Enforcing in times of crisis

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EBRD and secured lending enforcement

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Basic premise: security should reduce the risk of credit and increase the availability of credit on improved terms

- Enforcement should enable prompt realisation at market value of the assets
- Security effective and ultimately enforceable after debtor insolvency
- Parties' contractual freedom over the security agreement, including means of enforcement
- Courts need not be involved: can be replaced by quasi-public institutions, such as notaries
- Reform: progressive shift towards creditor-controlled [out of court] enforcement of collateral, especially when the collateral is not real estate
- 'Privatisation' of enforcement goes hand in hand with overall reform – Turkey and the SEMED region less advanced
- Surveys conducted in benign times showed that enforcement could take place relatively efficiently

➢ **How do these systems fare when tested in times of crisis?**

EBRD and insolvency law reform

Basic premise: Insolvency procedures act as an important safety-valve for the market and can influence investment/ credit decisions

- 'Plan B' if private/ consensual restructuring fails, but value-destructive: speed and efficiency of the essence
- EBRD 2009 Insolvency Law Assessment focus on creditor rights (**out of 30 countries** surveyed):
  - **23-25 countries**: secured creditors claims satisfied **#1** from proceeds of collateral
  - **21 countries:** moratorium on enforcement of security (growing trend)
  - **15 countries:** creditors have little or no say in appointment of IP
  - **? countries:** secured creditors excluded from the creditors' committee/ voting on compromise arrangement
- Significant level of insolvency law reform in the EBRD region since 2009:
  1. pre-insolvency access/ procedure (Croatia, Serbia, Slovenia?)
  2. 'pre-packaged' reorganisation plans (Latvia, Serbia, Moldova)
  3. voluntary guidelines for multi-bank restructurings (Latvia, Romania, Serbia)

EBRD Banking Environment and Performance Survey 1 and 2

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- BEPS 1: contains data on credit and deposit activities, risk management techniques and perceptions of the regulatory environment of a random sample of banks (220 banks in total) in EBRD's region of operations (20 countries) in summer 2005 (look-back to 2004)
- A common questionnaire, translated into each local language, was presented to a senior bank officer in a face-to-face interview
- BEPS 2: was conducted in 32 countries among a total of 611 banks in summer 2012 (look-back to 2011)
- Some similar questions which allow a timeline comparison before and after the financial crisis – new questions added in BEPS 2
- Both BEPS 1 and 2 provide an insight into banks' lending policies and practices, as well as banks' perception of the legal system

www.ebrd.com/pages/research/economics/data/beps.shtml

Has the crisis been a ‘cold shower’ for banks?

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- Negative perceptions are primarily expressed around the legal enforcement mechanisms
- In 2011, banks in all countries disagreed (or neither agreed or disagreed) with the statement that the law provides for an efficient **enforcement of pledges -** exceptions in *Belarus*, *Estonia, Georgia, FRY Macedonia*, and *Turkey* where banks are more positive
- Similar picture for enforcement of mortgages with the exception of *Estonia, Georgia, Jordan, FRY Macedonia*, *Slovakia* and *Turkey*
- In 2004, pledge enforcement **already perceived** as problematic in *Albania, Belarus, Bosnia, Croatia, Serbia, and Russia*
- In 2004, banks upbeat on **mortgage** enforcement in *Estonia, Latvia, and the Ukraine*. But picture grim in *Albania, Belarus, Bosnia, Bulgaria, Croatia, Czech Republic, Hungary, Lithuania, Romania, and Russia*

➢ Countries where we see a **real shift in perception of pledge and mortgage enforcement** are: **Moldova, Poland, Slovenia, and Ukraine** and (to a lesser extent) *Kazakhstan and Slovakia*

