinguishes between performing and impaired exposures). Similarly, its introduction helps to smooth provisioning.¹⁷

The implementation of IFRS 9 has presented ECA region financial sector regulators with considerable challenges. Although the importance of an early recognition of credit losses is widely recognized among financial sector regulators in ECA, countries have needed to make significant enhancements in supervisory processes, procedures, and – on occasion – risk management to pave the way for a proper implementation. Particular challenges have emerged around the models and analytical tools that banks have introduced for the assessment of credit risks. The complexity of these models makes it very challenging for banking supervisors to effectively scrutinize banks’ estimates and scenarios, also because the necessary quantitative skills are often in short supply. The underlying concern is the so-called model risk, associated with excessive reliance on models that (except for a few highly specialized insiders) are not fully understood. Consequently, regulators have understandable concerns that model estimates for credit risk and provisions may not fully reflect economic realities, and that they lack the capacity to challenge banks. They may also have concerns regarding banks’ capacity to run these models, which can be particularly challenging for smaller banks. In a bid to enhance efficiency, euro area banks have often sought to extend the use of models developed at the parent bank level to subsidiaries in ECA client countries.

¹⁷ The specific coverage of a portfolio depends on a number of considerations, such as the existence of collateral and collateralization levels, the interest rates in the market, the collateral enforcement framework, among others.

Banking regulators in ECA have therefore often maintained regulatory provisioning requirements in parallel to IFRS 9 accounting requirements. While the accounting framework is the main determinant of a bank's provisioning needs, the loan loss provisions recognized by banks for their problem loans may not always be adequate from a prudential perspective, which has a different scope, objective, and purpose. By setting a lower boundary for the amount of provisioning (as stipulated in prudential regulations), prudential backstops serve to prevent the occurrence of accounting underprovisioning and inflated capital adequacy ratios.

To mitigate the impact of IFRS 9 on capital ratios, the BCBS (2017)¹⁸ has allowed jurisdictions to adopt transitional arrangements aimed at avoiding a “capital shock”. Transitional arrangements should apply only to “new” provisions arising due to a move to ECL approaches. The transitional arrangements can extend up to 5 years, as is the case in the EU. During the transition phase, “new” provisions recognized as a result of IFRS 9 adoption are partly added back to capital. ECA countries have often used transitional arrangements.

The impact of COVID-19-related borrower relief measures on asset classification, forbearance, and provisioning

The economic impact of the pandemic motivated policymakers around the world to issue exceptional measures to provide relief to distressed borrowers. There are important differences in the scope and general design of these measures, but the common denominator is that they introduce temporary concessions to the contractual terms of borrowers' repayment obligations on loans owed to banks. In this way, and in marked

contrast to the GFC which originated from within the financial system, banks are expected to be able to provide a positive contribution to the mitigation of the economic fallout from COVID-19.

Policymakers in the EU and in ECA countries were quick to introduce various types of exceptional borrower relief measures.¹⁹ Authorities had little time and information available to prepare detailed and targeted response measures and thus broad-based measures were introduced, including blanket moratoria on debt payments (as well as on foreclosures, rental evictions, and insolvency). Policymakers in the ECA region have so far primarily introduced temporary payment moratoria, providing debtors an option to defer debt service payments. These schemes have been introduced in the majority of ECA countries. Within the subgroup of CESEE countries, Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Hungary, Kosovo, Poland, Romania, Serbia, and Slovakia have introduced temporary payment moratoria, albeit with important variations in terms of overall design and coercion mechanism vis-à-vis banks.²⁰ Moratoria of various kinds have also been introduced in the three South Caucasus countries (Armenia, Azerbaijan, and Georgia); Central Asia (Kazakhstan, Kyrgyz Republic, Tajikistan, and Uzbekistan), Russia, and Turkey. Some jurisdictions also introduced so-called enforcement moratoria, i.e. a temporary legal provision prohibiting creditors from enforcing collateral when the debtor has defaulted as a result of the crisis.²¹ Financial sector regulators have often provided general guidance regarding the broad parameters of payment moratoria, while leaving the ultimate responsibility for borrower selection and relief measures offered to banks.²² As an illustration, table 3.1 highlights the key design features of the borrower relief measures introduced in a selection of ECA countries as of October 2020.

18 <https://www.bis.org/bcbs/publ/d401.pdf>

19 The focus in this section is on payment moratoria. Enforcement moratoria are discussed in more detail in Section 5.

20 Belarus and Ukraine called upon banks to offer payment holidays to their customers but did not introduce moratoria, while the moratorium in Moldova was in place for a very short period of time.

21 See also Alonso Gispert et al (2020) for a cross-country overview of regulatory and supervisory responses to the pandemic. <https://datacatalog.worldbank.org/dataset/covid-19-finance-sector-related-policy-responses>

22 These arrangements have been characterized as “non-legislative moratoria”. By contrast, under “legislative moratoria” banks have a legal obligation to execute government orders, with detailed instructions as to who qualifies and what type of relief is to be offered prescribed in law.

Table 3.1 Borrower relief measures in selected ECA countries (as of November 2020)

	Albania	Bosnia	Kosovo	Montenegro
Applicable moratoria regimes	12/3/2020 (First measures) 28/5/2020 (Extended until end-August).	20/3/2020 (6 months) (First moratorium) 28/8/2020 (Second moratorium valid for six months).	16/3/2020-4/3/2020 (General moratoria) 8/6/2020 (First application). Second set of measures: loan restructuring until August 2021.	23/3/2020 (First moratorium) 19/5/2020 (Second moratorium ; repayment moratorium up to 90 days).
Legal obligation	No: bank-driven.	No: bank-driven.	First moratorium - Yes: customers' right. Second moratorium - No: bank-driven.	First moratorium – Yes: customers' right. Second moratorium – No: bank-driven.
Institutional scope	Banks, non-banks, and savings and loan association.	Banks.	Banks and financial institutions licensed to lending activities.	Banks, leasing companies, and micro-credit institutions.
Eligibility criteria	Individuals and legal entities negatively affected by the pandemic.	Individuals and legal entities whose creditworthiness has been affected by the pandemic. Loans with arrears > 90 dpd are excluded.	Broadly defined; Customers (individuals or legal entities) affected by the COVID-19 pandemic. Banks define eligibility.	No targeting in the first moratorium. Second moratorium: only customers whose loans are not 90 dpd/UTP or that have been restructured in 2020.
Relief offered by the moratorium	March-May 3 months moratorium (first moratorium) June-August additional 3 months (second moratorium).	Moratorium and other special measures, such as: - Grace periods - Maturity extension - Approval of additional loans - Other measures	Restructuring measures, broadly defined in the Decision, such as: - Grace periods. - Maturity extension. - Approval of additional loans. - Other measures.	3 months moratorium of all due payments of the loan (first moratorium). 3 months moratorium of all due payments of the loan + potential broader restructuring measures (second moratorium).
Uptake by legal entities	As of June 2020, 47.2%.	FBiH first moratorium 24.3%. RS 32.5% (end June 2020).	As of May 2020, 73.5%.	First moratorium (end May 2020) 49.86%.
Uptake by individuals	As of June 2020, 19.2%.	FBiH first moratorium 10%. RS 3.6% (end June 2020).	As of May 2020, 45.7%.	First moratorium (end May 2020) 56.6%.
Prudential treatment	Exemption from classification and provisioning rules while special regime is in force; the treatment for forborne loans is suspended until January 2022; loans restructured by end-2020 will not need to be reclassified. Provisioning foreclosed real estate suspended until December 2020.	Loans subject to the special measures regime: - Retain the same classification category. - There is a "freeze" on dpd from entry into moratorium. - Loans subject to moratorium are not considered "forborne loans", except stage 3 loans due to UTP criterion.	"Freeze" on dpd for restructured loans. Banks continue to be required to apply the UTP criterion to assess carefully the expected loan losses according to IFRS 9, considering guidance from the IFRS Foundation.	The bank will not reclassify the loans subject to moratorium to a worse accounting category (first & second moratorium). Second moratorium allows banks to classify eligible restructurings as new loans rather than forborne loans.

Table 3.1 continues

	North Macedonia	Serbia	Turkey
Applicable moratoria regimes	26/3/2020 (First moratorium). 1/9/2020 (Second moratorium), deferrals until end-March 2021.	17/3/2020 (First moratorium) 8/7/2020 (Second moratorium) until end-September 2020).	17/3/2020- (First moratorium) followed by ad-hoc suspension for specific banks in Q4.
Legal obligation	No: bank-driven.	Yes: customers' right (first and second moratoria).	First moratorium – Yes: customers' right. Ad-hoc suspension – bank-driven.
Institutional scope	Banks and saving houses.	Banks and leasing companies.	Banks.
Eligibility criteria	All individuals and legal entities.	No targeting. All individuals and legal entities (natural persons, farmers, entrepreneurs, and corporates).	Broadly defined; customers (individuals or legal entities) affected by the COVID-19 pandemic
Relief offered by the moratorium	<ul style="list-style-type: none"> - Maturity extensions. - Prolonging of loan repayment for an extended period. - Lower interest rate. - New facility to refinance an existing loan. 	Duration of loan holiday tied to emergency situation (first moratorium). Suspension for three months thereafter.	Suspension of payments of principal, interest, and installments with the same terms and conditions until 30/6/2020. Recent ad-hoc suspensions charges suspension interest rate.
Uptake by legal entities	As of June 2020, 34%.	84% (first moratorium) 91% (second moratorium).	No data
Uptake by individuals	As of June 2020, 57.2%.	69% (first moratorium) 82% (second moratorium).	No data
Prudential treatment	90 dpd criterion temporarily relaxed to 150 dpd (until end-September 2020). Restructured performing loans (until end-September 2020) not considered as forborne loans.	Loans that benefitted from moratorium which were not 90 dpd in March are not considered non-performing nor forborne.	Revised NPL definition in place until year-end (180 dpd instead of 90 dpd). The minimum number of dpd for monitoring loans under the stage 2 category was increased from 30 to 90 dpd. A previous requirement that restructured loans on which new arrears occur are automatically considered an NPL was lifted.

Proper design of these measures is critical to protect the public interest in safe and sound banking systems and financial stability at large.

Dijkman and Salomao Garcia (2020)²³ propose a set of high-level principles for the design of borrower relief measures. As a starting point, policymakers should have a thorough understanding of the financial impact on banks of any borrower relief measures. Policymakers also need to beware of moral hazard associated with borrowers who are financially capable but unwilling to pay, so-called zombie borrowers whose difficulties predated COVID-19. These problems can be addressed to a significant degree through targeting, ensuring that borrower relief measures benefit borrowers whose repayment capacity has demonstrably deteriorated due to COVID-19. In addition, it is important that policymakers ensure that the temporary nature of borrower relief measures is universally understood and that they start thinking early on about exit strategies. It is also critical that measures are undertaken in a transparent manner. Banks should be expected to produce reliable, frequent, up-to-date, and comparable information regarding loans that have benefitted from borrower relief measures. Lastly, the temptation to avoid a surge in NPLs and provisioning charges by easing regulatory definitions, even on a temporary basis, should be resisted. The easing of regulatory definitions and classification and provisioning requirements obfuscates banks' true asset quality challenges, undermines comparability within and across countries, and blurs the distinction between borrowers negatively affected by COVID-19 and zombie borrowers.

a) Guidance from international standard-setting bodies

A concerted effort has been undertaken to provide guidance to policymakers on the implications of borrower relief measures for loan-loss classification, provisioning, and accounting.

The starting point of BCBS²⁴ and EBA²⁵ guidance is that policymakers should use the flexibility embedded in existing frameworks. The notion of using existing flexibility in regulatory and supervisory frameworks while preserving consistency with international standards also features prominently in a joint IMF-World Bank Staff Position Note with high-level recommendations to guide regulatory and supervisory responses to the pandemic.²⁶ With respect to the prudential treatment of moratoria and other temporary borrower relief measures, the BCBS and the EBA recommend that the assessment of payment delays be based on a modified schedule of payments, i.e. taking into consideration the rearranged debt obligations after factoring in the specific borrower relief measures. Consequently, while a moratorium is in place (and debt obligations are suspended), the number of dpd on a loan effectively freezes.

Similarly, banks' assessments of the UTP criterion should be based on their assessment of whether the borrower is unlikely to repay the deferred payments. There is thus no requirement that loans that are subject to a payment moratorium adopted as a response to the pandemic be necessarily classified on account of the UTP criterion. What is important, however, is that banks are still required to apply the UTP criterion to borrowers

23 <http://pubdocs.worldbank.org/en/993701588092073659/Borrower-Relief-Measures-Note-for-ECA.pdf>

24 <https://www.bis.org/bcbs/publ/d498.pdf>

25 https://eba.europa.eu/sites/default/documents/files/document_library/Publications/Guidelines/2020/Guidelines%20on%20legislative%20and%20non-legislative%20moratoria%20on%20loan%20repayments%20applied%20in%20the%20light%20of%20the%20COVID-19%20crisis/EBA-GL-2020-02%20Guidelines%20on%20payment%20moratoria.pdf

26 <https://www.imf.org/en/Publications/Miscellaneous-Publication-Other/Issues/2020/05/20/COVID-19-The-Regulatory-and-Supervisory-Implications-for-the-Banking-Sector-49452>

whose short-term payment challenges are likely to transpose into long-term financial difficulties. Loans can only remain in the same classification category if banks are satisfied that borrowers' payment difficulties are temporary and can be addressed through a deferral of payments provided by the relief measures. Banks are thus required to continuously assess borrowers' repayment capacity, and promptly identify exposures that are considered UTP. Whenever an exposure is assessed to be UTP, it should be classified and provisioned accordingly.

International standard-setters have also stated that loans benefitting from payment moratoria should not automatically be considered as forborne, provided that the moratorium meets certain requirements. The underlying rationale not to consider loans subject to moratoria as forborne exposures is that under the current circumstances borrower relief measures are designed to address risks at a systemwide level. Relief measures have been provided across the board, as opposed to concessions that are tailored to the particular circumstances of an individual borrower. In this vein, the EBA makes a distinction between general payment moratoria and individual loan restructuring, i.e. where banks do not apply any general payment moratoria as specified in EBA guidelines, but instead apply some form of individual measures and renegotiate the loans taking into account the specific situation of individual obligors. The EBA has issued a set of requirements, stipulating the conditions that moratoria need to meet for loans not to be considered as forborne. It requires that moratoria were introduced because of the COVID-19 pandemic and were announced and applied prior to September 30, 2020; that they are applied by the vast majority of banks (in case of non-legislative moratoria); and that they apply to a broad range of borrowers. Furthermore, the EBA requires that

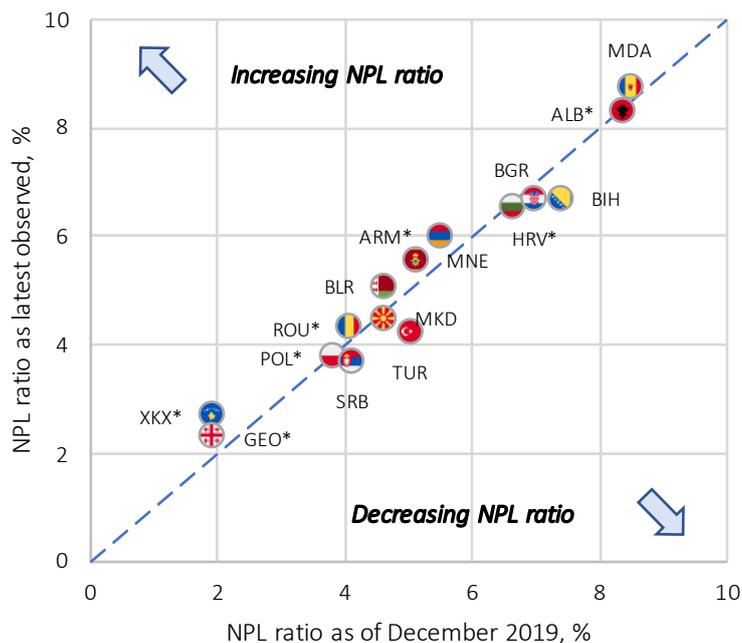
the moratorium only changes the schedule of payments (i.e. it only defers debt service obligations with no or negligible impact in NPV terms) and does not apply to new loans.

In terms of accounting, a payment moratorium in and by itself is not a trigger of default nor does it automatically imply a significant increase in credit risk. Standard setting bodies and regulators have reiterated the importance of a flexible, non-mechanical approach in applying ECL. Early on, the EBA stated that participation in moratoria or other types of borrower relief schemes should not automatically be considered as default.

Recent experiences have highlighted the difficulties of reconciling a forward-looking approach towards credit loss recognition with the need to preserve bank capital, needed for financing the recovery. Banks need to recalibrate their credit risk parameters to reassess their expected losses reflecting the current (and highly uncertain) economic outlook. Besides the need to reclassify a potentially significant share of banks' loan books from performing to underperforming, or even non-performing, much of the increase in ECLs is to reflect the deteriorating outlook for performing stage 1 exposures. In fact, EU banks' reports for the first half of 2020 already point to a significant increase in ECLs (KPMG, 2020).²⁷ Moreover, banks may need to recalibrate their credit risk parameters to reassess their expected losses according to the new economic expectations. Both may trigger a surge in loan loss provisions, resulting in sizable bank losses and capital depletion, that would undermine their capacity to support the economic recovery with credit. This highlights the potential tension between the need for pragmatism (to avoid a significant tightening in credit conditions) while upholding the spirit of

27 <https://home.kpmg/xx/en/home/insights/2020/08/ifrs-blog-european-banks-h1-covid-disclosures-ifrs9.html>

Graph 3.1: Recent developments in NPL ratios



Notes: 1) The vertical axis represents levels of NPL ratio as observed on November 19, 2020. The data points generally reflect values of June 2020, except those marked with *: Albania, Armenia, Georgia and Kosovo - September 2020; Romania and Ukraine - August 2020; Croatia and Poland - March 2020. 2) The NPL ratio of Ukraine was 48.36% as of December 2019, and 48.05% as of August 2020.

Source: IMF Financial Soundness Indicators, supplemented with statistics from national authorities.

IFRS 9 accounting requirements, which is predicated on a more forward-looking approach towards recognizing and provisioning for credit losses. This tension is yet to be resolved. The ECB recommended that banks should avoid procyclical assumptions in their models and opt for IFRS 9 transitional rules. The IFRS Foundation acknowledged the difficulty in incorporating the effects of COVID-19 into estimates on a “reasonable and supportable basis”, but changes in economic conditions should be reflected in macroeconomic scenarios used in those estimates. Lastly, the ECB also indicated that the reassessments of lifetime expected credit losses can be undertaken at the portfolio level, without the need to identify which individual financial instruments have suffered a SICR.

b) Practices in ECA countries

Although the borrower relief measures rolled out in the early stages of the pandemic were conceived as short-term, frequent extensions illustrate the scale of the economic disruption.

Most countries included explicit sunset clauses,

with closing dates for the measures ranging from a few weeks to several months from the moment of introduction. The general pattern, however, is that measures have been rolled over as the pandemic accelerated in many ECA countries after the summer months, hopes for a quick and vigorous economic recovery faded, and borrowers across the board continued to face disruptions in their income flows.

Most ECA countries have aimed to reconcile borrower relief measures with international standards on classification, provisioning, and accounting by using the flexibility embedded in existing frameworks. With the exception of North Macedonia and Turkey²⁸, countries in the region that had made a previous effort to align key regulatory definitions with applicable EBA and BCBS guidance left these definitions intact, including the hard 90 dpd backstop for classifying exposures as non-performing. However, as is the case in most EU countries (EBA, 2020)²⁹, the pattern in most countries in ECA region is that NPL ratios have so far hardly increased (graph 3.1).

²⁸ North Macedonia issued an amendment to the regulation on credit risk management wherein the 90 dpd criterion was relaxed to 150 dpd, while Turkey introduced a temporary 180 dpd criterion. North Macedonia reverted back to the 90 dpd backstop as of October, while the 180 dpd is in place in Turkey until the end of 2020.

