NPLs – the ongoing symptom of a failure to embrace the value of true turnaround

March 2018 Issue

March 2018 | SPOTLIGHT | BANKRUPTCY & RESTRUCTURING

Financier Worldwide Magazine

7

BY

Matthew Quade

BM&T European

Ten years ago, as the financial crisis resulted in ever-tightening credit conditions and the European debt crisis first began to rear its ugly head, it was seemingly apparent that over-leveraged businesses would have to address underlying operational performance issues to survive.

The multiple financial restructurings of balance sheets that had been common for the past decade with lax credit rules were no longer an easy option to extend the lifespans of inefficient companies.

Yet here we are 10 years later with little evidence that true turnaround, involving not just financial restructuring but a full examination of how a business is managed and operates, is really being embraced as the best way to preserve and enhance value and provide a boost to economies across the world.

Across Europe the oft-quoted figure of €1 trillion of non-performing loans (NPLs) remains a headache for the European Central Bank (ECB) and many banks across the continent, not just within the ECB's supervisory area or wider European Union (EU). Not only does this point to the failure of the banks themselves to address the issues they need to turnaround their own performance, but roughly a third of this value is lending to companies – companies that are over-leveraged and incapable of servicing their loans, but are able to keep trading due to the failure of their chief creditor to address the position.

Where NPL values on banks' balance sheets have been reduced materially, roughly 80 percent of this reduction has been achieved through sales of that debt to other parties. While the ECB and national central banks like to trumpet these achievements, the reality is that this does not change the fact that these NPLs still exist and still require workout.

There are many reasons for the continuing failure to achieve progress here. Firstly, the legal regimes in many countries not only vary hugely, but there is often a lack of suitable legal processes and mechanisms to allow consensual restructurings and turnaround to take place outside

Home
Latest Issue
Issue Archive
Annual Reviews
Advisor Handbooks
ExpertBriefing
FW News

Search Site
About
Contact
Subscribe
Editorial Submissions
Advertising
Terms & Conditions

JOIN MAILING LIST

Corporate Disputes
Risk & Compliance

Follow Us

of an insolvency procedure, poorly implemented or understood insolvency laws themselves, or overly punishing regimes that do not allow for the potential survival of a business.

The EU has started looking at attempting to bring about the harmonisation of laws across its member countries, but this is likely to prove nothing more than an unrealistic pipedream. In the meantime, truly understanding the possibilities and implications for debtors, creditors, management and advisers across each jurisdiction is key to designing and successfully implementing any turnaround and restructuring plan.

Even where legal changes are brought about, to take advantage of this requires cultural change to embrace the new possibilities and some real guts from those who first test the courts and in truth the lack of skills and experience in turnaround among both financial and legal advisers and the sitting judges also still proves a barrier.

New laws have been brought in across the continent designed to create more restructuring options and often to try and directly address the centre of main interests (COMI)-shifting tactics that many were adopting to take advantage of the UK's more mature and flexible regime in particular. However, in many countries these new laws either remain relatively untested, or where they were tested have been interpreted and implemented in a way that was not envisaged when they were drafted to the statute book and hence do not necessarily provide the solution that was envisaged.

The lack of turnaround skills and experience is also a problem in the banks themselves. One of the findings of the UK Financial Conduct Authority's (FCA) report into the global restructuring group workout

division of RBS was that employees therein had not been trained in turnaround techniques nor had an adequate understanding of turnaround. Many banks across Europe have been setting up dedicated workout teams for the first time. Even where these teams have been supplemented with experienced external recruitment, these skilled operators are often frustrated by their management's inability to understand or embrace the value-adding potential of turnaround-based workout strategies and the continuing focus on driving sales to shift NPLs off of their balance sheets.

Of course, the focus on sales also comes from the political and central bank supervisory pressure to reduce the holdings of these distressed loans. However, even if this relieves this pressure for the bank, it does not change the position of the underlying debtor, or do anything to improve their performance and hence create an improvement in value. As the third-party purchasers are commonly funds based abroad, their focus is to recover greater value in the underlying debts than that which they paid however they can, and there is little or no incentive to consider the impact on the local economy or to create greater underlying value from the debtor's perspective.

The ECB's own guidance to banks on NPLs was published in March last year and sought to try and address the broader options for managing and working out NPL positions. The ECB itself has gone on record as saying it wants to see credible plans for reducing NPL balances over a period of time for which sales are just one option, but there is little evidence of such broader plans being implemented as yet.

