IN SEARCH OF ALTERNATIVES TO ACCOUNT BLOCKING IN THE WESTERN BALKANS

In his novel *Little Dorrit*, Charles Dickens ridiculed the institution of debtors' prisons for keeping inmates from working and being able to repay their debts, as a result of which they languished in custody for years while creditors waited in vain for their money.

Although it does not deprive debtors of their liberty, account blocking – part of a system of corporate debt recovery that is widespread in the Western Balkans – has a similarly negative effect on their ability to pay creditors. Combined with cash sweeping, the practice denies businesses access to their bank accounts and working capital, effectively preventing them from continuing with their activities and servicing their debt. This impedes efforts towards out-of-court restructuring or reorganisation within bankruptcy and increases the likelihood of a viable firm in temporary financial distress going bankrupt and being liquidated.

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"As well as creating otherwise avoidable job losses and destroying economic value, this means creditors end up recovering far less money than they might do if an alternative system of debt enforcement were used," says Jaime Ruiz Rocamora, a Principal Counsel in the Legal Transition Programme (LTP) who specialises in debt restructuring and bankruptcy reform. "The system also creates an incentive for borrowers to resort to fraudulent behaviour to avoid losing their business."

Out-of-court restructuring and reorganisation are essential tools for preserving value in the corporate sector and improving the wider investment climate. In order to promote their use in the Western Balkans, the EBRD is helping regulators in the region implement alternatives to cash sweeping and account blocking as a way of securing and enforcing creditors' rights.

As part of these efforts, in 2017 the Bank launched a regional study of account blocking in four countries where it is widely used: Bosnia and Herzegovina, FYR Macedonia, Montenegro and Serbia. The study, which was funded by Luxembourg and completed early in 2018, assessed the impact of cash sweeping and account blocking on a corporate debtor's ability to successfully restructure or reorganise their debts. It also considered their effect on the extent to which creditors cooperate with each other to restructure a borrower's debts. The overall objective of the study is to suggest viable alternatives that could gradually replace cash sweeping and account blocking.

HOW ACCOUNT BLOCKING WORKS

While the laws and regulations establishing account blocking vary from country to country in the Western Balkans, the main features of the system are the same. When obtaining a loan, it is a standard requirement of the credit market that a business provide security in the form of a bill of exchange, which identifies a particular bank account held by the borrower.

In the event of default, the creditor submits the bill of exchange to the bank where the account is held. This triggers a two-stage process which is implemented by the centralised system of a country's national bank. In the first stage, cash is swept from the debtor's bank account and transferred to the creditor until the debt is repaid. If there is insufficient cash in that account, the creditor can use the bill of exchange to sweep all of the debtor's bank accounts until that creditor's claims have been repaid in full.

If that amount is still insufficient, the second stage of the process – account blocking – is triggered. This involves blocking all of the debtor's accounts in any bank and transferring to the creditor any payments made into those accounts until the debt is repaid in full.

The process does not involve going to court and is very quick and easy to enforce. As a result, cash sweeping and account blocking are the accepted market standard among creditors in the Western Balkans.

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"In Serbia, for example, a vast majority of lenders surveyed in the study insist on bills of exchange as collateral," says Jaime. "Bills of exchange are also very secure compared to alternatives such as account pledges which, due to inadequate legislation, currently afford creditors very little guarantee that they will recover any of the funds they have loaned."

EFFECTS OF CASH SWEEPING AND ACCOUNT BLOCKING

The impact of bills of exchange on debtors, however, is often damaging. Cash sweeping deprives a business of its existing working capital while account blocking stops debtors from accessing any future proceeds until the debt is recovered in full. Bills of exchange therefore interrupt the cash flow of debtors, which could prevent them from paying suppliers or employees. This disrupts their business, exacerbates their financial distress and increases the prospect of debtors heading towards bankruptcy, which usually results in liquidation and minimal rates of lender recovery.

"In the study, 60 per cent of commercial banks and 80 per cent of companies surveyed in Serbia – the biggest jurisdiction analysed – agreed that bills of

exchange reduce the business operability and liquidity of the debtor," says Jaime. "Despite this, respondents did not agree that enforcing bills of exchange was detrimental to the chances of achieving successful out-of-court restructuring or reorganisation."