²⁹ <https://eba.europa.eu/eba-saw-npl-ratios-remained-stable-q2-2020-although-early-signals-asset-quality-deterioration-banks%E2%80%99>

Nonetheless, some points of divergence are beginning to emerge. Recent developments have raised questions about the operationalization of the UTP criterion. With moratoria effectively freezing classification on account of dpd and mostly modest credit growth, a stable NPL ratio may suggest that the proportion of loans that has become non-performing on account of UTP is small. This could lead to the emergence of uncaptured credit risk emanating from the potentially sizable contingent of borrowers whose repayment capacity has been permanently eroded. It is possible that the lack of rigor in UTP enforcement is related to a poor operationalization of the UTP criterion prior to the pandemic. In addition, some countries introduced regulatory shortcuts aimed at abolishing or shortening the mandatory cure period before non-performing forborne exposures can be reclassified as performing (e.g. by considering rescheduled loans as new loans). Similarly, fast-tracking the migration of previously non-performing forborne exposures to performing status risks affecting the economic significance of reported asset quality indicators, and may preclude a proper monitoring of forborne exposures.

Supervisory and regulatory priorities in times of COVID-19

COVID-19 presents policymakers with a set of unprecedented challenges for supervisory and regulatory policies. Regulators have been balancing the need to preserve banks' capital for the recovery on the one hand with the public interest in safe and sound banks and with financial stability on the other. Going forward, tensions between these two competing needs may become more apparent as the impact of COVID-19 on banks' balance sheets is becoming palpable.

Policymakers will be facing several challenges in the near to medium term. Priorities for regulatory and supervisory policy include: (a) engineering a credible exit from the extraordinary support measures, particularly borrower relief measures; (b) upholding strong regulatory definitions for NPLs and forborne exposures; and (c) ensuring effective enforcement within a likely context of increased stress on banks' asset quality and capital.

a) Exiting from extraordinary borrower relief measures

While originally conceived as a short-term instrument to provide temporary support for liquidity-distressed borrowers, borrower relief measures adopted in ECA countries have been extended. Most ECA countries rolled out borrower relief measures in the second half of March. They have stressed the temporary nature of the measures, but with considerable variation with respect to their duration. By now, most countries have opted to extend the measures (e.g. in Albania, Bosnia, Kosovo, Montenegro, and Serbia).

The tendency towards extending the borrower relief measures needs to be seen against the backdrop of a highly uncertain outlook and considerable political and industry pressures. More than nine months into the pandemic, there is still a high degree of uncertainty regarding its duration and the economic recovery trajectory. With a significant part of the economy operating at below-potential levels, many borrowers continue to struggle to meet their debt-service obligations, translating into significant political pressures to roll over the measures. Concerned about the prospect of moving a sizable share of assets into the non-performing category and the corresponding surge in provisioning charges, banks may also advocate the extension of borrower relief measures.

Nonetheless, the prolongation of borrower relief measures is also associated with costs, some of which will only become visible over time. While the borrower relief measures help to reduce pressures on banks' capital, their extension can be associated with a negative impact on banks' liquidity, as the relief measures translate into a potentially significant reduction on cash flows and overall earnings on banks' loan books. In addition, the extension of measures can feed into borrowers' expectations that moratoria constitute a new normal, impeding a reversal to the status quo pre-COVID-19, and exacerbating moral hazard due to their deleterious effect on credit culture and repayment discipline. Lastly, prolonging the borrower relief measures may also be associated with a misallocation of capital. Zombie borrowers, whose financial difficulties predate COVID-19, will exert considerable pressure to benefit from the borrower relief measures. This can effectively lock up the credit stock in underperforming economic sectors and crowd out the financing needs of more dynamic borrowers.

These issues illustrate both the necessity and the complexity of engineering an orderly exit from the extraordinary borrower relief measures. While the questions of when and how to phase out the measures do not have a simple answer, the general principle should be to unwind them as soon as circumstances permit. It is imperative that policymakers start to develop a consensus view on the conditions in which the exceptional measures can be unwound (e.g., a clear indication that the pandemic is under control, suspension of emergency measures to stop the spread of the disease, or a sustained period of positive economic growth) and clearly and publicly communicate this.

Recent events in the EU have highlighted the difficulties of exit planning in a highly uncertain environment, with changes in the outlook necessitating policy reversals. The EBA initially opted to phase out measures at the scheduled expiry date of September 30, 2020. After the expiry date, banks could still offer payment holidays to their clients, but these loans should be classified according to the standard prudential framework, rather than according to the more favorable conditions of the EBA's April Guidelines on Legislative and Non-legislative Moratoria. Depending on the duration of the payment extensions, which in the EU has been on average between 6 and 12 months, payment moratoria would continue producing their effects for a while. The regulatory treatment set out in the EBA's Guidelines would thus continue to apply to all payment holidays granted under eligible payment moratoria prior to 30 September 2020, thus mitigating cliff effects from a sudden reclassification of existing loans. Following the acceleration of the second wave of the pandemic and the reintroduction of emergency measures across the EU, the EBA reintroduced its Guidelines on Legislative and Non-Legislative Moratoria in early December with minor enhancements. The revised Guidelines, which will be in effect until March 2021, specify that loans can benefit from the application of the Guidelines for a cumulative maximum of nine months. In addition, banks will be required to document to their supervisor their plans for confirming that loans subject to payment moratoria do not become UTP.³⁰

Instead of phasing out borrower relief measures altogether when reaching the closing date, measures can also be wound down in a more gradual manner. As explained, most ECA countries have opted to extend borrower relief measures upon reaching the closing date. This "reset moment" does however provide a window of

30 <https://eba.europa.eu/eba-reactivates-its-guidelines-legislative-and-non-legislative-moratoria>

opportunity to strengthen the overall design of the measures, as has been the experience in, for instance, Kosovo and Montenegro.³¹ Considering that the initial relief measures were conceived under considerable time pressure, which often precluded a thorough and comprehensive assessment of their impact, it is important that this opportunity is not lost. It also allows policymakers to gradually narrow down the scope of borrowers eligible for relief. As part of a transition towards more targeted regimes, policymakers can usefully introduce more stringent requirements regarding the financial viability of the borrowers that are benefitting from the relief measures. As a minimum, they can require that borrowers benefitting from borrower relief measures need to have a sufficiently strong payment track record pre-COVID-19, in order to rule out zombie borrowers.³² Going a step further, they may introduce a requirement for corporate borrowers that banks conduct an assessment of the debtor's viability. They may also opt to exclude certain industries that are manifestly facing difficulties that go beyond short-term liquidity needs (e.g. hospitality, transportation), and whose financial difficulties are best addressed with proper long-term loan restructuring measures. Similarly, countries may use the opportunity to replace legislative moratoria with bank-led moratoria, with banks generally in a better position to select eligible borrowers, addressing, for instance, improper use by willful defaulters (who have the financial capacity to repay but choose not to). Lastly, any decision to extend the measures should also be based on an assessment of the functioning of the previous scheme.

Decisions about the extension or phasing out of borrower relief measures need also to consider the financial impact on banks. An extension

implies that banks must forego regular debt service payments on a potentially significant part of their loan portfolio, which may impact their liquidity. At the same time, phasing out the measures will likely lead to an increase in total NPL volumes and provisioning charges, which will affect capital. It is therefore critical that decisions are informed by assessments of the likely financial impact on banks. The expected financial impact needs to be compared with banks' financial shock-absorbing capacity, including available liquidity and capital buffers over and above regulatory minimum standards. Clearly, countries with banking sectors that were already in a weak financial condition prior to COVID-19 face a delicate balancing act and need to take great care to avoid jeopardizing safety and soundness in the banking sector. A decision to phase out borrower relief measures may need to be accompanied by measures to replenish capital of weak banks, to ensure that these banks have enough capital space for a full recognition of credit losses.

b) Upholding strong regulatory definitions for NPLs and forbore exposures

It is hard to overstate the importance of the use of commonly accepted regulatory definitions of NPLs and forbore exposures. The use of regulatory definitions aligned with international practice underpins efforts to ensure that standard metrics of asset quality and capital strength are economically meaningful. As explained, these harmonized regulatory definitions have gained traction in ECA countries in recent years. Although the work is far from finished, the use of these definitions by banks and supervisors is critical for monitoring and assessing banks' asset quality in a consistent manner, both within and across jurisdictions, as well as to

31 Both countries replaced their previous legislative moratorium with bank-led schemes that leave banks considerable agency in terms of borrower selection and relief measures offered. As part of the redesign, Montenegro also discontinued the previous general moratorium, applicable to all borrowers regardless of repayment capacity and pre-COVID-19 repayment behavior.

32 This can be done in a fairly straightforward manner. Several regulators have, for instance, prohibited banks from providing relief measures to borrowers with loans that were already classified as NPLs at the onset of COVID-19.

facilitate timely action to address rising asset quality problems.

It is important that the hard-earned gains are preserved and that pressures to dilute regulatory definitions are resisted. By and large, the 90 dpd hard backstop for classifying exposures as non-performing has been upheld in most countries, with the exception of North Macedonia and Turkey. In a bid to promote restructuring of problem exposures, certain countries in ECA region (e.g. Albania, Montenegro) have relaxed the definition and prudential treatment of forborne exposures. In this manner, the mandatory cure period is effectively abolished, and banks are allowed to roll back any provisions. Evidently, this is problematic if borrowers' debt-servicing capacity fails to improve after restructuring, which is a considerable risk given the indications that banks are not vigorously applying the UTP criterion. The abolishment of the cure period may also inadvertently disincentivize banks from adopting a firm line vis-à-vis unviable borrowers, whose repayment capacity is permanently impaired, by enabling them to engage in extend-and-pretend practices. This can lead to the emergence of uncaptured credit risk, underprovisioning, and overstated capital, obfuscating the comparability of asset quality indicators across banks.

Proper enforcement of the UTP criterion is necessary for proactive identification of likely payment difficulties and to ensure that unviable borrowers are pushed towards an orderly exit.

Absent proper UTP assessments, banks will defer the recognition and provisioning of problematic exposures until actual payment delays occur. As noted, the remarkable stability of the NPL ratio may point to challenges in the operationalization of the UTP criterion that predate the COVID-19 pandemic. Nonetheless, a rigorous application of

the UTP criterion is critical for a proactive identification of non-performing exposures, considering that payment holidays have been offered to borrowers across the board, regardless of long-term repayment capacity. While there is an unusually high degree of uncertainty under the current circumstances, it is incumbent on banks to make continuous efforts to identify those borrowers whose difficulties are likely to transpire into longer term repayment difficulties, in line with the spirit of the UTP criterion.

A proper evaluation of asset quality requires close monitoring and detailed information regarding loans that have benefitted from borrower relief measures. Although supervisory reporting has been streamlined during the pandemic it is essential that banks produce reliable, frequent, detailed, and up to date information on loans that benefit from borrower relief measures and their impact on balance sheets. Going forward, as should be the case for any restructured and rescheduled loans, banks should be required to tag loans that have benefitted from borrower relief measures, perform periodic assessments, and report a set of standard indicators for assessing the credit risk of such loans (e.g., collateral and repayment behavior). Such information would also be useful input for prudential reports, in which banking supervisory agencies may give special attention to the monitoring and analysis of loans that have benefitted from borrower relief measures, also including them in watch lists. Although supervisors should take reasonable steps not to impose unnecessary administrative burdens on banks and take into consideration banks' constraints in terms of management information systems, technology, and human resources, they should also ensure that legitimate banking supervisory information needs are met.

c) **Effective supervisory enforcement in times of increasing stress on banks' asset quality**

Renewed pressures on banks' asset quality will create a more challenging environment for banking supervisors. As pressure on banks' asset quality increases, banks are increasingly incentivized to step up efforts to disguise the true extent of their difficulties. Weak banks face a particular incentive to do so as full recognition of credit losses may cause their capital to fall below regulatory requirements, triggering enhanced regulatory scrutiny, supervisory restrictions (e.g. on the payout of dividends and executive bonuses and launch of new products and business lines), reputational risks, and an adverse impact on the costs and availability of funding and capital. Faced with these incentives, some banks might go to great lengths to exploit regulatory loopholes or engage in questionable practices to present an overly optimistic picture on asset quality, which in turn can make a supervisor's job significantly more difficult.

These challenges may be compounded by pressures on the operational independence of prudential regulators. Such pressures may come in the form of interference aimed to soften enforcement, or to weaken regulation altogether. Industry and political pressures are likely to increase amidst mounting stress on banks' asset quality. Countries that have traditionally relied heavily on state-owned banks for economic management, and where the state not only acts as regulator but also as owner and promoter of a large part of the banking sector, may be particularly vulnerable.

Credit risk will likely top the list of supervisory priorities. Supervisory work programs will likely shift towards thematic examinations and in-depth on-site inspections focused on credit risk. These efforts will be necessary to obtain clarity regarding the true extent of the deterioration of asset quality

and the corresponding credit losses. Supervisors should also press banks on their operational readiness to manage rising volumes of bad assets (see Section 4).

Supervisors will need to be on high alert for extend-and-pretend practices, aimed at evading classification and provisioning requirements.

Faced with rising borrower distress, banks may resort to evergreening to avoid the recognition and provisioning for credit losses in their portfolio. Some of the red flags include preemptive rescheduling of problem loans, i.e. restructuring before loans become past due, often in multiple rounds. In addition, banks may proceed with restructuring measures without a proper assessment of the borrower's viability (see section 4). Another common practice is to restructure loans by deferring all amortizations to a single payment at the end of the maturity ("bullet loans"), often in the expectation that the loan is extended or renewed closer to the maturity date if the borrower is not in a position to make such a payment.

Banks' efforts to delay the recognition of inevitable losses will likely require increasing supervisory attention. Similarly, supervisors should also stand ready to scrutinize banks on the operationalization of the UTP criterion and challenge banks on the quality and depth of debtor affordability assessments that underpin loan restructurings. Although the uncertainty of the current outlook complicates banks' borrower viability assessments, supervisors should require banks to proactively address cases where borrowers are manifestly non-viable and ensure that banks refrain from questionable loan restructuring measures aimed at avoiding recognizing inevitable losses. The latter requires close monitoring by supervisors through a risk-based approach, enhanced off-site monitoring, focused on-site reviews (once resumed), peer analysis, monitoring of relevant sectors, sensibility analysis and,

depending on the circumstances, performing financial analysis of the largest borrowers in the system (i.e. large firms and groups).

Supervisors will also need to watch out for overvalued collateral, which is another frequent cause of underprovisioning for credit losses.

Collateral prices, particularly commercial real estate, are likely to suffer downward pressures. In a bid to reduce provisioning expenses, banks may be incentivized to maintain collateral at inflated prices where they are taken into account for provisioning purposes³³. Supervisors should thus be prepared to ensure that collateral values are kept up-to-date and adjusted as necessary, and to challenge banks on collateral values that appear optimistic. Supervisory scrutiny is critical both from a loan portfolio management perspective and also in cases where collateral enforcement results in repossession by banks. If repossessions become material, supervisors might consider paying particular attention to “other assets” accounts through targeted market-wide reviews as part of supervisory cycles, random sample checks, or through special assessments conducted by external firms (e.g. auditing firms) or reputable valuation companies.

Banks may also attempt to brush up reported asset quality by moving problem assets to affiliated entities, often in a highly untransparent manner to escape supervisory scrutiny. In trying to veil asset deterioration banks might move losses into de facto affiliated but unconsolidated entities, without proper losses recognition. Consolidated and cross border supervision are particularly important in curbing regulatory arbitrage. A full understanding of the group’s business(es) and main shareholders, their economic interests, as well as monitoring of intercompany transactions are important supervisory tools to assess the potential shifting of deteriorated

assets in an attempt to avoid provisioning or increased risk-weights. Considerable efforts may be necessary to see through these practices, following the principle of economic substance over legal form.

Strong supervision is necessary to effectively challenge banks on these practices. Robust regulation and adequate reporting is a necessary but not a sufficient condition for a proper identification of asset quality deterioration. Enforcement of these regulations is critical, even more so in times of deteriorating asset quality. While acknowledging the challenges banks are experiencing, proper enforcement through strong supervision is a top priority. Further down the road, in-depth assessments of banks’ loan portfolios and other assets may become necessary. Supervisors should be mindful of the limitations of prudential returns. Sufficient detailed and periodic information should be requested from banks, as reported asset quality indicators will not always tell the full story. Banks can face incentives to present an optimistic assessment of asset quality, and supervision may not succeed in revealing these flaws all the time. As explained, this can lead to the emergence of a significant amount of uncaptured and underprovisioned credit risk that inflates the capital adequacy ratio, undermining the economic significance of reported asset quality and capital metrics.

AQRs can be a useful tool to bring much-needed transparency regarding the financial position of banks and to strategize the restructuring of banking systems. AQRs are a point in time assessment of the accuracy of the carrying value of banks’ assets. They have been successfully used by various jurisdictions over the years, including some undertaken with the support of the World Bank. AQRs can be particularly helpful when there are lingering doubts about the economic significance of reported

³³ As noted before, inflated collateral values may also stand in the way of subsequent steps towards resolving NPLs, e.g. through sales to a third party or through write-offs, as these steps would expose the overvaluation and would require the bank to acknowledge the losses.

asset quality indicators. In undertaking a line-by-line assessment of banks' assets, AQRs help to obtain a more accurate picture of banks' asset quality, taking stock of classification and provisioning practices and identifying deviations from regulations, guidance, and accounting practices.³⁴ The ECB's 2014 AQR revealed significant amounts of previously unrecognized losses, with downward losses of banks' assets of €48 billion and an increase in the stock of non-performing exposures of €136 billion (Schoenmaker et al, 2016; ECB 2014).^{35 36} Following the European example, various ECA countries undertook AQRs of their own, including Albania (2014), Belarus (2016), Bosnia (2014), Serbia (2015), Ukraine (2015-2017), and more recently Bulgaria and Croatia as part of their entry into the SSM. Based on the outcomes of the AQRs, actions can be designed to enhance supervisory compliance and risk management, design bank-specific balance sheet repair plans, and to improve the resilience, credibility, and public trust in the banking sector.

AQRs may become useful at a later stage, once there is more clarity regarding the economic damage caused by the pandemic. An AQR may not yet be worthwhile given the current high level of uncertainty. In addition, not all business is fully operational, relief measures are still in place, and there is a fundamental lack of clarity regarding the credit losses caused by the pandemic. Once the dust settles, however, they could be very useful as banks might need to be challenged on their reported asset quality indicators and plans to strengthen banks' balance sheets will need to be designed and implemented based on accurate information.

34 While AQRs focus almost exclusively on assets, they can encompass very detailed analysis on underwriting practices, assessment of collaterals, and management and valuation of repossessed collaterals, other balance sheet items, intercompany transactions, as well as scenario analysis, depending on the decided scope of assessment.

35 <https://www.bruegel.org/wp-content/uploads/2016/06/Blueprint-XXV-web.pdf>

36 <https://www.ecb.europa.eu/pub/pdf/other/aggreatereportonthecomprehensiveassessment201410.en.pdf> <https://www.bankingsupervision.europa.eu/ecb/pub/pdf/aggreatereportonthecomprehensiveassessment201410.en.pdf?68911b281b9d831540bb474c334437e7>

4. BANK-LED AND SYSTEMWIDE NPL REDUCTION STRATEGIES

On the whole, banks in the ECA region are financially and operationally better prepared to face renewed pressures on asset quality than at the onset of the GFC. As discussed earlier, a lack of capital space and skills prevented banks from responding proactively to deteriorating asset quality in the early stages of the GFC. This time around, most banks in the region will be facing the pressures on asset quality from a stronger starting position, thanks to higher capital and liquidity buffers. Banks' relatively recent experience in working out high volumes of bad debt may even prove to be a silver lining. Post-GFC, banks in the region made considerable investments in people, systems, and procedures, which will likely translate into higher levels of operational readiness to deal with the increase in NPLs.