Perception of banks on efficiency of legal enforcement mechanisms for pledges

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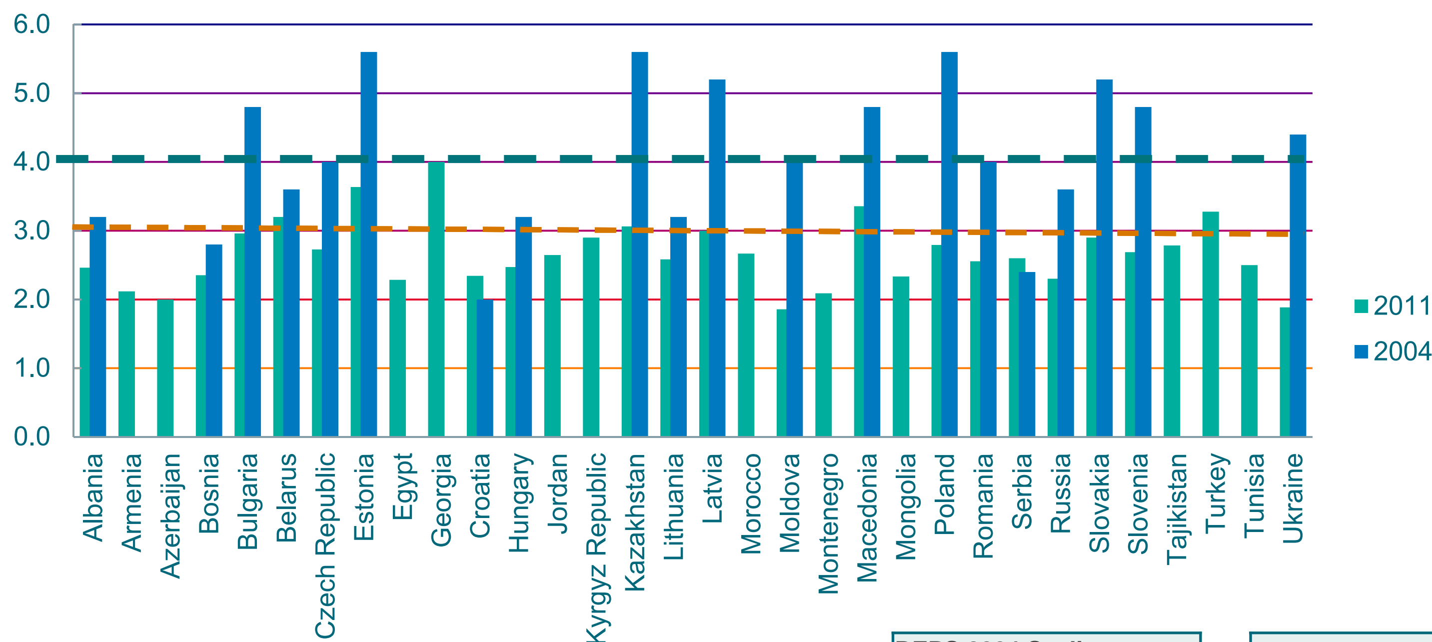

Neither agree or disagree + (2011)

Tend to agree + (2004)

BEPS 2004 Scaling
Strongly disagree: 1
Disagree in most cases: 2
Tend to disagree: 3
Tend to agree: 4
Agree in many cases: 5
Strongly agree: 6

BEPS 2011 Scaling
Strongly disagree: 1
Disagree: 2
Neither disagree nor disagree: 3
Agree: 4
Strongly agree: 5