Of course, another reason for this is the dominance of the larger advisory firms, which are great at analysis and producing data to show the size of a problem and also very capable of making fees on both

sides of a transaction. But they do not engage in actually addressing the root causes of the problems identified. We find parties again financially restructuring situations to put a sticking plaster on the current symptom and yet failing to truly remedy the causes of this sickness.

NPL sales do remain a necessary and valid option for banks in effecting their own turnarounds, and single ticket sales in particular should also trigger turnaround of the underlying debtors, albeit the lack of workout experience and skills in the banks still hinders this. Unable to truly evaluate the turnaround and recovery potential of the underlying debts in corporate portfolios in particular, there often remains a substantial bid-offer spread which buyer and seller are unable to reconcile. At the same time, the underlying weakness of banks' balance sheets in an environment where they are increasingly being asked to improve their Core Tier 1 Capital buffers creates a barrier to further write downs in value.

The introduction of IFRS9 and the ECB's addendum to its guidance will, if properly implemented, go a long way to addressing the valuation and provisioning issue. However, as has been shown in Romania, which is the most highly provisioned jurisdiction after the central bank took firm and direct action earlier than most, this in itself does not immediately trigger more sales or improved workout. In addition, the EU has recognised that the impact of IFRS9 could be so damaging to banks' balance sheets that it has introduced transitional provisions in the form of relief against the additional Core Tier 1 Capital requirements the increased provisions could create. So there is a further dragging out of the time period for truly addressing this problem.

One of the key reasons the NPL situation receives such focus is the

Home
Latest Issue
Issue Archive
Annual Reviews
Advisor Handbooks
ExpertBriefing
FW News

Search Site
About
Contact
Subscribe
Editorial Submissions
Advertising
Terms & Conditions

JOIN MAILING LIST

Corporate Disputes
Risk & Compliance

Follow Us

consensus of the need to free up bank lending to economies as a driver of growth, while in this cycle economic growth will itself further enable reductions in NPLs, but sales alone do not achieve this. If the NPL debtors' underlying problems are just shifted around and not dealt with, you also fail to create sustainable growth in those businesses and indeed any fresh demand for credit. In addition, not addressing efficiency and productivity issues means they remain a drag on local economies.

Of course, this is also symptomatic of governments' own focus on the need for year-on-year growth. There are many companies for which overriding focus on top-line growth without sufficient attention to the efficiency and stability of the managerial, financial and operational platform on which it is built is a cause of their distress. Funding growth through debt is what created this mess in the first place, but still seems to be the modus operandi for our governments and hence filters down as a standard approach for those companies the governments rely on as the drivers of growth. This culture needs to be questioned.

Regardless, whatever the starting point for a distressed company situation or NPL, applying the fundamentals of a true, holistic turnaround and workout approach where there is an underlying business with a viable offering is the best way to preserve and ultimately enhance value for all stakeholders, thereby strengthening banks' balance sheets and local economies. An increased focus on introducing the processes and skills to facilitate this should be the focus for governments and central banks.

Equally, where the underlying debtor entity does not possess a viable offering, rapid action to identify this and close the position down in an orderly manner is a key tool in a successful workout approach and

Home
Latest Issue
Issue Archive
Annual Reviews
Advisor Handbooks
ExpertBriefing
FW News

Search Site
About
Contact
Subscribe
Editorial Submissions
Advertising
Terms & Conditions

JOIN MAILING LIST

Corporate Disputes
Risk & Compliance

Follow Us

again needs the right processes and skills to be implemented successfully.

This is not just a message for Europe either – damaging NPL levels exist across the world following the financial crisis of 2007-09 and are currently seeing increased focus in higher growth markets like China and India too.

If lenders, central banks, regulators, governments and debtors work together to adopt a true workout and turnaround approach, the medium to longer term value gain is significant, and can prove a permanent treatment of the causes and not just the symptoms of the NPL crisis.

Matthew Quade is a managing director at BM&T European Restructuring Solutions. He can be contacted on +44 (0)20 3178 4902 or by email: mquade@bmandt.eu.

© Financier Worldwide

©2001-2018 Financier Worldwide Ltd. All rights reserved.

Home
Latest Issue
Issue Archive
Annual Reviews
Advisor Handbooks
ExpertBriefing
FW News

Search Site
About
Contact
Subscribe
Editorial Submissions
Advertising
Terms & Conditions

JOIN MAILING LIST

Corporate Disputes
Risk & Compliance

Follow Us