Nonetheless, despite a stronger starting position, bottlenecks can reappear. Banks may be reluctant to make the organizational changes and costly investment in resources and information systems necessary for working out large volumes of NPLs. Banks may also resist regulatory pressure to differentiate distressed but potentially viable borrowers from non-viable ones. They may be hesitant to accept the losses necessary to secure the long-term viability of the former, and reluctant to force the latter towards an orderly exit. Lastly, in the face of the worst economic shock since the Great Depression, capital space limitations may again keep banks from fully recognizing their exposures to troubled assets, hindering the initiation of timely measures to work out such exposures.

This chapter discusses NPL reduction strategies.

The emphasis in the first part of this chapter is on banks' operational readiness to manage rising volumes of NPLs. It considers the various channels available to banks to resolve NPLs, including some of the challenges and obstacles that banks in the region have encountered in practice, and addresses some of the practical steps that banks can undertake to boost preparedness, including through the establishment of dedicated workout units. Although banks carry the main responsibility for working out bad loans, a need for more direct public policy intervention can arise once banks' exposure to problem loans becomes a threat to financial stability, as discussed in the second part of this chapter. The second part of this chapter also discusses the need for policy coordination as part of nationwide NPL resolution strategies, as well as public Asset Management Companies (AMCs), that some countries have established to complement individual banks' NPL resolution efforts.

NPL reduction measures

Banks can employ a variety of measures to lower reported NPLs (table 4.1). This can be achieved through (i) loan restructuring, (ii) legal recovery, including through collateral enforcement and the initiation of insolvency procedures vis-à-vis the borrower, (iii) write-offs, and (iv) sales to third parties, including to AMCs.³⁷ These channels are not mutually exclusive. In practice they are often combined and undertaken in a specific order. Write-offs, for

³⁷ The Financial Stability Institute (2017) recognizes two additional measures (i) securitization and (ii) asset protection schemes but these channels are generally less relevant for developing and emerging countries as they require well-developed financial markets, and fiscal space, which are often absent in these countries. For these reasons, these channels are not further considered in this note. <https://www.bis.org/fsi/publ/insights3.pdf>

example, often take place after first fully exhausting all possible legal actions to recover the debt.

A conceptual distinction can be made between NPL resolution, collection, and disposal.

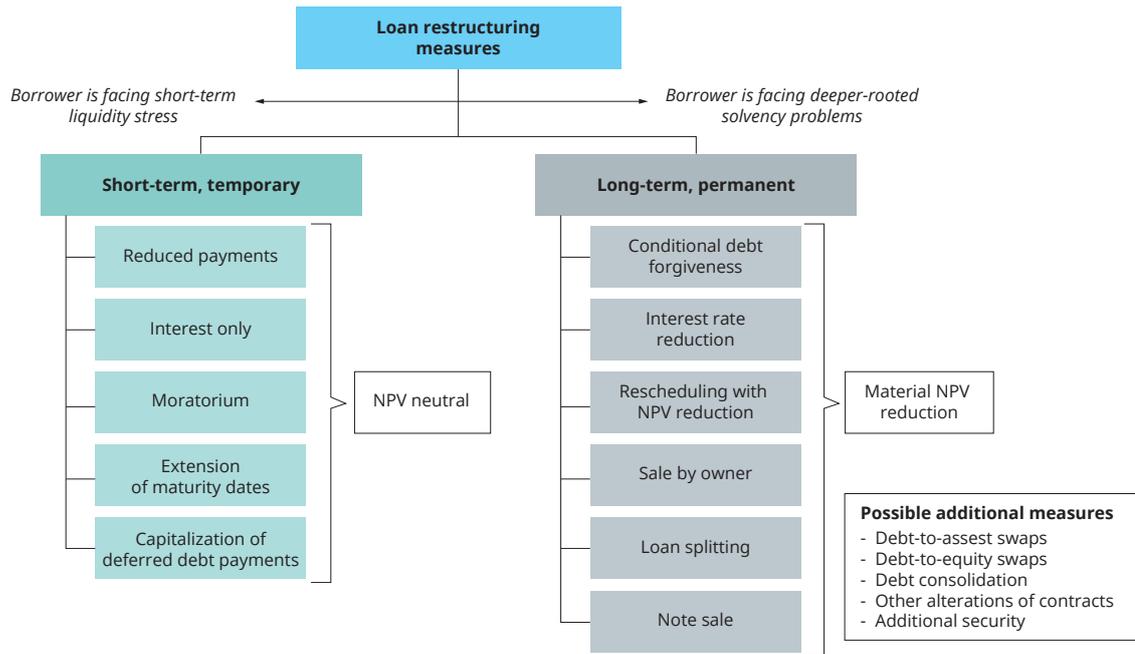
Resolution involves a set of measures aimed at restoring the financial viability of distressed borrowers, usually as part of loan restructuring.

Collection refers to a bank's efforts to reclaim on past loans that have gone bad, usually by initiating legal actions vis-à-vis troubled borrowers, to satisfy the bank's claims. Disposal involves the removal of NPLs from a bank's balance sheet, either through a transfer of ownership (as part of a sale) or by moving NPLs to a bank's off-balance sheet records (which occurs when NPLs are written off).

Table 4.1 NPL reduction measures

Instrument	Sub-Category	Description	Upfront eligibility requirements?
Loan restructuring	Short-term, temporary	Deferment of borrower's debt service obligations to a future date, in a NPV-neutral manner.	Borrower is experiencing short-term liquidity difficulties. Borrower is cooperative.
	Long-term, permanent	Loan restructuring that entails a NPV reduction.	Borrower is distressed but viability can be restored with restructuring that entails debt relief. Borrower is cooperative.
Legal actions	Collateral enforcement	Enforcing the collateral or guarantee pledged against the loan in or out of court.	No
	Insolvency process	Initiation of an insolvency petition against the debtor to ultimately force a reorganization or liquidation of the borrower. In other cases, the debtor may voluntarily file for insolvency, in which case the bank will need to prove its claim.	No
Write-offs	Write-off	Fully provisioned NPL is moved off-balance sheet. Borrower's debt remains.	Banks may need to demonstrate that all measures have been exhausted.
Sale	To a third party	Sale of NPL on commercial terms to an investor. Investor continues collection effort.	No
	To a public AMC	Transfer of NPLs to a centralized agency that manages recovery efforts. Used in systemic crises, complementing individual banks' efforts.	No

Graph 4.1: A schematic overview of loan restructuring measures



Source: Adaptation from Handbook for MSME NPL Management and Workout.
<https://www.bsi.si/en/publications/other-publications/handbook-for-msme-npl-management-and-workout>

a) Loan restructuring

Loan restructuring is a concession granted to the contractual terms of the loan in response to repayment difficulties that otherwise would not be considered by the lender. The term “loan restructuring” is often used interchangeably with “forbearance”. Both refer to concessions provided by lenders in response to the financial difficulties of borrowers. However, as explained in the previous chapter, international standard setters issued guidance in the early stages of the pandemic that loans benefitting from short-term loan restructuring measures (e.g. payment moratoria) should not be automatically considered as “forborne exposures”. For this reason, the term “loan restructuring” is used in this chapter.

It is useful to distinguish between short-term loan restructuring measures and long-term ones (graph 4.1). Short-term restructuring measures are designed to help liquidity-distressed borrowers navigate transient temporary repayment difficulties by allowing the borrower to pay later. Debt service obligations can be deferred in whole

(i.e. moratorium that suspends all debt service obligations) or part (e.g. through a temporary switch to interest-only payments or a temporary reduction in amortization obligations). Short-term restructuring measures generally do not lead to bank losses in NPV terms. The impact on NPVs can be neutralized by extending maturities and/or through the capitalization of deferred payments.

Long-term restructuring measures, by contrast, are meant for borrowers that are facing deeper-rooted solvency difficulties. The borrower is distressed but the expectation is that the borrower can be rehabilitated with long-term loan restructuring measures. In practice, this often entails a reduction in debt in NPV terms and thus an element of debt forgiveness for the borrower and credit losses for the bank. Measures include conditional debt service forgiveness, a permanent reduction in interest rates, and loan splitting³⁸ among others (see annex 1 for a more detailed discussion of various long-term restructuring measures). In practice, various long-term loan restructuring measures are often combined.³⁹

³⁸ Under loan splitting the debt is split into two parts: (i) the portion representing the amount that can be repaid from sustainable cash flow is repaid in equal installments of principal and interest; and (ii) the remaining portion represents “excess debt”.

³⁹ Note that even short-term and long-term restructuring measures can be combined. While a bank is negotiating with the debtor about long-term restructuring measures, it may decide to put in place a temporary moratorium (“standstill”) for the duration of the negotiations. This occurs most often in the context of the restructuring of large, complex, multi-creditor corporate loans.

Under normal circumstances, it is not considered good practice to restructure exposures owed to non-viable and uncooperative borrowers, given that there is a high likelihood of recurrent payment delinquencies. Experience indicates that restructuring such exposures will merely postpone the recognition of inevitable losses and is thus advised against. This does not mean that borrowers that have been assessed as viable and cooperative automatically qualify for restructuring. Even for these exposures, banks need to compare the expected NPVs for all four reduction options and opt for the channel that offers the best prospects. The need to get support out quickly and broadly, as part of a package of COVID-19 emergency measures, meant that the usual requirement – banks' confirmation that borrowers are viable and cooperative before considering loan restructuring measures – has in practice been relaxed for the duration of the payment moratorium. Indeed, some countries have introduced legislative payment moratoria that establish a legal obligation for banks to provide a payment holiday to eligible borrowers, regardless of viability and cooperativeness. Even in countries with non-legislative payment moratoria, political pressures and public opinion may lead to a similar outcome. Over time, as the extraordinary relief measures are phased out, banks will need to revert to their usual practice of confirming borrower viability and cooperativeness prior to considering loan restructuring.

Although the current borrower relief measures were originally intended as short-term restructuring measures, the distinction between short- and long-term measures is becoming blurred.

The borrower relief schemes introduced in many ECA countries were conceived under acute time pressure, and amidst major uncertainty regarding the duration of the pandemic. The crisis required support to be mobilized broadly and at speed rather than on a case-by-case basis as happens in

normal, non-crisis times. In the early stages of the pandemic, and under political pressure to act quickly, banks had little time or opportunity to analyze whether distressed borrowers were merely facing temporary liquidity difficulties or longer-term solvency issues. This, together with the fact that measures initially conceived as short-term support have been rolled over, highlights how the distinction between short- and long-term loan restructuring measures has become blurred.

Distinguishing borrowers with transitory liquidity difficulties from those with deeper-rooted solvency problems is a challenging task given the uncertainty of the economic outlook.

This distinction has far-reaching ramifications for the type of appropriate restructuring measures that banks should consider and matters for the proper and timely identification of credit losses. In this regard, a crucial factor is the bank's assessment of whether and when the troubled borrowers' income and cash flows can be expected to fully recover. As is the case with assessing a distressed borrower's viability, the answer is not always clear-cut even under the best of circumstances, let alone during a pandemic. Still, the current uncertainty should not discourage banks from making continuous efforts in this direction. It is critical that as the situation unfolds, banks proactively identify borrowers that are likely to face solvency challenges, recognize credit losses in a timely manner, classify and provision for such loans appropriately, and – provided that the borrower is assessed to be cooperative and distressed but viable – initiate discussions about long-term loan restructuring measures.

This time around, it is important to aim for quality in undertaking long-term loan restructuring.

In the aftermath of the GFC, ECA countries experienced serious challenges in ensuring a proper use of loan restructuring options. Poorly functioning debt recovery and insolvency systems and the

absence of secondary markets for NPL portfolios made legal enforcement comparatively unattractive (see Section 5) which had the unintended effect of disincentivizing banks from adopting a firm line vis-à-vis non-viable borrowers. Rather than forcing these debtors to an orderly exit (e.g. through legal actions), banks frequently engaged in dubious loan restructuring measures (e.g. long grace periods, bullet payments) to avoid or delay the recognition of inevitable credit losses, with little or no effort to assess a borrower's viability and future capacity to generate free cash flows available for debt service payments. At the same time, concessions offered to distressed but potentially viable borrowers frequently did not go far enough to secure their successful rehabilitation. Reluctant to provide distressed but potentially viable debtors debt relief in NPV terms⁴⁰, banks often resorted to piecemeal approaches such as (i) capitalization of unpaid interest and principal or (ii) restructuring loans with long grace periods and/or bullet payments (which were then often rolled over repeatedly) – postponing the problem rather than dealing decisively with the inability of the borrower to generate enough free cash flows to service the debt.

A lack of quality in restructuring resulted in a misallocation of credit, exacerbating the economic downturn following the GFC. Non-viable borrowers were kept afloat and lingered around, while distressed but potentially viable borrowers did not get the depth and quality of long-term restructuring measures they needed to fully recover. Consequently, banks' credit stock got stuck in underperforming sectors, at the expense of newer more dynamic sectors. A repetition of this scenario would significantly depress economic prospects in the years to come.

Long-term loan restructuring can be particularly complex for large corporate borrowers with multiple creditors. Multi-creditor negotiations about loan restructuring measures can be characterized as a collective action problem: Even though creditor banks would generally be better off cooperating, in practice they often fail to do so due to conflicting interests that preclude collaborative joint action. Banks are often understandably concerned that competing creditor banks seek to improve their position by holding out, rather than matching the concessions that have been offered. Furthermore, restoring the commercial viability of large corporate borrowers often not only involves a restructuring of the company's debts, but also a reorganization of the business, including potentially controversial measures such as the divestment of non-core activities and reductions in staff. This problem led policymakers in the region to establish a stronger legal basis and promote the use of workout measures (as discussed in the following section).

b) Legal actions⁴¹

Legal actions are usually the most suitable instrument for uncooperative or non-viable borrowers. Once banks have determined that a distressed borrower is uncooperative or non-viable, the next step is usually the initiation of legal actions to recover the debt. This can entail judicial enforcement against the debtor, including collateral enforcement (in the case of secured loans), the enforcement of third-party guarantees, or a petition to request the opening of insolvency proceedings, among other alternatives. Collateral enforcement typically entails the initiation of legal actions, sometimes in-court and sometimes out-of-court, aimed at the repossession and subsequent sale of the

⁴⁰ In some countries, legal and tax frameworks did not allow for debt forgiveness, at times imposing criminal liability on measures to reduce debt. The issue is discussed in more detail in Chapter 5.

⁴¹ Further details on the different types of enforcement and their consequences will be elaborated in section 5 that discusses the enabling legal environment.

collateral. Insolvency proceedings are collective and involve all creditors of the distressed borrower, subject to court supervision. The initiation of insolvency proceedings requires that conditions stipulated in the insolvency law are satisfied, e.g. a debtor's inability to pay debts as they mature or liabilities in excess of assets. Insolvency cases can usually be requested by both creditors and the debtor itself. Therefore, sometimes the bank needs to participate in these processes even if the bank was not the creditor requesting the initiation of the debtor's insolvency proceedings.

The increase in NPLs in the aftermath of the GFC exposed serious shortcomings in ECA countries' legal systems, which in some cases became seriously strained under a heavy burden of litigation cases and bankruptcies. Legal systems were generally poorly prepared to deal with such a major surge in NPLs. Among the problems were time-consuming procedures with highly uncertain outcomes, as well as unpredictability in the application of the laws. This made legal actions comparatively unattractive. The shortcomings in legal systems prevented banks from adopting a tough line vis-à-vis non-viable borrowers, which were kept afloat with dubious loan restructuring measures. At the same time, legal systems were ill-equipped to facilitate the rehabilitation of distressed but potentially viable borrowers, which were often prematurely steered towards liquidation. A notable feature in some ECA countries was the scarcity of insolvency cases, despite elevated NPL ratios and even though some countries did have insolvency laws in place. The lack of familiarity among key actors and the absence of a "rescue culture" appear to be the key factors behind this phenomenon (see also Section 5).

In a bid to preserve economic activity, several ECA countries temporarily suspended the right

of creditors to enforce during the GFC. This generated another problem: the proliferation of some strategic defaulters that were financially capable to repay but opted not to, knowing there would be no enforcement. Even when such moratoria were lifted, these issues lingered on, as courts had only limited capacity to deal promptly with their cases (or could be influenced to delay the proceedings). In hindsight, the increase in NPLs following the GFC was not only driven by a deterioration in the financial standing of borrowers, but also by moral hazard associated with willful defaulters. These experiences underscore the importance of ensuring that borrowers pay according to their financial capacity.

c) Write-offs

Post-GFC, banks in the ECA region have relied heavily on write-offs to lower reported NPL ratios. In countries such as Albania, North Macedonia, Romania, and Serbia, the removal of legal and taxation impediments paved the way for large scale write-offs (including by streamlining onerous requirements that banks exhaust all other options before write-offs are allowed; see chapter 5), allowing banks to quickly reduce reported NPL ratios and to refocus on their core business of providing new lending rather than the management of bad assets (Bauze, 2019).⁴² As was the case in some EU countries, local regulators exerted increasing pressures on banks to write off legacy problem loans, and in some cases introduced limits as to how long banks could keep fully provisioned NPLs on their balance sheets.

A write-off is a formal recognition in a bank's financial statements that a borrower's asset no longer has value. Loans can be written-off once credit losses are fully provisioned for and there is no realistic prospect of recovery. Banks derecognize

⁴² <http://pubdocs.worldbank.org/en/372351569367201917/FinSAC-NPL-Write-offs-CESEE-Region.pdf>

written-off loans from their financial statements on account of uncollectability. Written-off loans are transferred to the off-balance sheet records. A write-off does not involve debt forgiveness. The borrower still owes money to the bank.⁴³ In light of these features, write-offs do not constitute a resolution channel for dealing with NPLs. In fact, it is often observed that following a write-off, the momentum for resolving problem loans fades. This can then lead to situations where banks are warehousing large volumes of written-off loans with low recovery values on their off-balance sheet records, without further effort to work them out or sell them off.⁴⁴ The ECB therefore requires banks to draft NPL reduction strategies that include foreclosed assets for banks with high NPLs. In the absence of any debt forgiveness, the borrower remains trapped with an unaffordable debt burden and no prospect of an exit.

d) Sales

Banks can reduce their exposure to problem assets by selling off portfolios of NPLs to distressed asset investors. They can do so through private selling, auctions, or – in countries with deep financial markets – through securitizing NPLs. Sales can be structured in various ways, the most common of which is a “true” sale, but profit sharing is practiced as well. A “true” sale means that assets are completely transferred to the buyer and the seller does not have any exposure to NPLs after this transaction. Profit sharing arrangements are often

put in place to overcome the price gap between what an investor is willing to pay and the price at which the bank is willing to sell. Banks may accept a lower price received upfront if they can expect to receive additional future cash flows based on a profit-sharing arrangement.⁴⁵ An initial minimum acceptable return is set, with the seller and investor agreeing to split any excess returns. Irrespective of the structure of the sale, the investor may significantly increase collection efforts vis-à-vis the borrower.

The development of secondary markets for NPLs has emerged as a topic of considerable interest to policymakers. In a bid to diversify the range of NPL disposal channels, policymakers in the euro area have made a concerted effort to develop such markets. NPL sales have played a critical role in reducing NPL ratios in EU countries with serious asset quality problems. Efforts to develop secondary markets have been most effective for unsecured problem loans, such as retail loans, credit card debt, etc. These assets are typically straightforward to work out and there is transparency for investors concerning their value given the absence of collateral. Due to the unsecured nature of these assets and the resultant high levels of provisioning, sales typically take place at very low prices relative to book value, making it easier for investors to achieve their targeted returns. By contrast, secondary market activity is more limited for complex, secured loans in part due to information asymmetries between buyers and sellers of such loans

43 In case the borrower resumes servicing its debt, or the exposure is sold, a recovered amount would be directly recorded in the profit and loss (P&L) account.

44 Aware of this problem, the ECB uses the term non-performing assets (NPAs) that includes non-performing exposures (NPEs) plus foreclosed assets. Banks with high balances of foreclosed assets are called upon to address such assets in their NPL resolution strategies.

45 In addition, sales can also be structured with the selling bank participating in the structuring of the sale, either by providing senior financing to the Special Purpose Vehicle (SPV) that is acquiring the assets or by investing in the junior tranche to capture some of the upside (similar to a profit-sharing structure).