Perception of banks on efficiency of legal enforcement mechanisms for mortgages

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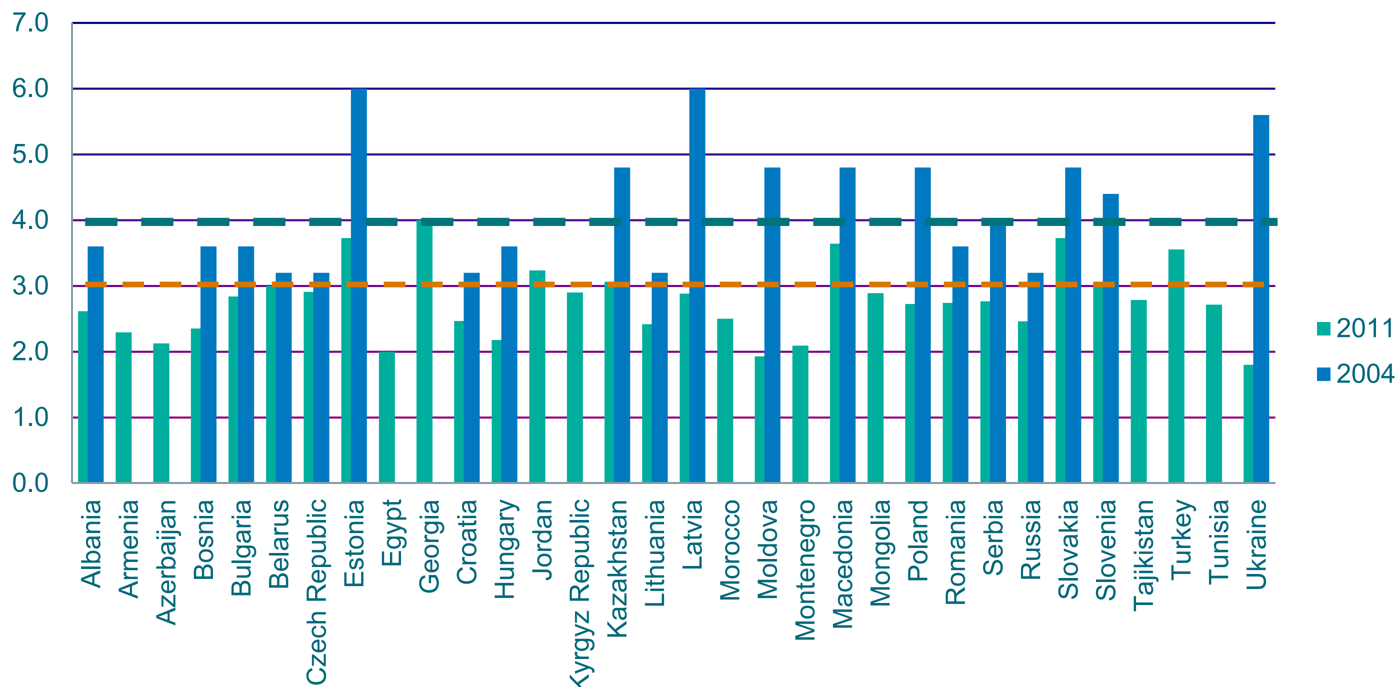

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Did creditor-controlled enforcement help?

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Can we see a correlation between existing legal mechanisms of enforcement (out of court versus court-led) and banks' perception of enforcement efficiency?

- Not really! In *Moldova, Slovakia and Ukraine* there has been a negative shift in banks' perception despite existence of creditor-controlled legal enforcement mechanisms for pledges and mortgages
- Anecdotal evidence suggests that out-of-court enforcement mechanisms did not always fare well in times of crisis – e.g. *Moldova, Serbia and Romania*
- **Introduction of creditor-controlled or out-of-court legal enforcement mechanisms has not been the panacea that it was once believed to be – it also needs to be *viable***

Creditor controlled enforcement regimes

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Ability of the creditors to influence the enforcement procedure in selected jurisdictions

	Yes	*No*
*Can the **pledge holder** exercise control on the way realisation takes place?*	Albania; Bosnia and Herzegovina; Bulgaria; Croatia; Czech Republic; Estonia; Georgia; Hungary; Kazakhstan; Kyrgyz Republic; Latvia; Lithuania; FYR Macedonia; Moldova; Montenegro; Romania; Russia; Serbia; Slovak Republic; Slovenia; Tajikistan; Ukraine	Armenia; Azerbaijan; Belarus; Mongolia; Poland;Turkey; Turkmenistan; Uzbekistan
*Can the **mortgage creditor** decide on the way the sale will be conducted or exercise control?*	Czech Republic; Hungary; Kazakhstan; Kyrgyz Republic; Moldova; Russia; Serbia; Slovak Republic; Ukraine;	Bulgaria; Croatia; Estonia; Georgia; Latvia; Lithuania; Poland; Romania; Slovenia; Turkey

Source: EBRD Secured transactions and Mortgage Surveys, 2011

Impact on lending?

