Preventive restructuring procedures as effective tools to address the problem of NPLs

Bad debts under the sofa or a more permanent solution?

Preventive restructuring procedures as effective tools to address the problem of NPL

i) What do we mean by the problem of NPL's?

ii) How does an NPL stop being an NPL?

iii) How do preventive restructuring procedures play a role or cause a hindrance?

The NPL problem

A loan is non performing when the borrower is in financial distress :

i) Unable to pay debts as they fall due : Illiquidity.

ii) Value of its assets < Amount of its debts : Insolvency.

Financial distress can take a long time to resolve.

BIS September 2017 quarterly report ; Zombie companies account for 10% of all european debt issues. (The BIS defines Zombies as listed firms older than 5 yrs with a ratio of EBIT to interest costs of below .

Such businesses :

- are fragile to unexpected external shocks (strikes, geopolitical events etc..)
- suffer more from competitive pressure (eg price wars or new entrants)
- are less able to invest in maintenance, growth capital expenditure or new technologies
- cannot envisage acquisitions
- lose best employees / unable to attract new talent and
- are not even good take-over targets beacuse in addition to the normal risks associated with an acquisition, a buyer would have to contend with excessive debt!

What should be the objectives of an ideal legislative framework to solve financial distress?

- To ensure viable businesses are able to retrieve a **competitive capital structure .** It is quite possible to have a VIABLE company with a NON VIABLE capital structure.

- To enable value creating but financially distressed projects to access **fresh liquidity**

- To render capital allocation in the **economy more efficient**, liberating capital trapped in underperforming projects so that it can be re-deployed to other value creating projects.

- Depending on political and social objectives defined by the legislator, to allocate the value represented by the company assets amongst its various stakeholders **according to rank**.

- To be predictable and fair in order to reduce the risk premium paid by all businesses **including those that will never know financial distress.**

- To ensure **RAPID** resolution, ideally through out-of court negotiation. The longer financial distress lasts, the worse for all stakeholders.

- To avoid public sector carrying the **direct and indirect cost** of private sector failure.

How does an NPL stop being an NPL?

- When at least one of five things happens :

i) **Amend and Extend**. For cyclical business or truly temporary problems this may be the most appropriate solution. However it can also be a temptation to defer difficult decisions. Beware of Zombie creation !

ii) **Consensual Asset Sale** to repay creditors or transfer to them the ownership of the assets : ie sale at market value

iii) **Capital Restructuring** : debt tranching, debt to equity swap or debt write-off. This provides the company with more financial resilience and ability to raise new money.

iv) **Non-Consensual Asset Sale** : ie liquidative sale. For businesses at the end of their life cycle this can be the best option to preserve value.

v) **Secondary Market Sale of NPL** to distressed debt specialist who aim to access value through one or several of the above

How do « preventive » restructuring procedures help with these 5 solutions?

- Before stakeholders can decide which of the above solutions to adopt, they need time i) to assess whether the enterprise is viable / what the available value is and ii) to conduct a negotiation which can be complex. **This requires a stay** of some kind which needs to be a feature for the benefit of all parties.
- It needs to happen **early enough** so the business still has enough cash during the stay. Ideally an incentive should be given to new money providers with court control to protect interests of existing creditors
- It needs to provide **adequate protection to secured creditors** (otherwise they won't want to become secured creditors in the first place..)

How do «preventive » restructuring procedures help?

- Capital restructuring sometimes require losses to be allocated to creditors or shareholders with (on a proper valuation basis) no economic interest in the enterprise. These **should not** be in a position where their "veto" could delay or disrupt otherwise viable restructurings. There should be a possibility, under appropriate circumstances, for decisions made by creditors with a continuing economic interest in the enterprise to bind creditors that no longer have an economic interest (otherwise referred to as a "cramdown" of such out-of-the-money" creditors).
- Enable creditors to present **their own plans**. This increases supply and reduces cost of new capital/liquidity raised by injecting competition into the process.
- Solve the problem of the « hold out » stakeholder seeking to monetise a blocking stake.
- By enabling a recovery of **value** rather than just recovery of **cash** when appropriate.
- By **minimising the time** required and **increasing the predictability** of the definitive solution, the value of the NPLs is enhanced through a reduction of the period of financial distress and execution risk.

How do «preventive » restructuring procedures lengthen financial distress?

- When the above does not apply
- Include an appeals process which naturally provides uncertainty and longer time before the problem is solved definitively
- Require unanimous consent
- When the stay process allows a mere deferral of the problem by hindering the new economic owners of the business rather finding a balanced value preserving solution. A well intentioned interference with creditor rights will have perverse consequences and risks generating the opposite effect
- Hinder secondary market transfers of bank debt

Conclusion : Key messages

- Financial distress is often regarded as a conflict opposing a creditor with a borrower which needs to be « saved ». It is more correct to regard the problem as a negotation between the stakeholders of the borrower on how to share the burden of ensuring maximum value is preserved.
- Restructuring Procedures only need to prevented if they are not efficient. Ideally, they should be regarded as a means if out-of court negotiations fail, to implement a solution which preserves the maximum value whilst recognising the subordinated players should assume the losses first.
- There will always be financial distress, even in good macro-economic climate. **The key is to render its management more efficient and predictable for all.**

Conclusion : Key messages

- The original directive was not perfect but actually well written and required very little modification namely:
  - Better protection for the secured creditors
  - Exclude appeal process
  - Maintain the absolute priority rule
  - Ensure creditors can submit a plan
- NB : Out of court procedures, mediations or even informal debt restructuring negotiations should NOT be regarded as substitutes for an effective, fair and predictable formal insolvency process. However such dispute resolution methods will see their efficiency considerably enhanced by the existence of an efficient downstream insolvency regime since what occurs downstream heavily impacts the conduct of an upstream negotiation.