(ECB, 2016).^{46 47} In recent years, efforts have been ongoing to overcome these information asymmetries through the development of standardized data templates (so-called data tapes; see box below).

These efforts, among others, doubled the volume of European loan portfolios traded – from €100 billion in 2014 to €203 billion in 2018.⁴⁸

Box 4.1 Overcoming information asymmetries in NPL markets – EBA NPL templates

In 2017, the EBA issued NPL templates to reduce information asymmetries between prospective buyers and sellers of NPLs.⁴⁹ Their main purpose was to stimulate the development of a functioning secondary NPL market in the EU. The EBA developed two sets of templates: (i) NPL portfolio screening templates and (ii) NPL transaction templates. The latter was more granular and aimed at enabling prospective buyers to conduct detailed financial due diligence on loan files for loan valuation purposes.

The EBA NPL transaction template includes the following data categories: (i) portfolio, (ii) counterparty (group), (iii) loan, (iv) historical collection and repayment schedule, (v) external collection, (vi) forbearance, (vii) property collateral, (viii) non-property collateral, and (ix) forbearance enforcement and swap. Under each category, additional data points are included (for example, collateral location, legal status, enforced date, and so on). In the property collateral category, for example, 58 data points are included. Each data point is assigned a mark for its criticality during the valuation process: (i) critical, (ii) important, and (iii) moderate. Some of the data points are attributable to corporate loans while others only to residential mortgages.

Within the ECA region, larger, more developed countries have been most successful in building markets for NPLs. Between 2015 and 2019, total NPL sales in the Vienna Initiative countries⁵⁰ amounted to €14.5 billion. Although Bulgaria, Croatia, Hungary, Romania, and Slovenia account for the bulk of the transactions, smaller deals have

also taken place in frontier markets in the Western Balkans. As is the case in the euro area, secondary markets have developed first for unsecured retail and credit card loans.⁵¹ The Western Balkans are at a disadvantage vis-à-vis their larger, more developed peers in their prospects to develop secondary markets. Prospective investors in distressed assets will

46 Buyers would fear that assets they are bidding for are of low quality and bid at a correspondingly low price. The sellers, being able to distinguish between low and high-quality assets, trade only in the former type – the lemons – whereas the market for the remaining assets fails.

47 ECB (2016) “Addressing market failures in the resolution of nonperforming loans in the euro area” In ECB (2016) Financial Stability Review, November 2016. <https://www.ecb.europa.eu/pub/pdf/fsr/financialstabilityreview201611.en.pdf>

48 Deloitte. Deleveraging Europe. October 2019. <https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/corporate-finance/deloitte-uk-de-leveraging-europe-2019.pdf>

49 A slightly revised version was introduced in 2018. <https://eba.europa.eu/eba-revises-standardised-npl-data-templates>

50 As part of the NPL initiative, the Vienna Initiative monitors NPL transactions for Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Montenegro, North Macedonia, Poland, Romania, Serbia, Slovakia, and Slovenia.

51 In some jurisdictions, a licensed entity is needed to buy unsecured retail and credit card loans, while the licensing requirement does not apply for investments in SME and corporate loans. Even though the former are easier to price, the need for a license can prevent investors from bidding for unsecured retail NPL portfolios.

need to make sizable upfront investments in the due diligence of markets. The opportunities to recoup these upfront costs are limited by the small size of domestic markets in the Western Balkan countries.

Nonetheless, the development of secondary markets for NPLs could support policymakers in their efforts to resolve rising volumes of bad assets. NPLs that have been written off and that have been transferred to banks' off-balance sheet records would be an obvious candidate. As noted, recovery prospects for these loans are generally poor and further deteriorate over time, while banks have often shied away from taking action to resolve these loans. In practice, potential deals often fail to materialize on account of a persistent pricing gap (i.e. a discrepancy between the price at which banks would be prepared to sell NPLs and the price at which specialized operators are willing to buy). Banks may have unrealistic expectations regarding the market value of such written-off loans and may also not always fully account for the costs of carrying such assets, including the costs of any collection efforts.

Lastly, transparency regarding the identity of prospective NPL buyers is necessary to contain moral hazard. In countries such as Greece, Serbia, and Ukraine, willful defaulters have been known to strategically default on their debts, wait for the loan to be written off by the bank, then buy back these loans at a fraction of the nominal amount. They have often used a variety of techniques (e.g. purchase by affiliates or complicated chains of sales) to obscure the identity of the investor. Monitoring is needed to avoid these types of practices.

Banks' NPL reduction strategies

In normal times, banks routinely manage incidental NPLs. Banks are usually best positioned to manage early arrears and incidental NPLs, particularly for large corporate exposures. They know their clients and their capacity to repay, thus they are best prepared to restructure, collect, and sell NPLs, in line with regulatory requirements governing the timely recognition and resolution for such assets.

Different circumstances can, however, arise when the credit cycle turns and when the volume of NPLs increases significantly. Although banks continue to have the primary responsibility for managing rising volumes of NPLs, there has been growing recognition that regulatory requirements can play a key role in ensuring that banks respond promptly. Faced with high and persistent NPLs in some euro area countries following the GFC, the ECB and EBA have required banks with asset quality difficulties⁵² to articulate NPL reduction strategies in line with detailed regulatory guidance on recognition, provisioning, reporting, and workouts.⁵³ In these strategies, banks present comprehensive action plans and agree with the supervisory agency on quantitative NPL reduction targets. Strategies should be embedded in banks' risk and capital strategies to avoid marginalization, be reviewed at least annually, and be approved by the bank's management body. With NPL volumes set to increase significantly across the board, banks will likely again be expected to articulate NPL reduction strategies and agree with supervisory agencies on NPL reduction targets.

⁵² The benchmark that the EBA uses is an NPE ratio of more than 5 percent.

⁵³ See ECB Guidance to Banks on NPLs, March 2017 https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf and EBA Guidelines on management of non-performing and forborne exposures, November 2018. <https://eba.europa.eu/sites/default/documents/files/documents/10180/2425705/371ff4ba-d7db-4fa9-a3c7-231cb9c2a26a/Final%20Guidelines%20on%20management%20of%20non-performing%20and%20forborne%20exposures.pdf>

The operationalization of banks' NPL reduction strategies has important repercussions for organization and resources. While banks' strategies provide a roadmap, banks will need to revisit their business model as part of a broader shift in emphasis from selling new loans to reclaiming past ones. In this context, they will need to take more granular decisions on the internal organizational structure, the allocation of internal resources (human capital, information systems, and funding), and the design of proper controls (policies and procedures) to monitor interim performance and take corrective actions to ensure that the overall reduction goals are met. Drawing on country experiences across the ECA region, the remainder of this section discusses some of the more practical aspects that banks need to consider.

a) Establishing workout units

Executing the NPL reduction strategy requires the set-up of dedicated workout units, in charge of handling problematic exposures. Workout units are operational departments in charge of handling a banks' problem assets. Workout units should be separate from loan origination departments, so that troubled loans can be moved away from original relationship managers and to avoid confirmation bias after the initial extension of credit. Once it becomes clear that a problematic exposure cannot be resolved within a reasonable time horizon, it should be transferred to the workout unit for more intensive oversight and resolution. To avoid problem loans lingering unduly with the originating unit, delaying their resolution, banks may establish internal triggers for a mandatory transfer to the workout unit (although in practice the transfer may take place before reaching the trigger point). The most frequently used trigger is 90 dpd, possibly complemented with indicators of financial distress other than payment arrears. Workout units play a critical role in selecting the

appropriate course of action for NPLs, with separate teams responsible for the management of (i) early arrears (< 90 dpd), (ii) late arrears, restructuring, and forbearance, (iii) legal actions, focusing on borrowers whose financial condition or cooperation level does not allow for restructuring, and (iv) the management of foreclosed assets. NPLs transferred to the workout unit do not necessarily have to be worked out internally. The workout unit may also recommend disposing of NPLs through sales, or by outsourcing the recovery process to a specialized third party (e.g. a servicing company) which may be able to manage the recovery more efficiently than banks' workout units.

Establishing and operationalizing workout units now helps to mitigate the risk that banks are overwhelmed by rising NPLs later. Establishing a fully functional workout unit takes time. Rather than waiting until reported NPLs start increasing, banks should already start preparing for the challenges by putting in place a functional workout unit. Although banks in ECA countries with post-GFC NPL resolution challenges frequently still have workout units in place, these units have often been down-scaled significantly on the heels of decreasing NPL ratios. With asset quality pressures on the horizon, it is time to reverse this trend. Banks that have disbanded workout units altogether should reestablish them as a matter of urgency. Regulatory guidance about the need to put in place fully functional workout units may also be useful.

Staffing workout units can be particularly challenging. In the aftermath of the GFC, countries experienced serious shortages of seasoned workout experts which was resolved by retraining loan origination staff to do loan restructuring, and by involving external experts on a contractual basis. In this respect, the fact that banks in ECA countries have relatively recent NPL resolution experience may prove an important advantage. In addition,

subsidiaries of EU-based banks could be better positioned for NPL workout due to knowledge transfer from their headquarters.

Banks are not always willing to commit the human and financial resources necessary to make the workout units fully functional. It is often observed in ECA countries that workout experts are assigned an excessive number of cases.⁵⁴ This will impact the effectiveness of the collection effort, potentially backfiring in the form of lower recoveries and longer recovery terms.⁵⁵ The reluctance to properly staff the workout unit often stems from overly optimistic expectations regarding the recovery of collateral values and future credit losses. Regulatory guidance or peer pressure can play a useful role in overcoming this kind of resistance.

Adequate information systems are of paramount importance for the well-functioning of the workout unit. The low level of loan file digitalization and poor internal management information systems in banks were among the impediments to more rapid NPL resolution in ECA after the GFC. This was a particularly acute challenge for small local and state-owned banks, as subsidiaries of large international banks were generally using modern systems from their parent banks. While most new loan files may be adequately digitalized by now, the amount of information necessary for detailed NPL analysis is often missing (e.g., details on collateral, details of contacts, and previous correspondence with the borrower).

Banks should also develop policy manuals that establish standard timelines for the management and resolution of NPLs. The longer a borrower remains past due, the less likely repayment becomes. Successful resolution, therefore, requires that the workout unit adheres to a tight but realistic timetable to ensure that the debt is restructured, sold to a third party, or collected through legal proceedings (in the case of non-viable borrowers) in a timely manner. The ECB Guidance on NPLs requires that a bank's policies and procedures with respect to NPL borrowers are documented in a written policy manual that covers recommended timelines and other aspects related to the resolution of NPLs.⁵⁶

b) Portfolio segmentation and the borrower viability assessment

Portfolio segmentation is the first step in developing a cost effective and efficient approach to NPL resolution. It involves the process of dividing a large heterogeneous group of NPLs by grouping borrowers with similar characteristics, allowing the bank to better tailor resolution strategies to the requirements of each group. Portfolio segmentation is best undertaken early on, upon transfer of the loan to the workout unit.

Portfolio segmentation consists of two stages, with the first step focusing on filtering out exposures for which further analysis is not opportune. This can include exposures that are already in legal proceedings (which can be automatically assigned to the team working on legal recovery within the workout unit), as well as micro-exposures with

54 One example of an extreme case – 1,000 cases were assigned to a junior workout expert in a country with a very high NPL ratio.

55 To give an indication, in a recent TA project it was recommended that on average, an experienced expert could handle 5 – 7 complex cases, a mid-level expert 10 – 15 cases of medium size and complexity, and a junior expert 20 – 30 small, simple cases.

56 This includes NPL classification and provisioning, arrears management, restructuring policies, enforcement policies, write-off and debt forgiveness policies, multi-bank distressed debt policies, collateral valuation policies, and outsourcing/NPL servicing policies.

small outstanding loan amounts⁵⁷ (which can be either promptly written-off with full provisioning and/or sold in batches to a third party).

During the first stage, the workout unit will also need to confirm that the borrower is cooperative. Loan restructuring is unlikely to succeed with non-cooperative borrowers. Workout units should therefore define non-cooperative borrowers and document their non-compliance. In this context,

particular attention needs to be paid to willful defaulters (see box 4.2), borrowers that repeatedly fail to respond to the bank's request for meetings, financial information, and access to their premises, books, and records, as well as borrowers who do not engage constructively with the lender (e.g. those that are generally unresponsive, consistently fail to keep promises, and/or reject loan restructuring proposals out of hand).

Box 4.2 Willful defaulters

Rather than leaving the definition of willful defaulters to banks, regulators can also provide a definition. Establishing a regulatory definition has the advantage of promoting greater consistency in industry practices and allowing banking supervisors to address instances where banks' practices fall significantly short of regulatory requirements.

As an example, in July 2015 the Reserve Bank of India issued a Master Circular on Willful Defaulters to strengthen the Regulation on Problem Assets.

The following events were identified as indications of willful default:

- “(a) The unit has defaulted in meeting its payment/repayment obligations to the lender even when it has the capacity to honor the said obligations.
- (b) The unit has defaulted in meeting its payment/repayment obligations to the lender and has not utilized the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes.
- (c) The unit has defaulted in meeting its payment/repayment obligations to the lender and has siphoned off the funds so that the funds have not been utilized for the specific purpose for which finance was availed of, nor are the funds available with the unit in the form of other assets.
- (d) The unit has defaulted in meeting its payment/repayment obligations to the lender and has also disposed of or removed the movable fixed assets or immovable property given by him or it for the purpose of securing a term loan without the knowledge of the bank/lender.”

⁵⁷ In a recent technical assistance project, a loan balance of €10,000 was used as a threshold. Given the very small expected recovery value, it does not make economic sense for the bank to allocate scarce resources to try to establish viability of these borrowers and design a customized, case-by-case workout strategy.

The second stage is to assess the borrower's viability. Banks' workout units usually develop their own policies and methodologies. While it is difficult to set a general framework for the viability assessment, a fully bank-driven approach can lead to widely diverging practices across the industry. Banks may also lack the incentives for a rigorous borrower viability assessment, instead opting for perfunctory analyses driven by the objective to avoid the recognition of credit losses. In a bid to overcome these problems (while avoiding the other extreme of imposing a standard blueprint), some regulators have introduced requirements for banks to develop internal methodologies for the borrower viability assessment, which can be embedded in the bank's NPL reduction strategy, with high-level regulatory guidance for the design of these methodologies.⁵⁸ This approach also allows for light-touch monitoring of banks' practices through day-to-day supervision.

The viability assessment is most challenging for corporate borrowers, particularly under the current circumstances. The assessment includes an analysis of the borrower's financial ratios, such as the debt to earnings before interest, taxes, depreciation and amortization (EBITDA) ratio, the interest rate coverage ratio (i.e. EBIT/interest expense) and operating income. Earnings and operating income can be difficult to predict in normal times, but the current uncertainty of the economic outlook significantly exacerbates the challenges. Threshold values need to be set to identify corporate borrowers that are non-viable. While the appropriate benchmarks depend highly on country-specific circumstances and industry features (e.g. capital intensity of the sector), as a general rule of thumb a debt-to-EBIT-DA ratio of more than five, an interest rate coverage

of less than one for a sustained period of time (e.g. two years), and persistent negative operating income can be seen as indications of a distressed financial position.⁵⁹ In addition, a more qualitative assessment of the borrower's business model and the economic environment needs to be undertaken. Under the current circumstances, sectors hit heavily by the crisis such as tourism, travel, air-transportation, and commercial real estate (office space and hotels) warrant particular attention.

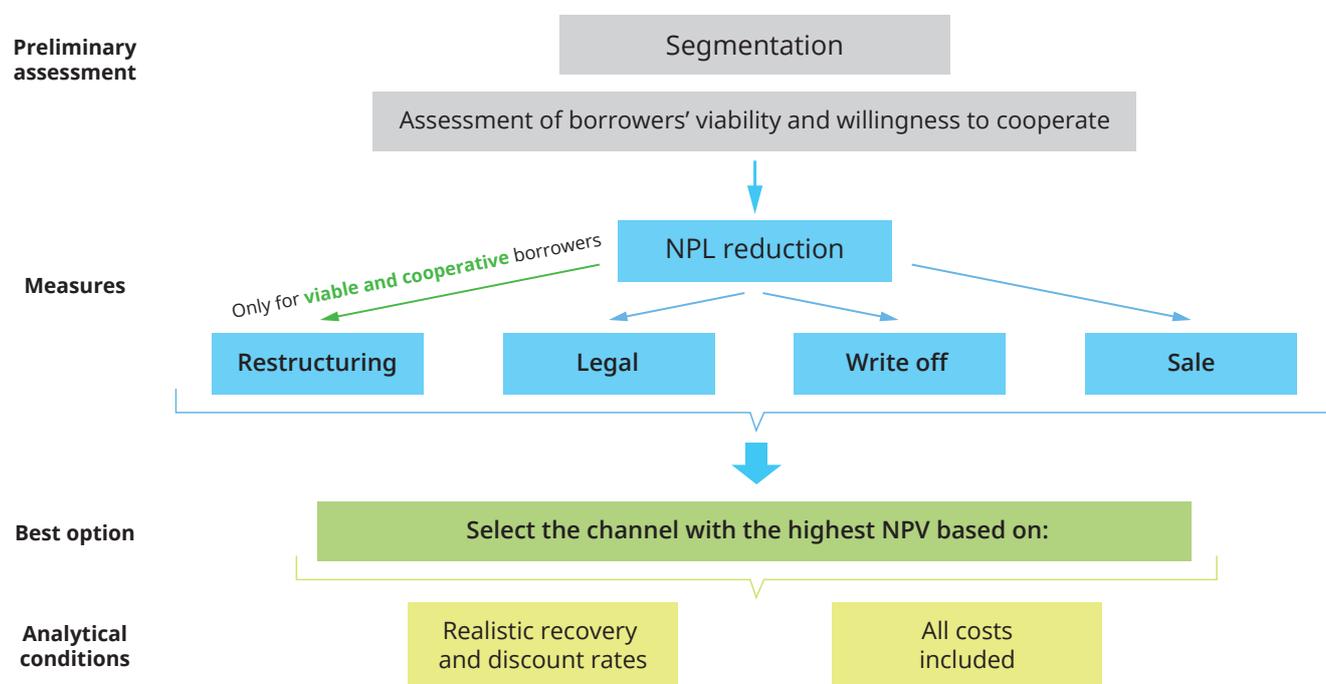
After filtering out borrowers that are manifestly non-viable, the remaining group of borrowers will need to be analyzed further. There will inevitably be borrowers for whom the initial viability assessment does not yield an unequivocal outcome. Such "marginally viable borrowers" will need to be assessed and evaluated further before a final decision can be taken, which will likely also involve considerable qualitative judgment.

The viability assessment of retail borrowers is based on financial and behavioral analysis. The following financial indicators could be considered for the viability analysis of retail borrowers: (i) loan to income, (ii) debt to income, (iii) debt service to income, and (iv) loan-to-value (LTV). As a rule of thumb, debt service (interest + principal) to income should be less than 30 percent and LTV, at origination, should be less than 80 percent for mortgage loans. Behavioral indicators (e.g., usage of credit lines for credit cards, and debt servicing patterns) play an important role in the credit scoring of retail borrowers. As SMEs, particularly micro companies, do not prepare extensive financial statements, this segment could be treated as retail exposures.

⁵⁸ This approach has been introduced with FinSAC support in Ukraine and in Slovenia.

⁵⁹ For loans to SMEs and small companies, that are often collateralized with real estate, an LTV of more than 80 percent can also be considered a useful benchmark.

Graph 4.2 a schematic overview of the various stages in the NPL workout process



c) Selecting the appropriate NPL reduction measure

The appropriate measure can be selected once the borrower's viability and cooperation has been assessed. As explained, the restructuring option should only be considered, but not automatically granted, for borrowers that the bank deems viable and cooperative. For all other borrowers, the menu consists of legal actions, write-offs, or sales.