The EBRD study, however, demonstrates that this is the case. Data collected by the Bank, with support from consultants, shows that the overwhelming majority of businesses subject to account blocking measures see their finances deteriorate considerably over time. The prospect of the debtor's finances worsening dramatically discourages creditors from participating in out-of-court restructuring or reorganisation plan negotiations, leaving liquidation as the inevitable consequence of the debtor's worsening financial situation.

Furthermore, in order to protect their cash flow and continue running their business activities, many debtors resort to fraudulent measures such as using the bank accounts of an affiliated company or those of directors or managers' family members to receive and make payments. As a result, debtors are reluctant to share information with creditors about their business operations. This reluctance effectively prevents them from entering recovery plan negotiations with lenders.

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RACE BETWEEN CREDITORS

Another feature of bills of exchange that hinders out-of-court restructuring and reorganisation is that it incites creditors to act individually as opposed to working together to restructure the debtor's finances. Cash sweeping and account blocking prompt a race between creditors, as the first one enforcing a bill of exchange sweeps all the cash from the debtor's bank accounts and blocks all of these accounts until their claims have been fully repaid. In practice, this triggers a chain reaction of creditors submitting bills of exchange in order to reserve as much of any remaining cash as possible.

Even creditors who do not hold bills of exchange or who prefer work-out solutions are deterred from participating in out-of-court restructuring because the process is unprotected from other creditors enforcing their bills of exchange and ruining the start of any negotiations. And while court reorganisation allows judges to impose a stay on creditors enforcing their claims, the speed with which lenders can enforce bills of exchange means that they typically trigger cash sweeping and account blocking before the start of any reorganisation process.

GRADUAL CHANGE RECOMMENDED

We have seen how cash sweeping and account blocking pose a threat to the survival of viable businesses in temporary financial difficulty. The widespread use of bills of exchange in the Western Balkans and the lack of other reliable security instruments over cash assets mean, however, that any regulators wishing to reform the system will need to do so gradually in order to win support from creditors and avoid depressing the region's already-sluggish liquidity market.

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The EBRD study therefore recommends a three-stage model for reforming the credit environment in Bosnia and Herzegovina, FYR Macedonia, Montenegro and Serbia. The first stage would involve removing the account blocking features of bills of exchange, which would retain their cash sweeping powers but not their ability to block future inbound cash flows to the debtor's accounts. This would reduce the incentive for creditors to take unilateral action.

Also as part of this initial phase, the study urges legislators to undertake legislative reforms in order to create a functional and reliable account pledge system as an alternative to account blocking. In particular, these reforms would allow account pledges to cover any account balance top-ups and could protect cash subject to an account pledge from claims arising from bills of exchange or from court decisions.

In the second phase, some two to three years after the introduction of a functional and reliable account pledge system, the legislator would strip bills of exchange of their power to sweep cash across all of a debtor's accounts and instead limit cash sweeping to a specific debtor account. Reforms within this second stage would ensure the debtor's continued access to working capital.

Lastly, the final reforms would remove the direct cash sweeping powers of bills of exchange, which would only be enforceable through a court ruling (as is the case in Austria and Germany).

MAXIMISING VALUE

Taken together, these reforms aim to bring the credit environment in the Western Balkans closer to internationally accepted standards of best practice and significantly increase the use of out-of-court restructuring and, to some extent, reorganisation within bankruptcy.

Corporate debt restructuring mechanisms are essential for the development of an effective creditor rights regime, which in turn helps to create a more stable financial system. Nevertheless, as Jaime points out, encouraging creditors in the Western Balkans to use alternative cash collateral as opposed to bills of exchange will require something of a culture change. Out-of-court restructuring and reorganisation are vital for giving companies in temporary financial difficulty a second chance to generate revenue, rather than going into liquidation and losing all the value created.

"But it will take time to persuade lenders in the region that this is the best way of increasing their debt recovery rates, as well as of maximising value for their debtors' employees, owners and business partners and for wider society, which benefits from these businesses' taxes."

Jaime adds: "We are grateful to Luxembourg for financing this study and we very much hope that the relevant authorities in the four countries concerned will make use of its findings to improve their systems in a way that would benefit creditors and debtors alike."