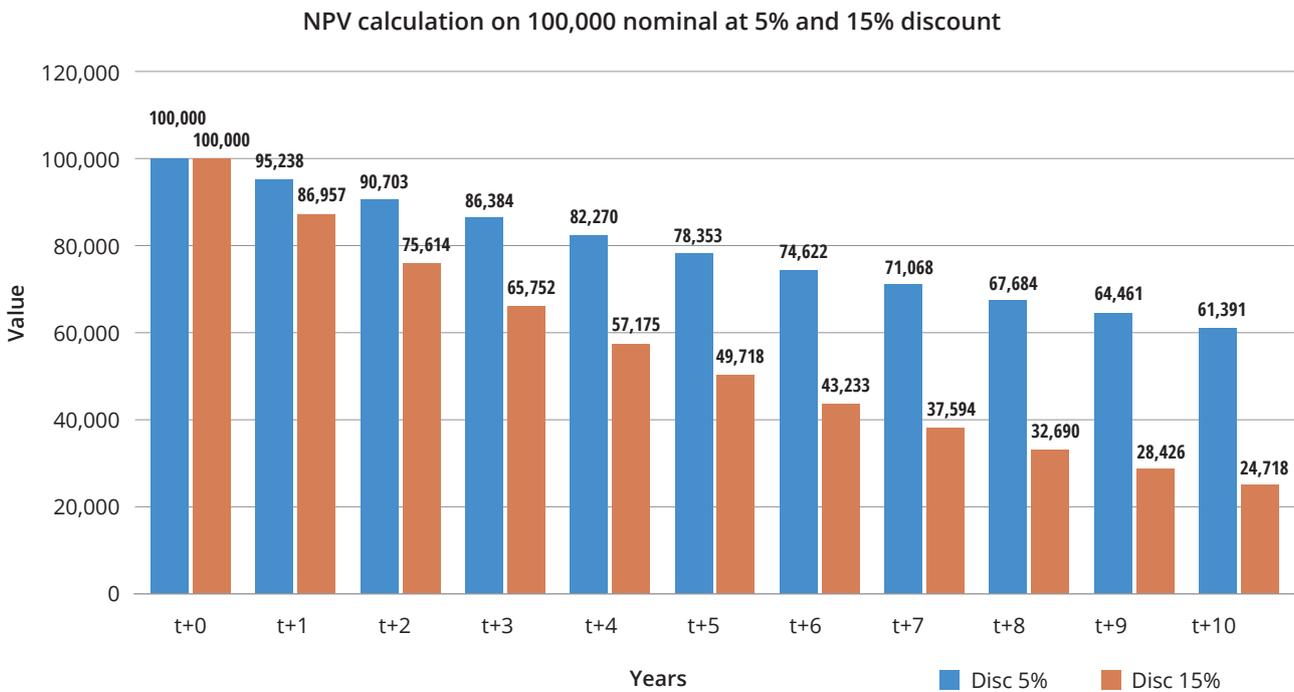
Banks' decisions on the choice of NPL resolution channel should be guided by comparisons of expected recoveries using NPV calculations. The NPV is the sum of the present values (PV) of

a stream of payments over a period of time. It is based on the concept of time value of money, i.e. money received in the future is less valuable than money received today.⁶⁰ Comparing NPVs for different resolution options allows banks to identify the commercially preferable option, factoring in the time value of money and fully accounting for costs, including opportunity costs (see Box 4.3 that discusses the workout of micro, small and medium-sized enterprises (MSME) loans in Slovenia). NPV calculations and comparisons can also help to justify a bank's measures in case these are scrutinized ex post, as often occurs in state-owned banks.⁶¹ Annex 2 discusses a simplified example with NPV comparisons.

⁶⁰ To determine the NPV, the net cash flow (cash payments of principal, interest, and fees less the bank's out-of-pocket costs for legal fees, consultants, etc.) received annually is calculated. Each of these amounts or future values is then discounted to the present by using an appropriate market-based discount rate. The sum of the PVs equals the NPV.

⁶¹ In many ECA countries, managers of state-owned banks refrain from granting partial debt forgiveness schemes to semi-viable companies, as part of long-term restructuring measures, due to concerns that state prosecutors will accuse them of mishandling state property.

Graph 4.3 NPV estimation at 5 and 15 percent discount.



NPV calculations should be based on conservative estimates for recoveries, discount rates, and carrying costs. It is extremely important to have realistic expectations about recoveries. Poorly functioning insolvency regimes, for example, directly translate into lower recovery rates which will need to be properly reflected. Such low recovery rates make legal enforcement comparatively unattractive, which may have the unintended side effect of incentivizing banks to steer problem loans, including cases of questionable viability, towards restructuring. In practice, banks' decisions to pursue legal enforcement are often based on optimistic, unrealistic assumptions regarding the time this can take. Similarly, discount rates tend to be quite high, to reflect that the value of distressed assets tends

to erode very quickly over time. Discount rates can be established by first setting a standard base rate with specific surcharges depending on the characteristics of the loan, such as past delinquency status and documentation deficiencies (Thomas, n.d.).⁶² Graph 4.3 provides an example of the dramatic change of NPV using different discount rates. Lastly, it is often observed that banks underestimate the carrying costs of maintaining NPLs. Banks will need to realistically account for all the costs, including costs incurred during the enforcement process (e.g., taxes, fees, maintenance, legal costs) and costs associated with collection efforts.

62 <https://www.slideserve.com/jillian-erickson/loan-valuation-using-present-value-analysis-william-thomas-u-s-department-of-treasury>

Box 4.3 Working out MSME loans in Slovenia

The workout of MSME loans presents banks with particular challenges. MSME NPLs are large by numbers but small by nominal amounts. Based on these parameters, the workout of MSME NPLs is a labor-intensive and a costly process. Therefore, MSMEs account for the majority of businesses worldwide and are important contributors to job creation and global economic development. They represent about 90 percent of businesses and more than half of employment worldwide. Formal MSMEs contribute up to 40 percent of national income in emerging economies.

The World Bank assisted the Bank of Slovenia in the development of a handbook for the management and workout of problematic MSME loans. After resolving many NPLs of large corporates through a national AMC established in 2013, the emphasis gradually shifted towards the workout of MSME NPLs. According to the Bank of Slovenia, in mid-2016 MSME loans accounted for more than 70 percent of banks' remaining NPL stock, totaling €1.5 billion or around 4 percent of national income. MSME NPLs were often small (36.5 percent had nominal amounts of less than €10,000) and frequently heavily in arrears, as many small loans had not been serviced for a long time. The handbook, developed as part of an EU-funded technical assistance project completed in 2016, aimed to provide guidance to banks in working out MSME NPLs.

The exercise highlighted the limitations of banks' internal capacity to work out a large amount of MSME NPLs. Considering the size of the country and its banking system, the scope for substantially expanding existing workout units was deemed limited. The problem was exacerbated by skills shortages. At the same time, access to NPL servicing and collection companies improved and NPL markets started to develop, with increasing interest from professional NPL investors.

The handbook recommended banks to separate MSME NPLs below €10,000 (so called "micro-exposures") into a separate portfolio during the initial NPL segmentation process. The threshold at €10,000 was based on a careful analysis of the MSMS NPL portfolio in Slovenia. Given the very seasoned NPL stock, with very low expected recoveries, it was not considered rational to allocate scarce resources to design a tailor-made solution for these micro exposures. The handbook therefore recommended (i) a very simple, standardized workout approach, including a prompt write-off after full provisioning and/or (ii) a sale of portfolio to a third party for these exposures. The focus on a standardized approach or sale would allow the bank to focus on larger NPL cases requiring more resolution skills. In addition, it would allow NPLs to be resolved in a cost-efficient manner, which should be one of the main guiding principles in the workout process.

The handbook is available online.

<https://www.bsi.si/en/publications/other-publications/handbook-for-msme-npl-management-and-workout>

d) Following up on long-term loan restructuring

If the bank's workout unit decides to opt for long-term loan restructuring, it will need to agree with the borrower on a revised repayment schedule that the borrower can realistically meet. In a best-case scenario, the bank and

the borrower arrive at a consensual solution that satisfies both parties and results in a successful long-term loan restructuring. The bank will need to develop a thorough understanding of the borrower's financial position to calibrate the proposal, including borrower's affordability, cash generating capacity, and available collateral.

Table 4.2 Affordability assessments of corporate borrowers – a schematic overview

Action	Information source	Output
Assessment of borrower's total liabilities – analysis of borrower's leverage (the ratio of debt/EBITDA)	Bank's internal information, credit bureaus, other registries, borrower's financial statements	Borrower viability assessment
Future cash flows, adjusted for expenses and taxes – analysis of borrower's ability to service the debt (the ratio of EBIT/debt interest payments)	Borrower's financial statements, reliable GDP and sectoral growth forecasts	Sustainable level of debt service capacity to allow for company's growth

An affordability assessment is key to draft a viable long-term restructuring plan. The starting point for the affordability assessment is a comprehensive view on the borrower's liabilities. The bank will need to factor in all the borrowers' debts (including those owed to other creditors) in order to understand the debtor's total indebtedness, and aggregate debt service obligations. To gather this information, banks can consult credit bureaus or registries or other external sources. Banks will need to make a conservative assessment of the borrower's regular income, with an adjustment for expenses and taxes. The analysis of financial statements and cash flows can serve as the basis for affordability assessments of corporates. For retail borrowers, employment prospects, age group, and debt servicing patterns can be used. For the purpose of retail loan restructuring the concept of reasonable living expenses can be introduced. On the basis of this information, the bank can determine a debt level that is consistent with the borrower's debt-shouldering capacity and a decision can be made about the amount of debt relief in NPV terms that needs to be provided (see Table 4.2 for a schematic overview for corporate borrowers).

The repayment obligations of the restructured loan should match expected cash/income flows of the borrower. To optimize the chances that the borrower stays current on payments of the

restructured loan, banks need to consider future income flows of the borrower. The new repayment schedule should be calibrated to include this analysis. For example, the expected retirement age should be considered for retail borrowers or an expiry of a patent or license for a corporate.

Banks will also need to assess any pledged collateral. Banks should review if the existing collateral is correctly registered and whether it will be easily enforceable in the case of non-payment. Banks might opt for additional collateral if feasible.⁶³ According to good practice, revaluation of collateral should be performed prior to loan restructuring to ensure the amount of collateral pledged against the loan remains adequate. This is particularly important in situations with declining property markets and in cases where collateral is not in the form of real estate.

The performance of the restructured loans should be closely monitored for their performance under new loan terms. As explained in Section 3, loans can only be moved back to the performing loan category after the borrower has rebuilt a track record in servicing the rescheduled debt. This is to ensure that loan 'evergreening' practices, previously often used by banks, are discontinued.

⁶³ A practical caveat is that in many cases a request for additional collateral may be rendered void by the relevant insolvency laws if it is soon followed by initiation of a bankruptcy process. Most ECA countries have insolvency laws with standard provisions called "voidance actions" that permit courts to undo transactions that may be prejudicial to the debtor or to other creditors.

Systemwide NPL resolution strategies

While banks have primary responsibility for the management of distressed loans, circumstances can arise that require more direct public policy measures, complementing banks' NPL reduction efforts. Direct public policy interventions may be warranted when (i) banks' exposure to problem loans jeopardizes their capacity to finance the real economy, or threatens the stability of the financial system; (ii) banks are unable to recognize their losses due to thin capital positions or lack the necessary skills to work out large volumes of problem loans; and/or (iii) the legislative framework for debt enforcement and insolvency is weak or unable to accommodate a large number of cases. In these circumstances, public policy measures can play a useful role in overcoming obstacles and significantly accelerate the rate of NPL reduction.

a) Coordinated NPL reduction strategies

Reducing high NPLs requires the active participation of an array of stakeholders to align policies across different areas. It has been observed that NPL reduction, if left to its own devices, tends to proceed at an unduly slow pace. Accelerating NPL resolution to a more desirable pace requires a pro-active approach that ensures the buy-in of a wide range of actors. Key stakeholders include banks and other private sector representatives (such as institutional investors and third-party service providers), national authorities, including central banks and banking supervisory agencies, finance and justice ministries, and civil society representatives, including consumer organization. A successful strategy must build on robust coordination and interaction among these actors to ensure that their actions and measures are well-aligned.

Government-initiated coordination mechanisms can play a useful role in cases when NPL ratios are at elevated levels and when NPL reduction is hindered by deep-rooted structural problems. Coordination can take place through the

establishment of high-level working groups, that include senior representatives from participating agencies. These groups can be usefully supported by one or more task forces that undertake the technical work in support of the high-level working group's decisions. The mandate of the high-level working group should be to fully diagnose the obstacles to NPL resolution, set reform priorities, and ensure that all stakeholders are clear on their role in implementation. A coordinated public communications strategy as well as a dedicated project management office would help ensure effective implementation. Post-GFC experiences in several ECA countries confirm the importance of policy coordination at the national level (see Box 4.4 on the experiences of Albania and Serbia).

In countries with a high level of foreign bank participation, policy coordination at the international level can usefully complement domestic efforts. The Vienna Initiative played a key role when the GFC hit with full force. Launched in January 2009, the Initiative brought together public and private sector stakeholders of EU-based cross-border banks, as well as the European Bank for Reconstruction and Development (EBRD), IMF, and the World Bank. While the immediate focus was on preventing disorderly withdrawals by foreign parent banks from ECA countries, over time the emphasis shifted towards resolving the legacy issues exposed by the GFC, including NPL resolution. Following the launch of an influential report in 2012, that identified the many obstacles for NPL resolution in the region, the Vienna Initiative established an NPL workstream that draws on work within the IMF, World Bank, European Investment Bank (EIB), the European Commission, and the EBRD. The Vienna Initiative remained active in the following years. In the aftermath of the pandemic, it has significantly stepped up its activities with a renewed emphasis on financial stability, including NPL resolution.

Box 4.4 National NPL reduction strategies – the experiences of Albania and Serbia

In the aftermath of the GFC, Albania and Serbia experienced a surge in NPLs, with NPL ratios well in excess of 20 percent. In both countries the GFC heralded a pronounced economic slowdown while a significant depreciation of local currencies led to the emergence of forex-induced credit risk. Serbia's NPL ratio peaked at 23.5 percent in 2013 with particularly elevated NPL levels in the construction (49 percent), real estate business (40 percent), and manufacturing and mining (25 percent) sectors. Asset quality pressures also contributed to the failure of five banks between 2008 and 2014. Albania's NPL ratio increased from 6.5 percent in 2008 to 24.9 percent by September 2014. The construction and real estate development sectors were the most exposed to asset quality problems.

Serbia

The Government of Serbia issued a decree to establish a national NPL working group in May 2015. The working group comprised participants from the Ministries of Economy, Finance, and Justice and the National Bank of Serbia as core members. It agreed that international financial institutions (IMF, World Bank, IFC, EBRD) would take an active role in the work of the working group and the design of the strategy. In addition, the Deposit Insurance Agency (as the manager of assets transferred from bankrupt banks) and the Chamber of Commerce were involved to address issues pertinent to their areas of specialization.

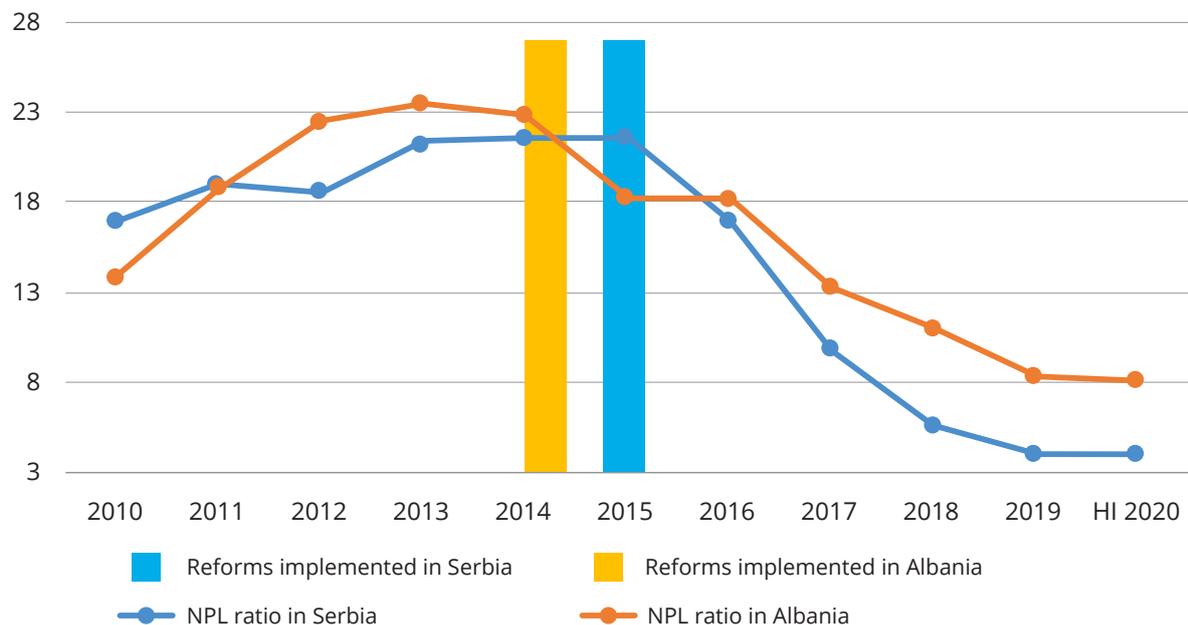
The decree tasked the working group to prepare and implement a comprehensive strategy for the reduction of NPLs in Serbia. The strategy⁶⁴ consisted of four pillars: (i) improving banks' capacity in dealing with NPLs, (ii) enabling conditions for the development of the NPL market, (iii) improving and promoting out-of-court restructuring, and (iv) improving in-court debt resolution and mortgage framework. The strategy was informed by a KPMG study of the impediments to the sale of NPLs in Serbia⁶⁵. Two separate action plans were prepared to implement the strategy over the period of three years – one by the National Bank and one by the Ministry of Finance. The progress of reforms outlined in the action plans was reviewed and discussed at the working group on a quarterly basis. The mandate of the working group was extended by the government in the autumn of 2018 until 2020 to address remaining issues and to work on the prevention of NPLs in the future. Under this new program, FinSAC in cooperation with KPMG Serbia prepared a study on the corporate viability of Serbian enterprises, covering the period 2014-2018.

The strategy contributed to a rapid decrease in the NPL ratio. By September 2020, the NPL ratio had reached a historic low of 3.4 percent. Graph 4.3 shows that the NPL ratio started to decrease in 2016 after the start of reforms envisaged in the strategy. However, despite the decrease in the NPL ratio, the corporate viability study conducted in 2019 showed that the number of companies with financial difficulties remained broadly unchanged, raising questions about the sustainability of the NPL reduction drive.

64 NPL Resolution Strategy. Official Gazette of Serbia, Nr. 72/15. [https://www.mfin.gov.rs/UserFiles/File/strategija%20kreditni/1%20NPL%20Strategija%20\(eng\)%20-%20Rezime.pdf](https://www.mfin.gov.rs/UserFiles/File/strategija%20kreditni/1%20NPL%20Strategija%20(eng)%20-%20Rezime.pdf)

65 Analysis of the existing impediments to the sale of NPLs in Serbia. EBRD and KPMG. December 2015. https://mfin.gov.rs/UserFiles/File/strategije/NPL_resolution_in_Serbia_DRAFT_FINAL_18APR.pdf

Graph 4.4. NPL ratio in Serbia and Albania (in percent).



Source: National Bank of Serbia, Bank of Albania, IMF Financial Soundness Indicators.

Albania

A similar national NPL reduction strategy was implemented in Albania. An inter-institutional working group on NPL resolution in Albania was established with a decree issued by the Prime Minister in 2014. The Ministries of Economic Development, Tourism, Trade, and Entrepreneurship were made responsible for coordinating the work of the working group, which also consisted of the Bank of Albania and the Ministries of Finance and Justice. The IMF, IFC, and World Bank also supported the working group.

In August 2015, the Prime Minister and the Governor of the Bank of Albania endorsed a comprehensive twelve-point NPL Action Plan prepared by the working group. The Bank of Albania and the Ministry of Justice were to take the lead on the implementation of the reforms. The Bank of Albania was put in charge of the following reforms: (i) a revision of the credit risk regulation, (ii) addressing the 35 largest defaulting groups of corporates, responsible for more than half of the outstanding stock of NPLs, (iii) improving the licensing of NPL buyers, (iv) adopting a framework for out-of-court workouts, and (v) upgrading the Credit Register, among others. The actions planned by the Ministry of Justice were: (i) drafting a new bankruptcy law, (ii) amending the Code of Civil Procedure, (iii) amending the Law on Registration of Immovable Properties, and (iv) amending the Law on Securing Charges.

One of the key reforms was a Bank of Albania regulation that required banks to write-off NPLs that had been classified as full loss for more than three years. This measure contributed to a significant increase in write-offs, which led to a decrease in the NPL ratio to 18.2 percent by end-2015. To address large corporate NPLs, the Bank of Albania issued a Guideline on Corporate Loan Restructuring in 2014, but this effort was less successful due to a lack of cooperation among banks and remaining weaknesses in the judicial framework. In 2019, the Bank of Albania issued a

new regulation on the out-of-court treatment of distressed borrowers⁶⁶ that gave banks enhanced incentives to resolve multi-lender NPLs, by establishing similar majorities as the ones envisaged in the recently adopted insolvency law.

Legal reforms helped to improve Albania’s NPL resolution environment. The passage of a modernized insolvency law (110/2016)⁶⁷ was a major step forward in the Albanian legal system. Reform to the Albanian civil procedure code partially improved the efficiency of auctions and judicial enforcement, however, progress in this area was not as significant as in other countries in the region.

b) Public Asset Management Companies (AMCs)

Some countries have established AMCs to reduce and work out NPLs.^{68 69} An AMC is an entity that manages non-performing assets removed from the financial system with the goal of maximizing the recovery value of these assets. The focus in this section is on public or majority public-owned AMCs, that are usually created to address high levels of NPLs across the financial system and that are typically part of a broader package of measures aimed at restoring financial stability and the flow of credit to the economy, although private-owned AMCs also exist in some ECA countries. Discussions about the creation of public AMCs tend to come up as pressures on asset quality increase, as is illustrated by the current discussion about establishing an AMC for the EU.⁷⁰

Public AMCs can be established either as an entity tasked with resolving failed financial institutions and liquidating their assets, or as an entity that purchases assets from open banks. Examples of the former are the Resolution Trust Corporation (RTC) in the USA, Securum in Sweden, and the Savings Deposit Insurance Fund (SDIF) in Turkey, while the Korea Asset Management Corporation (KAMCO), Danaharta in Malaysia, and more recent cases in Ireland, Spain, and Slovenia are examples of AMCs that purchase assets from banks that are still operating.

66 Regulation 51/2019 “On out-of-court treatment of distressed borrowers by banks”.

67 The World Bank provided extensive input to the drafting of this new law. It introduces modern reorganization proceedings and includes a chapter on “pre-packs” (or accelerated restructurings), provisions that permit the granting (and priority) of rescue financing to borrowers in financial distress, and a clear regime of creditors’ priorities, among others.

68 This section is based on Cerruti and Neyens (2016). <https://openknowledge.worldbank.org/bitstream/handle/10986/24332/9781464808746.pdf?sequence=2&isAllowed=y> and Dobler et al (2020) <https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2020/02/10/Managing-Systemic-Financial-Crises-New-Lessons-and-Lessons-Relearned-48626>

69 Advanced countries have also used asset protection schemes to stabilize financial systems to underwrite banks’ troubled assets (e.g. the Troubled Asset Relief Program (TARP) introduced in 2008 in the US) against a fee. The instrument was primarily used by advanced countries during the GFC. Although these schemes do not require an upfront disbursement, their feasibility relies on the public sector’s capacity to make good on those guarantees, and the confidence of market participants that it will do so. Considering the limitations in fiscal space that emerging economies often face, particularly in times of a broad-based crisis, the instrument is not widely used outside advanced economies. For this reason, it is not discussed further in this note.

70 For example, privately-owned AMCs in Turkey have a de facto monopoly on the acquisition of NPLs from state-owned banks (see also Section 5). In other countries, such as China, AMCs were originally established to support the clean-up of banks’ balance sheets and over time evolved into financial conglomerates. The business model of private AMCs is often focused on rapid disposal and generation of returns through margins on resale, rather than buy-and-hold strategies with workouts of troubled assets. Reliance on short-term funding can exacerbate pressures to generate quick returns and may preclude time-consuming workouts.

Some public AMCs are accompanied by publicly funded bank recapitalization schemes to avoid capital space constraints impeding efforts to increase transparency and clean up banks' balance sheets. This has been the case in, for instance, Malaysia and Spain. Banks that had been weakened due to the burden of NPLs were given a one-off opportunity to recapitalize with public support so that prudential banking regulations would not be breached. In exchange, banks that benefitted from the scheme underwent significant restructuring to secure their long-term viability.

There is no clear consensus on whether public AMCs should be supervised. Where banks are financially exposed to AMC bonds (received in exchange for transferred problem loans), supervision can be justified to ensure that the AMC remains financially sound, to avoid losses on banks' portfolios of AMC bonds. However, supervisory agencies may not be equipped to understand and supervise an AMC. Bringing an AMC under financial supervision may also send a message that it is a permanent fixture, even though it is intended as an exceptional and temporary tool.⁷¹

Public AMCs can have important potential advantages in resolving high NPL levels. First, by forcing banks to recognize losses, public AMCs can promote transparency in banks' exposure to problem assets. Particularly in countries where there is widespread mistrust about the reliability and integrity of reported indicators of asset quality, this can be an important step towards restoring public confidence in the banking sector. Public AMCs that are accompanied by bank recapitalization schemes, allowing banks to recognize the true extent of their asset quality problems, can be particularly powerful

in restructuring weak but viable banks and in promoting transparency. Second, public AMCs can provide economies of scale in the management of distressed assets, and greater cost-efficiency owing to their size and specialization, particularly if public AMCs can focus on a relatively homogeneous set of large, complex loans, such as real estate development loans. Third, by gathering a large volume of homogeneous distressed assets, the public AMC can package them for sale to outside specialist investors, while also benefitting from enhanced bargaining power with both purchasers and borrowers. Fourth, transfer to a public AMC provides time to realize the value of these assets, thereby avoiding unnecessary losses associated with fire sales. Fifth, by carving out the largest and most complex exposures, public AMCs take some of the pressure off banks' workout units and help the bank to refocus on new lending. Lastly, by consolidating loans to a distressed borrower with a single party, public AMCs effectively eliminate complex multi-creditor issues that typically involve substantial costs and delays.

At the same time, poorly designed and managed public AMCs can do more harm than good. If not designed and managed properly, a public AMC may generate significant losses for taxpayers, undermine credit discipline, and create moral hazard. Among the problems observed in practice are (i) political interference, pressuring the public AMC to support well-connected borrowers or strategic sectors with no clear link with financial stability; (ii) weakening credit discipline, when willful defaulters can buy back their original debt at a fraction of the original value, or by incentivizing banks to continue the origination of bad loans (which is a particular concern when the public AMC acquires assets at a

71 Of the AMCs included in Cerruti and Neyens (2016), only SAREB in Spain and AMCON in Nigeria are supervised by the central bank. The SDIF was initially under the authority of the banking supervisor, then provided with formal independence together with stronger governance.

premium over market prices); (iii) a non-transparent buildup of contingent liabilities for the government that is funding the public AMC; and (iv) “warehousing”, i.e. a failure to dispose of acquired assets in a timely manner.

Mirroring experiences in other World Bank countries, experiences with public AMCs in ECA countries underscore the importance of sound design. Although proposals to establish publicly owned AMCs were launched in several countries following the GFC (e.g. in Ukraine), they were eventually established in only a few ECA World Bank client countries.⁷² Experiences across regions indicate that emerging countries often find it challenging to get the institutional set-up right. Among the common pitfalls are governance challenges, including a lack of protection from undue political interference and staffing arrangements that favor political connections over expertise. In addition, public AMCs in emerging countries are often plagued by incentive problems associated with inflated acquisition prices of problem assets. In some of the public AMCs in ECA, banks can dispose of problem assets at book value. Not only is this a powerful disincentive for robust underwriting practices at loan origination, the acquisition of problem loans at inflated prices makes it virtually impossible for the public AMC to generate a return and operate in a financially sustainable manner. Consequently, the risk of a buildup of contingent liabilities for taxpayers looms large.

The effectiveness of public AMCs in achieving their stated benefits thus depends on a long list of preconditions. Public AMCs are most likely to be effective if they have a clearly articulated, narrow mandate (e.g. resolving NPLs), with measurable goals, a sunset clause, a commercial focus, and

robust governance, transparency, and disclosure arrangements. Similarly, the acquisition of loans needs to be time-bound (so that banks have a proper incentive to sell quickly and to promote robust underwriting practices on new lending), and at realistic prices⁷³ (to reduce the risk that public AMCs unwittingly build up contingent liabilities for the government). Furthermore, the funding of the public AMC should provide time to realize the underlying value of the assets while preventing a permanent warehousing of bad loans (see Dobler et al, 2020). Lastly, public AMCs are more likely to be effective when embedded in a broader comprehensive NPL resolution strategy, with strong political will to recognize losses and undertake comprehensive reforms, supported by detailed, accurate, and up-to-date information regarding banks’ exposure to troubled assets, and underpinned by robust bank resolution, debt recovery, and creditors’ rights frameworks.

A public AMC is thus not a silver bullet for NPL resolution. Public AMCs are costly to establish and to operate, and their ultimate impact depends critically on the fine details of their design. It takes a long time for AMCs to become operationally effective and in the meantime recovery prospects and values can continue to fall rapidly. Therefore, their costs and benefits should be assessed carefully and all other options should be examined before recommending the creation of a public AMC. Alternative measures should be considered if a sound institutional design cannot be guaranteed, when the political will to recognize losses is lacking, when there is no clarity about the level of banks’ exposures to troubled assets, or when there are profound weaknesses in the enabling environment.

⁷² Azerbaijan and Kazakhstan among others established public AMCs following the GFC.

⁷³ Ideally, market-prices if available.

c) The EU context

Some of these design features are covered in EU regulations for establishing AMCs. According to these regulations, AMCs can be established either (i) without involvement of public resources (i.e., private AMCs) or (ii) with public support that is compatible with the EU Treaty (Art. 107). To comply with state aid rules, the transfer price of assets to the AMC may be above the market price as long as it does not exceed the real economic value, defined as the “underlying long-term economic value of the assets, on the basis of underlying cash flows and the broader time horizon”. The transfer of assets at book value is not permitted. If the transfer price exceeds the applicable market value of the assets, then the existence of state aid (to the bank that is selling the distressed assets) is presumed (Galand et al, 2017).⁷⁴ Under the EU Banking Recovery and Resolution Directive (BRRD), such public support would usually trigger the bail-in of the bank’s junior creditors and hybrid instruments holders and requires the implementation of a restructuring plan for the bank to return to long-term viability. In exceptional circumstances, exemptions to the restructuring and bail-in requirements could be granted, for example on the grounds that the public support addresses a market failure or remedies a serious disturbance in the economy or threat to financial stability.

The European Commission has published guidance on the design and set-up of a public AMC. In March 2018, the European Commission published the AMC Blueprint⁷⁵ to provide guidance to Member States. It requires AMCs to be fully compliant with the EU legal framework including state aid rules, the BRRD, and the Single Resolution Mechanism Regulation. Furthermore, it elaborates

on (i) the suitability of assets to be transferred to an AMC, (ii) asset valuation and transfer price aspects, (iii) the need for granular, timely, and accurate data on loans and collaterals, (iv) funding aspects, and (v) safeguard mechanisms and proper supervision. The AMC Blueprint describes scenarios under which NPLs can be transferred from a bank to a public AMC. The European Commission envisages four scenarios: (i) no state aid: a publicly supported AMC purchases NPLs from a bank at market price (i.e. the AMC merely acts as a market maker); (ii) resolution: in the context of a resolution of a failed bank, the use of the asset separation tool can require the creation of an AMC to take over and resolve the failed bank’s estate; (iii) insolvency proceedings against a failing bank under national law: separation of the “good” part of an ailing bank for sale, from the “impaired” part managed by an AMC, under ordinary insolvency proceedings; and (iv) precautionary recapitalization: exceptional state aid when a bank is not failing or likely to fail but is likely to become distressed if economic conditions were to worsen materially. Transfer of NPLs to an AMC can be associated with a state recapitalization of a bank under certain conditions.

⁷⁴ <http://european-economy.eu/2017-1/non-performing-loans-and-state-aid-rules/>

⁷⁵ EC AMC Blueprint. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018SC0072&from=EN>

5. THE ENABLING ENVIRONMENT: INSOLVENCY AND CREDITORS' RIGHTS

The aftermath of the GFC highlighted the critical importance of well-functioning insolvency frameworks and creditor rights for NPL resolution. Weaknesses, such as the absence of a business rescue culture and a heavy reliance on poorly functioning courts, with time-consuming judicial processes and unpredictable rulings, hindered the initial policy response and caused major bottlenecks in subsequent efforts to reduce banks' exposure to problem assets. These shortcomings rendered legal enforcement comparatively unattractive, encouraging banks to keep non-viable borrowers afloat with extend-and-pretend practices. They also hindered the development of secondary markets for NPLs and weakened repayment discipline by allowing willful defaulters to halt debt service payments without facing consequences.

In the decade following the GFC, many ECA countries embarked on comprehensive legal reforms to modernize their insolvency and creditors' right systems. Most ECA countries have reformed their enforcement laws, bailiff systems, civil procedure codes, and insolvency legislation among others. As part of their national NPL reduction strategies, countries such as Albania, Greece, Hungary, and Serbia also strengthened their frameworks for loan recovery and financial distress, debt resolution, and insolvency systems. These reforms gave a new impetus to countries' NPL resolution drive and have been an important factor behind the lowering of reported NPL ratios in many ECA countries in the years prior to the pandemic.

The pressures on asset quality will put these overhauled legal systems to the test. Over time, rising levels of borrower distress as a result of the COVID-19 pandemic will inevitably increase the number of enforcement cases, litigation, and insolvency. The increase in caseloads and the increased difficulties in differentiating between viable and unviable borrowers will likely strain existing administrative and institutional capacity. Bottlenecks may emerge, leading to longer times to deal with judicial proceedings, lower recoveries for creditors, and deteriorating prospects for distressed but potentially viable debtors to continue operating as a going concern.

This chapter focuses on the enabling environment for NPL resolution. It adopts a holistic perspective, covering the ability of creditors to recover their claims, the enabling environment for rehabilitating distressed but potentially viable borrowers, as well as some of the legal preconditions for facilitating the sales of portfolios of NPLs. All these elements will need to work together seamlessly to successfully manage rising volumes of NPLs and, ultimately, restore economic activity and lending. This chapter discusses the importance of legal systems for NPL resolution, with an emphasis on some of the specific COVID-19-related challenges that can be anticipated, reforms undertaken by ECA countries in legal systems in the aftermath of the GFC, ad hoc legal measures adopted as a response to COVID-19, and – lastly – priorities for public policies going forward.

The importance of legal systems for NPL resolution

The prospect of renewed pressures on asset quality in ECA region puts a high premium on establishing a legal environment that supports banks' efforts in resolving NPLs. Legal systems matter at every stage of the NPL resolution process. A modern, credit-based economy requires predictable, transparent, and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system. These systems must be designed to work in harmony, as elaborated in the World Bank's Insolvency and Creditor Rights (ICR) principles (World Bank, 2015)⁷⁶ and the UNCITRAL Legislative Guide on Insolvency Law.⁷⁷ Contracts need to be binding and enforceable, collateral should serve its ultimate purpose of guaranteeing transactions and should be easily enforceable upon default. The legal and regulatory system should not introduce elements that impede or significantly discourage NPL transactions (i.e. portfolio sales). Tax and banking regulations should not be major impediments to write-offs and out-of-court agreements between firms in financial distress and their main creditors. Moreover, the insolvency system should permit distressed but viable firms to be brought back to commercial viability and promote the swift liquidation of unviable borrowers. Each of these elements should be applied by a cadre of trained, efficient, and transparent institutions that encompass bailiffs, tax authorities, insolvency administrators, and, critically, courts.

a) Credible enforcement and insolvency frameworks

Well-functioning enforcement mechanisms and insolvency frameworks are critical for the effectiveness of banks' efforts to recover bad loans and for their appetite to support the economic

recovery with fresh lending. An efficient, transparent, and predictable legal and institutional system for recovering debt is the cornerstone of any functioning credit market. When faced with increasing strains on asset quality, poorly functioning frameworks will hinder banks' efforts to collect on bad loans, and (through lower expected recoveries) will ultimately also increase credit losses. In addition, the absence of reliable mechanisms to quickly seize and sell any pledged collateral or (in the case of unsecured loans) enforce against any immovable or movable property of the debtor will make banks and other credit providers reluctant to lend to new customers. This can particularly disadvantage underserved, credit-constrained sectors in the economy and keep the banking sector from fulfilling its potential in supporting the economic recovery with credit. Enforcement and insolvency frameworks are also key for maintaining repayment discipline and for developing markets for portfolios of NPLs. Moral hazard associated with willful defaulters has been particularly problematic in ECA countries where borrowers have had ample opportunity to delay enforcement proceedings by engaging in delay tactics such as repeated appeals, postponements, or on account of slow, ineffective, or corrupt courts. Lastly, the quality of legal and institutional systems for recovering debt is an important factor determining the returns that prospective investors in portfolios of NPLs can expect. It is therefore an important factor influencing the pricing of distressed assets, as well as the feasibility of developing markets for such assets.

Existing legal and institutional systems of debt resolution and insolvency can impede banks' capacity to resolve NPLs. In practice, most legal systems have shortcomings in one or more areas that affect NPL resolution. Common problems

⁷⁶ <http://www.worldbank.org/insolvency>

⁷⁷ https://uncitral.un.org/en/texts/insolvency/legislativeguides/insolvency_law

include: difficulties in enforcing the debtor's assets in an extra-judicial or judicial process (either because of weak laws or because of poor enforcement systems); poor collateral legislation or dysfunctional registries (real estate, pledges, etc.); difficulties in restructuring a company due to impediments in the insolvency system or in the tax legislation; poorly designed or outdated liquidation regimes, including possible unclear repayment priorities—for example, privileged creditors (such as government tax and employee wage claims) may have priority over secured lenders; an environment unconducive to workouts; central bank (or supervisory) regulations that discourage distressed asset sales; regulatory challenges related to NPL portfolio purchases (for example, requirements that the purchaser is registered as a local financial entity); unfavorable tax treatment of NPL transactions; requirements for the ultimate debtor's consent to transfer purchased assets; difficulties in restructuring a company due to the lack of capacity of key local players such as insolvency practitioners or judges; absence of priority for rescue financing or debtor-in-possession financing to distressed companies; among many others (Cerruti et. al., 2019).⁷⁸

The legal and regulatory environment should provide proper incentives for banks to aim for quality restructurings. This is an area where many countries in ECA region experienced serious challenges in the aftermath of the GFC. The problem was twofold. First, poorly functioning enforcement and insolvency frameworks biased banks' decisions vis-à-vis non-viable borrowers towards low-quality restructurings. This locked up the credit stock in

underperforming economic sectors, contributing to the rise of zombie borrowers⁷⁹, at the expense of more dynamic borrowers. Second, the lack of exit for non-viable borrowers coexisted with significant missed opportunities in terms of preserving economic activity, jobs, and livelihoods. Efforts to rehabilitate distressed but potentially viable borrowers often failed in the absence of modern out-of-court restructuring frameworks, while courts (that were often lacking in economic and financial expertise and resources) steered such borrowers towards liquidation if the insolvency system was used at all.

Well-functioning, modern insolvency frameworks enable the financial and operational restructuring of distressed but potentially viable borrowers.

In addition to the traditional liquidation tool (i.e. the sale of the borrower's assets or business and distribution of the proceeds among creditors), modern insolvency frameworks also permit reorganization to restore the commercial and financial viability of the distressed borrower.⁸⁰ Reorganizations comprise two elements: (i) financial restructuring, i.e. the restructuring of the borrowers' liabilities⁸¹ and (ii) operational restructuring, i.e. fundamental changes in the company's operations (such as divestment, discontinuation of non-core activities, and reductions in staff) to restore its commercial viability.

Expedited reorganization proceedings (also known as "pre-packs") allow the debtor and creditors to negotiate efficiently out-of-court. As per a specific process, typically prescribed by the insolvency law, these agreements are brought to the

78 See Chapter 2 <https://hubs.worldbank.org/docs/ImageBank/Pages/DocProfile.aspx?nodeid=31386200>

79 This also occurred in advanced countries (Banerjee and Hoffman, 2018). https://www.bis.org/publ/qtrpdf/r_qt1809g.htm

80 See the World Bank ICR principles and the UNCITRAL Legislative Guide on Insolvency Law.

81 Note that *financial* restructuring comprises a wider set of liabilities than *loan* restructuring, which focuses on credit facilities provided by banks. Financial restructuring may also involve liabilities with suppliers, the tax authority, labor claims, etc.

court for approval. Once the legal requirements are met⁸² and court approval has been obtained, these agreements bind dissenting and non-participating creditors, which solves the problem of so-called holdouts and free riders.⁸³ One of the key objectives in insolvency proceedings, whether accelerated or standard, is to achieve the necessary majorities amongst each class of creditors for the approval of a reorganization plan, comprising financial and operational restructuring.

Insolvency frameworks can greatly help the feasibility of arranging successful rehabilitation, by allowing creditors to reliably estimate their expected recoveries under various resolution scenarios. This is particularly important in complex, multi-creditor cases. As is the case in other emerging economies, loans in ECA countries are often not syndicated. Consequently, large borrowers often have loans with various banks, each of which may have different strategies and collateral positions vis-à-vis the same borrower, which can make it difficult to achieve a successful workout. Enforcement and insolvency systems that work in a predictable manner help to overcome these difficulties by allowing creditors to assess their own situation more accurately.

Legal frameworks need to enable debt reduction and should be supported by tax regimes that do not unduly disincentivize restructuring. A workout or a reorganization that is considered

“taxable”, especially if the applicable taxes or levies are disproportionately high, may discourage the parties from closing a deal. The treatment of workout restructurings and formal reorganizations should be similar, to avoid incentivizing the parties to file a judicial process if the tax treatment is preferential in those circumstances.⁸⁴ The legal difficulties for tax authorities and state-owned banks to grant debt reductions in out-of-court workouts (and, sometimes, also in in-court reorganizations), also poses a challenge for efficient debt restructuring. While a few countries have adopted legislation expressly permitting tax authorities to grant “market-based” debt reductions or concessions in the context of a reorganization, these have not been widely used. The reluctance to grant concessions seems to be due to fears that tax authorities and state-owned banks could face political retaliation and charges of destroying state property.

b) Timely write-offs and sales of portfolio of NPLs

There are often legal requirements that banks first exhaust all possible measures before write-offs are allowed and tax deductibility is granted. Banking regulations generally allow, and at times even encourage, banks to write-off loans.⁸⁵ The act of writing-off does not imply that banks are forfeiting their claim on the borrower, nor does it impede banks’ collection efforts. In practice, however, write-offs and the granting of tax deductibility do often require banks to first exhaust all other options. This

82 The requirements are generally similar those of a full reorganization process, including majorities and publicity of the agreement. Pre-packs, in their different variations, were extensively used to resolve large Argentine companies during the 2001 crisis and in Serbia to restructure SOEs in the last decade, just to cite two examples. They are frequently used in the US as well.

83 Holdouts are creditors that are in a position to block a restructuring and use that leverage to extract additional value for themselves (i.e., payment in full from the debtor) while free riders are creditors that do not contribute to a restructuring but obtain the benefit of a financially healthier debtor at the expense of those creditors that made concessions.

84 During crises, a preferential tax treatment is often granted to restructurings, for example, by waiving income tax in case of “haircuts” (debt reductions are usually an “income” for debtors, and therefore taxable). In a context of acute financial distress or widespread crises, many countries eliminated such tax for a determined period of time which helped to promote reorganizations.

85 Going a step further, in some countries banking regulations encourage banks to write-off fully provisioned loans that have been non-performing for several years.

entails a final court ruling which can be difficult and time-consuming to obtain.⁸⁶ Although most jurisdictions now allow deductions for tax purposes for provisions and write-offs, the conditions that need to be met for the deductions to be allowed can sometimes introduce added complexities for banks when booking provisions or writing-off loans.

Several legal and regulatory preconditions need to be in place to allow for the sales of portfolios of NPLs.

The sale of NPLs requires that the legal system allows the transmission of claims on the borrowers to the investor in such assets without requiring the debtor's consent. The investors then replace the bank that originated the loan as the creditor, with a similar juridical position and corresponding rights and obligations. Other potential legal obstacles for NPL sales can include bank secrecy and data protection laws, that can impede the sharing of information between the bank and acquirer; requirements on the registration of security interests transferred with the NPLs; notification to debtors and the position of guarantors of NPLs; and preemption rights of borrowers, among others. Lastly, regulatory frameworks need to allow prospective investors to set up appropriate investment structures for the investment in distressed assets. In Turkey, for instance, a captive market exists as state-owned banks can only sell NPLs to licensed AMCs, diminishing the feasibility of garnering (foreign) investor interest and overall market development.

Efforts to strengthen the enabling environment for the development of NPL markets need to be underpinned by sound financial consumer protection frameworks. Concerned that prospective investors, such as hedge funds and other investment funds, would significantly step up collection

efforts, financial consumer organizations have at times resisted legal reforms to enable the development of NPL markets. These concerns highlight the importance of robust financial consumer protection to protect borrowers against overly aggressive or unfair collection efforts by prospective investors.

Legal and institutional reforms in ECA between the GFC and COVID-19

Many ECA countries introduced temporary enforcement moratoria in the early stages of the GFC. They did so by imposing temporary stays on creditor enforcement against debtors, aimed at avoiding a premature liquidation of firms that were experiencing payment difficulties during the crisis. With banks and other creditors experiencing serious liquidity pressures at the time, the concern was that creditors' scramble for liquidity would increase the risk of pushing distressed but viable firms into liquidation. The suspension of creditor enforcement was a relatively crude tool. It constituted a legal obligation for banks and applied to a broad range of borrowers, with no role for banks in assessing the borrower's long-term viability, willingness to pay, and whether the financial difficulties could be credibly attributed to the crisis. Consequently, many of the borrowers that benefitted from the suspension in creditor enforcement failed to keep up with repayment obligations once the measures were withdrawn. In some countries, such as Greece and Ukraine, the withdrawal of these measures proved challenging, particularly for natural persons (see box 5.1).

⁸⁶ Usually, first instance court decisions can be appealed and, depending on the debtors' willingness to defend and the court system of the country, the resolution of a final judgment can take anywhere between a couple of months to several years.

Box 5.1: Enduring enforcement moratoria for natural persons

Following the GFC, some countries suspended creditors' ability to enforce against certain debtors. Countries affected by the GFC sometimes saw their currencies suffer sharp depreciations. Against a backdrop of widespread forex-denominated lending, these depreciations led to the emergence of forex-induced credit risk. Consequently, unhedged retail borrowers with incomes in domestic currency experienced increasing difficulties in meeting their debt service obligations. In Ukraine, for example, a moratorium preventing the enforcement of forex-denominated mortgages against natural persons was imposed in 2014⁸⁷, and has been extended so it remains in force.⁸⁸ Similarly, there have been specific moratoria in other countries' affected sectors preventing creditors from enforcing against them or from petitioning their bankruptcy.⁸⁹ Greece issued the Katseli law in 2010⁹⁰, which provided for a stay in the enforcement of all claims against eligible debtors (natural persons). This moratorium lasted a decade, and there seems general agreement that it was abused by bad-faith debtors.

These experiences illustrate that exiting from enforcement moratoria is politically challenging. Absent proper communication that stresses the temporary and exceptional nature of these measures, the risk looms large that these enforcement moratoria are perceived as a "new normal", preventing their timely withdrawal and fueling strategic behavior by willful defaulters that are financially able to repay but opt not to. In addition, enforcement moratoria prevent creditors from exercising their rights as agreed in the original contract and, therefore, create unpredictability in the system. While legitimate social considerations may have justified their introduction, experiences in Greece and Ukraine highlight that these measures can be prone to political pressures favoring their prolongation.

Avoiding a repetition of such a scenario should be a top priority for policymakers in countries that have introduced enforcement moratoria in the aftermath of the pandemic.

Expectations need to be managed carefully and policymakers will need to clearly communicate the time-bound and exceptional nature of the measures to borrowers. The experiences of Greece and Ukraine illustrate that absent such efforts, pressures to prolong enforcement moratoria are difficult to resist.

87 Law 1304-VII (On Enforcement against Property Provided as Collateral for Foreign Currency Loans), 3 July 2014

88 Law 3640 (2020).

89 For example, the SOEs in the coal mining sector, which benefitted from such suspension as per law 2021-VIII (On Recovering Solvency of State Coal Mining Enterprises), 24 May 2017.

90 Law 3869/10, whose main objective was to assist vulnerable debtors and protect their primary residence.

Subsequently, the difficulties in resolving rising volumes of NPLs brought home the need for reforms to address weaknesses in debt resolution, insolvency, and creditors' rights.

In the decade following the GFC, many countries reformed their enforcement laws, bailiff systems, civil procedure codes, and insolvency legislation. Several countries also undertook measures to allow for faster enforcements, including by introducing out-of-court mechanisms for enforcement. Some countries also implemented institutional changes to strengthen the judiciary and capacity of the main actors (judges, bailiffs, insolvency administrators etc.), with reforms often still ongoing at the start of the pandemic.

Thanks to these legal and institutional reforms, ECA countries are now in a better position than before to resolve rising volumes of bad debts.

The list of countries that modernized their insolvency and debt resolution systems in the region is extensive (see Box 5.2). Reform efforts focused

on a broad range of areas, such as: (i) the modernization of insolvency laws, including through the introduction of proper reorganization systems; (ii) the introduction of the possibility of financing viable companies in financial distress while undergoing a reorganization.⁹¹ Also, granting priority to creditors that provide fresh financing, in line with leading practices; (iii) the introduction of a “best interest of creditors test” or a similar rule that determines that no creditor should have a plan imposed that offers a pay-off lower than the liquidation of the company; (iv) the introduction of accelerated reorganization proceedings; (v) the incorporation of an expedited treatment for no-asset cases; (vi) the introduction of electronic auctions; and (vii) the possibility to sell the business as a going concern, even during liquidation, etc. These reforms, together with changes in the strengthening of enforcement proceedings (i.e. often through introducing the option to proceed with an out-of-court enforcement) considerably strengthened the legal framework of many countries in ECA.

Box 5.2: Insolvency and debt resolution in reform – post-GFC experiences in ECA

Following the GFC, several countries in ECA region embarked on far-reaching structural reforms to revamp their insolvency laws. The increase in NPLs following the GFC brought home the need to reform insolvency regimes to allow banks to work out rising volumes of NPLs, preserve financially distressed but potentially viable businesses, and curb credit losses for banks. Albania, Armenia, Bulgaria, Cyprus, Kazakhstan, Latvia, and Romania⁹² among others, opted to significantly modernize their insolvency laws by repealing old statutes and passing new legislation, generally aiming to move away from traditional liquidation regimes and incorporate modern insolvency creditor/debtor regimes with an emphasis on reorganization.

In countries most deeply affected by the GFC, the general trend has been to reform insolvency legislation in several rounds. ECA countries such as Serbia, Ukraine, and others

⁹¹ In most cases, companies that are undergoing restructuring need cash urgently, to repay their imminent liabilities. A successful rehabilitation is practically impossible to achieve if the law does not allow the provision of fresh financing.

⁹² The World Bank Group assisted the governments of Albania and Kazakhstan in their efforts to revamp insolvency systems.

introduced a series of modifications to their legislation in the years following the GFC.⁹³ Most eliminated complex provisions incorporated in their insolvency systems by putting in place simpler and more straightforward procedures, including pre-arranged reorganizations (also called “pre-packs”), and then making further amendments to their systems as challenges emerged.

A handful of countries opted for more targeted reforms of their insolvency regime. Some countries, such as Estonia, Croatia, and Poland, made major amendments to their systems aimed at avoiding unnecessary liquidations of viable companies. This was done, for example, through the creation of additional pre-insolvency proceedings, which the EU later (2019) incorporated in a Directive.

There has been a general trend in the EU to enhance the use of out-of-court frameworks to alleviate the pressure on courts. System-wide increases in NPL volumes lead to a surge in the number of filings and can overburden court systems, which subsequently struggle to fulfill their basic functions properly. Several EU countries that experienced steep increases in NPL volumes in the aftermath of the GFC (including Greece, Latvia, Portugal, Romania and Slovenia) remodeled their out-of-court workout frameworks. Out-of-court workouts are particularly useful in times of crises as they involve no judicial intervention and thus offer a faster, cheaper, and more flexible alternative compared to formal insolvency proceedings.

Recent developments in the EU may give these legal reforms a new impulse. In 2019, the EU adopted a new Directive on Restructuring and Insolvency (2019/1023), that aims to standardize pre-insolvency proceedings. This addressed preventive restructuring frameworks, discharge of debt and disqualifications, and measures to increase the efficiency of procedures concerning restructuring, insolvency, and discharge of debt. The Directive obliges all EU Member States to incorporate pre-insolvency proceedings. Once fully implemented, it will lay a framework that enables the early restructuring of firms that are facing *imminent* financial distress. The objective is that debtors file earlier for pre-insolvency proceedings, which offers better prospects for engineering a successful turnaround – as it is often the case that debtors only file for reorganization at a late stage when there is little left to save and recovery prospects are poor. The

EU Directive already passed before the pandemic, in March 2019. The pandemic will help to accelerate its implementation.

In addition, an EU Directive to strengthen collateral enforcement has been proposed.⁹⁴ The proposal promotes the introduction of accelerated, extrajudicial collateral enforcement. This would help avoid the unnecessary erosion of collateral values due to time-consuming enforcement procedures, strengthen recovery rates, reduce credit losses for originating banks, and increase the attractiveness of bad loans with accelerated collateral enforcement for prospective investors in portfolios of NPLs, boosting the development of markets for such assets. Once in place, the expectation is that banks and other credit institutions would seek to allow for accelerated, extrajudicial collateral enforcement on newly originated loans.

⁹³ In the EU, reforms in Greece and Spain followed a similar process.

⁹⁴ <https://ec.europa.eu/transparency/regdoc/rep/1/2018/EN/COM-2018-135-F1-EN-MAIN-PART-1.PDF>

Despite ECA region's many legal reforms over the past decade, institutional capacity to put these enhanced legal frameworks to effective use is often weak. Outdated perceptions are part of the problem. Borrowers still view the insolvency system as a stigma while banks seek to avoid it due to past problematic experiences and concern over handing control to a judiciary that is perceived to be inefficient. Judges may lack training and specialization in commercial cases (not to mention insolvency or enforcement) and have only limited resources to perform their duties. Insolvency administrators are often poorly remunerated, not properly supervised, and can lack the proper qualifications. The introduction of private bailiffs –to attract younger, more dynamic, and transparent professionals – has not always lived up to expectations as many countries have experienced that former public bailiffs have often been rehired as private ones. In sum, while many ECA countries have done a commendable job in modernizing their enforcement and insolvency laws, weaknesses in the supporting institutions, including skills gaps in courts, untrained and minimally supervised insolvency administrators, and a lack of familiarity among creditor and debtor advisors with newly introduced restructuring tools, may prevent them from reaping the full benefits of past reforms.

These institutional capacity constraints may become acute when faced with renewed (COVID-19-related) pressures on asset quality. Crises test legal and institutional systems, as they impose an additional burden on the banking, corporate, and judicial system, with an increase in debt and litigation cases stretching the capacity of a wide range of actors – creditors, debtors, advisors, and the judiciary.

Legal measures in ECA region following the pandemic

The pandemic has promoted innovations in court systems, that can improve access to justice and reduce delays and costs. Several countries have forged ahead with digitization by strengthening their electronic court systems. Given the health concerns over the pandemic, and the consequent closures and procedural suspensions during the emergency period, some ECA countries have introduced or enhanced the infrastructure for electronic filing for insolvency and remote creditor meetings, among other improvements to make insolvency proceedings electronically accessible. In addition, ensuring access to judgments online also increases the transparency of justice systems and can contribute to enhanced consistency in case-law. Latvia⁹⁵ and Scotland⁹⁶ are among the countries that have made reforms along these lines.

In addition, some countries have undertaken short-term legal measures to flatten the so-called bankruptcy curve. Some countries have introduced or raised threshold requirements for creditors commencing insolvency processes. Poland, for instance, adopted the Anti-Crisis Shield 4.0, which suspended the 30-day deadline for filing a petition for bankruptcy, while Belgium, the Czech Republic, Italy, Russia, and Spain introduced short-term restrictions for creditors to petition bankruptcy proceedings. In addition, several common law countries⁹⁷ have for a limited time suspended the legal requirement of directors to put companies into insolvency and the associated personal liability

95 <https://www.insol-europe.org/download/documents/1703>

96 <http://www.legislation.gov.uk/asp/2020/10/schedule/1/part/5/enacted>

97 See <http://www.legislation.gov.uk/ukpga/2020/12/contents/enacted/data.htm> and <https://services.parliament.uk/Bills/2019-21/corporateinsolvency-andgovernance.html>

(Menezes and Muro, 2020).⁹⁸ The suspension of the duty to file and the corresponding legal liability is meant to flatten the insolvency curve. Suspending personal liability of directors for wrongful trading will offer some relief during this crisis, when assessing business solvency is difficult and restructuring solutions may be sought. Lastly, several countries suspended or extended procedural terms. Bulgaria, for example, imposed a general stay on procedural terms and suspension of court hearings, effective for the period of the emergency.⁹⁹ It applies to all procedural terms on administrative, litigation, arbitration, and enforcement proceedings. Croatia suspended all sales of assets and enforcement proceedings.¹⁰⁰ Electronic public auctions for the sale of assets in court proceedings (including bankruptcy proceedings), as well as enforcement procedures are suspended for the duration of the pandemic, while the default interest rate has been temporarily abolished. Italy temporarily suspended hearings and procedural terms and eliminated the duty to recapitalize in order to avoid liquidation.¹⁰¹

Although the policy objective to preserve economic activity is highly relevant under the current extraordinary circumstances, these short-term legal measures can have unintended side effects if they remain in place for too long. Many insolvency systems, in their standard form, already provide for a suspension in creditors' enforcements, giving debtors breathing space to reorganize. In countries where reorganization proceedings work properly, the stay in creditor enforcement is used to design a restructuring plan. This is, however, not the case in all countries. The additional time

granted by enforcement moratoria may add to delays in proceedings. While these short-term measures played a useful role at the beginning of the crisis, their impact needs to be monitored closely as their prolongation can inadvertently block or delay the exit for zombie borrowers, that were often already facing financial difficulties prior to COVID-19 and have poor recovery prospects. Similarly, these measures can weaken incentives for debtors to repay to their full financial capacity. With a reduced threat of legal action, willful defaulters that are financially capable of repaying but opt not to may use the opportunity to default. How the trade-off between these potential benefits and unintended drawbacks works out in concrete cases is highly country specific, but these side effects highlight the importance of credible exit strategies.

Policy priorities going forward

In the short-term, policymakers will need to design a credible exit strategy from the current short-term legal measures. The short-term legal measures are essentially a crisis tool, designed as a circuit breaker to avoid unnecessary liquidations. They do not provide a long-term solution. Once creditors can again enforce and petition bankruptcies, vis-à-vis debtors that they consider to be non-viable, the backlog of deferred cases could potentially overload court systems. Countries have generally stressed the temporary and exceptional nature of these short-term legal measures. Many include sunset clauses with clear end dates, but the experiences of Greece and Ukraine illustrate

98 In most countries, directors have a duty to act in the creditors' interests when a firm is on the edge of insolvency. This is designed to prevent businesses from significantly growing their liabilities when management knows the business is unlikely to be able to repay them. A duty to file for insolvency and the corresponding liability for any damages to creditors arises as the debtor becomes insolvent. See <http://pubdocs.worldbank.org/en/912121588018942884/COVID-19-Outbreak-Implications-on-Corporate-and-Individual-Insolvency.pdf>

99 [https://www.lexisnexis.co.uk/blog/restructuring-and-insolvency/insol-europe-lexisnexis-coronavirus-\(covid-19\)-tracker-of-insolvency-reforms-bulgaria](https://www.lexisnexis.co.uk/blog/restructuring-and-insolvency/insol-europe-lexisnexis-coronavirus-(covid-19)-tracker-of-insolvency-reforms-bulgaria)

100 <https://www.insol-europe.org/technical-content/covid19>

101 Law Decree 17 March 2020 no 18 (converted into law 24 April 2020 no. 27), and Law Decree 8 April 2020 no. 23 (which will be converted into law 60 days from its publication, which took place on 8th April 2020), [https://www.lexisnexis.co.uk/blog/restructuring-and-insolvency/insol-europe-lexisnexis-coronavirus-\(covid-19\)-tracker-of-insolvency-reforms-italy](https://www.lexisnexis.co.uk/blog/restructuring-and-insolvency/insol-europe-lexisnexis-coronavirus-(covid-19)-tracker-of-insolvency-reforms-italy)

that political pressures can be difficult to contain and that there is a real risk that these enforcement moratoria become permanent fixtures. As is the case with the moratoria and other exceptional borrower relief measures, the general principle is that these measures should be unwound as soon as economic circumstances permit. Similarly, communication is critical to ensure that the short-term legal measures are not perceived as a new normal, to minimize unintended effects on repayment discipline and to avoid that zombie borrowers are given a fresh lease of life.

Once the initial mitigation measures have been lifted, incentives may need to be provided to promote restructuring of distressed but potentially viable borrowers. Encouraging workouts should be one top priority.¹⁰² In this context, the predictability of the framework for out-of-court restructuring is a key factor. The better positioned parties are to predict the outcome of out-of-court restructurings, the less likely they will resort to lengthy and expensive in-court debt recovery or insolvency proceedings. Establishing a fully functional out-of-court framework that yields predictable outcomes is generally a multiyear process – it cannot be done overnight (and less so in the midst of a crisis). A robust legal framework is a necessary but insufficient condition for predictability, since laws need to be interpreted and applied by officials and institutions that are often lacking in capacity, resources, and transparency. Non-binding central bank guidelines merely suggesting commercial banks provide a standstill to debtors and engage in negotiations with good-faith, potentially viable, borrowers have proven to be insufficient in many countries affected by the GFC. Incentives can be provided to debtors and creditors in the form of

time-bound special regimes that offer debtors and creditors one-off benefits, such as tax benefits, in exchange for agreed workout plans. These incentives can be accompanied by moral suasion on banks and creditors, encouraging them to work towards a feasible solution for distressed but potentially viable borrowers.¹⁰³

Ensuring that collateral can be enforced quickly and efficiently is a priority in ECA countries.

Several ECA countries (e.g. Latvia and North Macedonia) have been able to make good progress in collateral enforcement by enacting out-of-court enforcement laws that limit a debtor's defenses and having a fairly transparent online system of auctioning property. In many other countries in the region, collateral enforcement continues to be problematic, due to a lack or poor implementation of past reforms. It remains the case in many ECA countries that collateral enforcement is characterized by time-consuming processes and uncertain outcomes, with outdated auctioning systems leading to low recoveries. The EU proposal for a Directive to strengthen collateral enforcement and promote the introduction of accelerated, extrajudicial collateral enforcement may also be relevant for non-EU ECA countries, although its full implementation and operationalization may take time.

Post-GFC reforms have helped to align insolvency laws in ECA with good practices, but continued efforts are needed to strengthen the institutions that apply these laws. Although there is considerable cross-country diversity, a considerable gap has often emerged between modernized insolvency laws and practice due to skills gaps and limited resources in courts, untrained and minimally supervised insolvency administrators, and a lack

102 For further information about workouts, see World Bank Group. 2017. A Toolkit for Out-of-Court Workouts. World Bank, Washington, DC. © World Bank. <https://openknowledge.worldbank.org/handle/10986/28953> License: CC BY 3.0 IGO.

103 As the Bank of England did during the London approach, possibly one of the most famous workout guidelines.

of familiarity among creditor and debtor advisors (Kargman, 2020).¹⁰⁴ Insolvency is still a stigma in many countries and a resource not used sufficiently to save viable businesses. Continuous efforts are needed to bridge the gap and enhance the supporting institutional framework.

Frequent legal reforms can exacerbate the gap between modernized frameworks and actual practices. While countries across ECA region have repeatedly reformed their insolvency systems, institutions often struggle to keep up – affecting the predictability and certainty of outcomes. Frequent legislative changes can also make it hard for judges to apply the correct legislation to the multiplicity of cases they need to rule on using different statutes. In order to create a predictable system, it is necessary that reforms are absorbed, interpreted, and understood by the banking, business, legal, and judicial communities. Continuous efforts to modernize insolvency regimes can be counterproductive if this precondition is not met.

The capacity of the institutional framework to uphold and consistently apply the existing body of laws is a key consideration in deciding whether the time is ripe for further legal reforms. In countries that are still facing serious shortcomings, reform efforts should focus on upgrading the institutional framework, rather than embarking on complex new laws. If, however, the legal framework is underpinned by well-functioning institutions, further legal enhancements can be considered. The new EU Directive on Restructuring and Insolvency, that aims for more alignment in pre-insolvency proceedings across Member States, may be particularly relevant. Its overarching objective is to encourage

an earlier initiation of reorganization proceedings. It is difficult to overstate the importance of pre-insolvency proceedings considering that reorganizations are in practice often initiated at a late stage, when there is little left to save. The new Directive seeks to overcome this problem by requiring legal changes aimed at enabling the initiation of preemptive reorganizations in the event of imminent (as opposed to actual) financial distress.

Lastly, enhanced data collection systems can help countries assess the performance of insolvency frameworks in practice and inform further reforms. The current practice in most countries is that insolvency law, and creditor-debtor law in general, is designed without the support of detailed data on the actual performance of the system or challenges experienced in its application (Garrido et al, 2019).¹⁰⁵ The continuous collection and analysis of data can help policymakers in targeting legislative changes to address specific problems. Aggregate statistics about the number of insolvency, collateral enforcement, and restructuring cases would be very helpful in assessing the performance of insolvency frameworks in practice, allowing policymakers to assess to what extent past reforms have achieved their stated objective. It would be important to closely monitor the number of agreed and, ultimately, performed restructurings. The latter measure gives a more accurate indication of whether the mechanisms in place are effectively used to restore the commercial viability of distressed borrowers.

104 See also Kargman, S. (2020). Challenges of emerging market restructurings in the age of COVID-19. International Insolvency & Restructuring Report 2020/21. <http://blogs.harvard.edu/bankruptcyroundtable/files/2020/08/IIRR-2020-21-S.-Kargman-Challenges-of-EM-Restructurings-in-the-Age-of-COVID-19.pdf>

105 The paper gives a detailed overview of the type of data that could be usefully gathered to inform future policy-making, see <https://www.imf.org/en/Publications/WP/Issues/2019/02/04/The-Use-of-Data-in-Assessing-and-Designing-Insolvency-Systems-46549>

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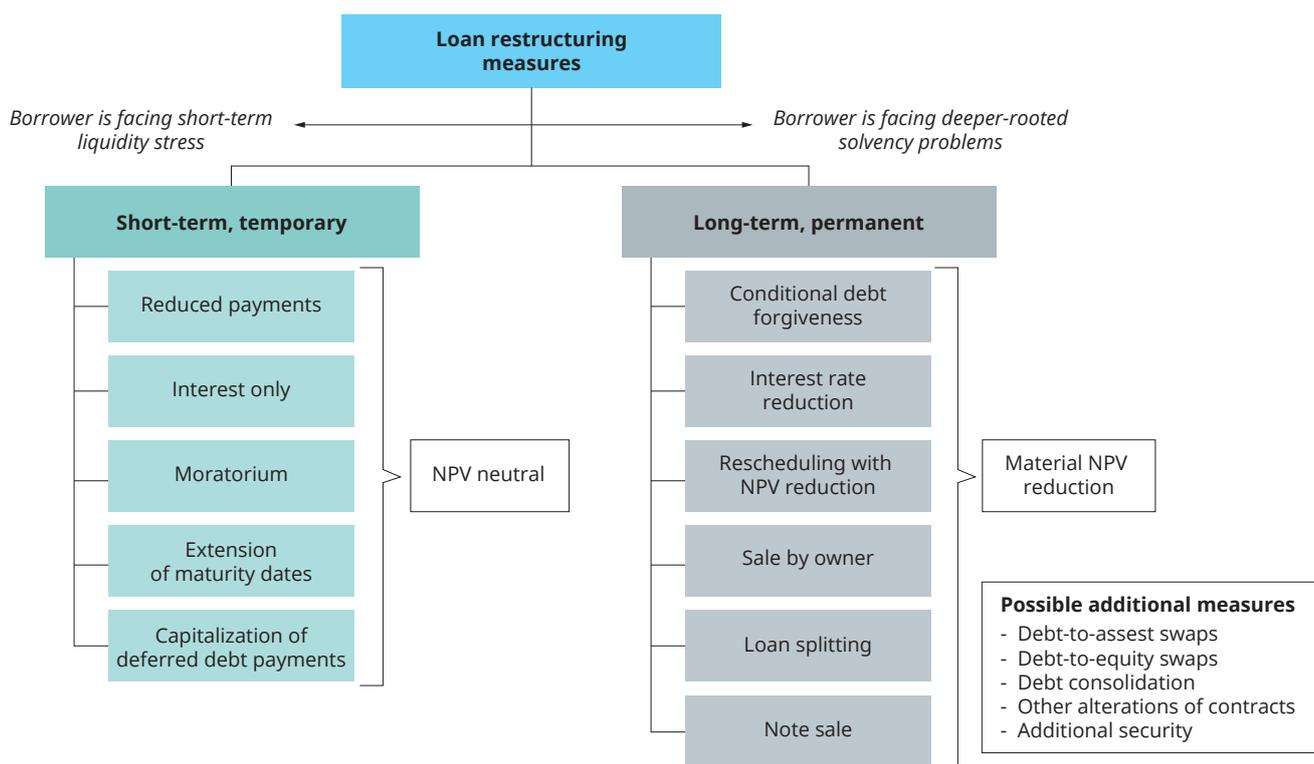
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Annex 1: Short-term versus long-term loan restructuring

A conceptual distinction can be made between short-term loan restructuring measures¹⁰⁶, aimed at providing temporary relief to borrowers following a short-term disruption in income and cash flows,

and longer-term loan restructuring designed to reduce a borrower's debt. The graph below illustrates this distinction and summarizes the range of possible measures.



Source: Adaptation from Handbook for MSME NPL Management and Workout. <https://www.bsi.si/en/publications/other-publications/handbook-for-msme-npl-management-and-workout>

Short-term measures are appropriate to use when there is a reasonable expectation that the borrower's sustainable cash flow will be strong enough to allow the resumption of its existing payment schedule at the end of the forbearance period. This is admittedly a challenging proposition at this point in time, while the economic impact of COVID-19 is still unfolding, and it is often not yet clear whether a particular borrower suffers from short-term liquidity challenges, or whether repayment capacity is

permanently impaired. Notwithstanding, the short-term measures in the graph above can be used in combination with longer term solutions such as an extension of maturity, revision in terms, and additional security. Specific short-term measures to consider include:

- **Reduced payments** – the company's cash flow is sufficient to service interest and make partial principal repayments.

106 Note that short-term measures can also be used to give time for banks to assess the situation and determine an appropriate course of action, thus leading the way for longer term measures.

- **Interest only** – the company's cash flow can only service its interest payments and no principal repayments are made during a determined period of time.
- **Moratorium** – an agreement allowing the borrower to temporarily suspend payments of principal and/or interest for a clearly defined period, usually not to exceed 90 days. This technique is also often used in the beginning stages of a workout process (especially with multi-bank borrowers) to allow the bank and other creditors time to assess the viability of the business and develop a plan for moving forward.
- **Rescheduling/extension of maturity** - extension of the maturity of the loan (i.e., of the last contractual loan installment date) allows a reduction in installment amounts by spreading the repayments over a longer period.
- **Interest and repayment capitalization** – adds deferred payments and/or deferred interest to the outstanding principal balance for repayment under a sustainable revised repayment program.

Longer-term/permanent options are designed to permanently reduce the borrower's debt. Most borrowers will require a combination of the options mentioned below to ensure repayment. In all cases, the bank must be able to demonstrate (based on reasonable documented financial information) that the borrower's projected cash flow will be sufficient to meet the restructured payment terms. Specific options to consider include:

- **Conditional debt forgiveness** - involves the bank forfeiting the right to legally recover part or the whole of the amount of an outstanding debt upon the borrower's performance of certain conditions. This measure may be used when

the bank agrees to a "reduced payment in full and final settlement", whereby the bank agrees to forgive all the remaining debt if the borrower repays the reduced amount of the principal balance within an agreed timeframe. Banks should apply debt forgiveness options carefully since the possibility of forgiveness can give rise to moral hazard, weaken the payment discipline, and encourage "strategic defaults". Therefore, institutions should define specific forgiveness policies and procedures to ensure strong controls are in place.

- **Interest rate reduction** – involves the permanent (or temporary) reduction of the interest rate (fixed or variable) to a rate that is more sustainable for the borrower. This option could be considered when the evolution of interest rates has resulted in the borrower receiving finance at an exorbitant cost, compared with prevailing market conditions. However, banks should ensure that the lower interest rate is sufficient to cover the relevant credit risk.
- **Rescheduled payments** - the existing contractual payment schedule is adjusted to a new sustainable repayment program based on a realistic assessment of the borrower's cash flows, both current and forecasted. The rearranged payment schedule usually leads to a reduction in debt in NPV terms. Rescheduled payments are usually combined with an extension of maturity. In addition to normal rescheduling, additional repayment options can include:
 - a) **Partial repayment** - a payment is made against the credit facility (e.g., from a sale of assets) that is lower than the outstanding balance. This option is used to substantially reduce the exposure at risk and to enable a sustainable repayment program for the remaining outstanding amount. This option

is generally preferable, from the creditor's standpoint, to the balloon, bullet, or step-up options described below.

- b) **Balloon or bullet payments** – are used in the case of more marginal borrowers whose sustainable cash flow is insufficient to fully repay the loan within the rescheduled tenor. A balloon payment is a final installment substantially larger than the regularly scheduled installments. As a rule, it should not exceed 30 percent of the original principal amount of the loan. Bullet loans carry no regular installment payments. They are payable in full at the maturity date and frequently contain provisions allowing the capitalization of interest (payment in kind interest) throughout the life of the loan.
 - c) **Step-up payments** – should be used when the bank can ensure and demonstrate that there is a good reason to expect that the borrower's future cash flow will be sufficient to meet increases (step-up) in payments.
 - **Sale by owner/assisted sale** – this option is used when the borrower agrees to voluntarily dispose of the secured assets to partially or fully repay the debt. It is usually combined with the partial repayment option or conditional debt forgiveness. The borrower must be monitored closely to ensure that the sale is conducted in a timely manner and the agreement should contain a covenant allowing the owner to conduct the sale if the borrower fails to do so within the specified timeframe.
 - **Loan splitting** – is used to address collateral and cash flow shortfalls. In this option, the debt is split into two parts: (i) the portion representing the amount that can be repaid from sustainable cash flow is repaid in equal installments of principal and interest (with a maturity not to exceed 5 years); and (ii) the remaining portion represents "excess debt" (which can be subordinated). This portion may be further split into several parts/tranches (which may be non-interest bearing or payment in kind notes) and is frequently used in combination with payments from the sale of specific assets or bullet payments at maturity.
 - **Note sale** – individual note sales are most commonly used when a new investor wishes to restructure a company's overall debt burden on commercially acceptable market terms. This option is usually combined with conditional debt forgiveness and requires that the purchase price be equal to or greater than the current NPV of the restructured loan.
- Additional measures** are not considered to be viable stand-alone restructuring/forbearance options as they do not result in an immediate reduction in the loan. However, when combined with one or more of the previously identified options, they can provide incentives for repayment or strengthen the bank's overall position.
- **Debt-to-asset swap** – converts the loan, or a portion of the loan, into "other assets owned" where the ultimate collection of the original loan requires the sale of the asset. This technique is generally used in conjunction with conditional debt forgiveness or partial loan repayment and maturity extension options. The management and sale of real estate properties also requires specialized expertise to ensure that the bank maximizes its returns from these assets.
 - **Debt-to-equity swap** – converts the loan, or a portion of the loan, into an equity investment. Generally used to strengthen the capital structure of large highly indebted corporate

borrowers. Like the debt-to-asset swap above, this option may also require the bank to allocate additional resources for managing the new investment.

- **Debt consolidation** – combines multiple exposures into a single loan or a limited number of loans (more common for retail exposure). This solution should be combined with other measures addressing existing arrears. This option is particularly beneficial in situations where combining collateral and secured cash flows provides greater overall security coverage for the entire debt than individually. For example, by minimizing cash leaks or by facilitating re-allocation of cash flow surplus between exposures.
- **Other alterations of contract/covenants** – when entering a restructuring agreement, it is generally necessary to revise or modify existing contracts/covenants to meet the borrower's current financial circumstances. Examples might include revising ratios, such as minimum working capital, or providing additional time for a borrower to sell excess assets.
- **Additional security** - additional liens on unencumbered assets (e.g., pledge on a cash deposit, assignment of receivables, or a new/additional mortgage on immovable property) are generally obtained as additional security from a borrower to compensate for the higher risk exposure or cure existing defaults in loan-to-value ratio covenants.

Annex 2: An example of comparative NPL analysis

In this highly simplified example, the factory of an SME borrower has been severely damaged in a devastating flood. The customer requests that its currently outstanding € 1,000,000 loan be restructured as follows: 1 year interest only with the balance to be repaid in 4 annual installments. The interest rate on the loan will be 5 percent. Simultaneously, an independent third-party investor offers to purchase the loan for € 825,000.

For the purposes of the NPV analysis, the bank's standard risk adjusted discount rate is 7 percent.

The collateral was valued within the past month by the bank's internal appraisal staff at € 833,333 and a 10 percent discount has been applied to adjust the price to its estimated auction sale value in year 2 under the bankruptcy scenario. The value of the property has been reduced an additional 10 percent if the bank resorts to legal actions to recognize the additional length of time to conclude these proceedings. Expenses for the enforcement proceedings are estimated to be € 2,500, and the expected duration is 3 years. Under these circumstances, the analysis indicates that selling the loan to a third party offers the highest expected NPV.

Sample NPV analysis of workout options

	NPV	Y1	Y2	Y3	Y4	Y5
Restructure	812,155					
Principle		0	250,000	250,000	250,000	250,000
Interest		50,000	50,000	37,500	25,000	12,500
Cash Flow		50,000	300,000	287,500	275,000	262,500
Loan Sale	825,000					
Cash						
Proceeds						
Legal actions	548,811					
Sale at auction				675,000		
Cost of Proceeding		(800)	(950)	(750)	674,250	

The above results are highly sensitive to the choice of the discount rate. Determining the rate is an art not a science and it should reflect both the riskiness of the borrower and a proxy for the cost of the workout. In the above example, for instance, the assumption has been made that the bank will use its internal legal staff for any enforcements or insolvency proceedings. No deductions are made, therefore, to reflect these costs. If, however, the bank had chosen to use an outside counsel, that

cost would have been reflected in the analysis as cash outflows, reducing the ultimate recovery value. Very importantly, the bank should keep in mind that loan restructuring is associated with substantial expenses to prepare, negotiate, and monitor the restructuring agreement. Banks can choose to adjust discount rates upward to more fully reflect these costs or consider using standard cost per year in the analysis so as to reflect the true costs of various workout solutions.



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