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*Has the rate of rejection of loan applications for lack of acceptable collateral **increased** between 2004 and 2011 - in other words, have banks reverted to a more conservative lending approach?*

- In 2004, lack of cash flow or profitability of the borrower constituted the most frequent reason for rejecting a loan application (except in *Belarus*, *Bosnia*, *Latvia* and *Russia* where the highest frequent reason was lack of acceptable collateral)
- Lack of acceptable collateral as a **frequent reason** for rejecting a loan application was also cited in *Bulgaria, Croatia, Kazakhstan, Lithuania, and Serbia*
- In 2011, this is **cited in all countries with the exception of Egypt, Mongolia and Tajikistan**

Impact on required collateral?

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Has the type of assets accepted by banks as collateral for SME loans in 2011 changed, compared to the type required in 2004?

- In 2011, **all countries require most frequently real estate and personal guarantees**
- The only countries to report a slightly different lending approach are: *Belarus* (collateral over equipment and vehicles and inventory is more common); *Egypt* (has a more diverse range of collateral and is frequently prepared to lend to SMEs unsecured); and *Lithuania* (which also has a more diverse range of collateral).
- In 2004, the range of collateral taken by banks was much wider….
- In *Poland,* banks frequently took security over all types of assets
- In *Hungary* and *Lithuania*, banks reported less frequent collateral taking
- **Shift of banks towards traditional types of security. Is this a permanent change? Or is this a mere swing of the pendulum?**

Collateral required in 2011

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Top three types of assets which banks take frequently as collateral for SME lending

2011	Real estate and land	Equipment and vehicles	Livestock	Inventory	Cash and other liquid assets	Personal guarantees	Entire Business (Floating Charge)	No assets (that is, an unsecured loan)	Other
Albania	79%	42%	7%	23%	63%	87%	27%	17%	0%
Armenia	84%	60%	13%	44%	62%	77%	38%	14%	13%
Azerbaijan	83%	63%	13%	45%	57%	75%	35%	17%	18%
Bosnia	85%	63%	19%	35%	49%	78%	50%	31%	75%
Bulgaria	82%	67%	30%	47%	67%	81%	53%	9%	100%
Belarus	65%	85%	3%	83%	55%	62%	15%	29%	50%
Czech Republic	81%	67%	17%	51%	58%	75%	40%	20%	23%
Estonia	82%	66%	28%	57%	48%	66%	53%	14%	100%
Egypt	54%	66%	30%	54%	64%	70%	47%	48%	63%
Georgia	78%	66%	19%	50%	57%	74%	41%	21%	28%
Croatia	79%	63%	19%	47%	58%	76%	40%	21%	36%
Hungary	79%	63%	19%	47%	59%	75%	40%	22%	38%
Jordan	79%	62%	18%	46%	59%	76%	40%	22%	36%
Kyrgyz Republic	79%	62%	19%	46%	58%	77%	39%	22%	36%
Kazakhstan	85%	73%	6%	63%	59%	73%	42%	29%	6%
Lithuania	75%	77%	27%	63%	56%	60%	35%	21%	100%
Latvia	79%	64%	19%	50%	59%	76%	41%	22%	34%
Morocco	79%	64%	19%	50%	59%	75%	41%	21%	35%
Moldova	82%	64%	21%	61%	45%	71%	34%	21%	63%
Montenegro	80%	63%	19%	50%	58%	76%	41%	22%	36%
Macedonia	80%	64%	18%	49%	59%	75%	41%	21%	36%
Mongolia	85%	67%	19%	53%	39%	50%	28%	8%	50%
Poland	79%	64%	18%	49%	58%	73%	40%	23%	36%
Romania	79%	63%	18%	49%	59%	73%	40%	22%	40%
Serbia	79%	63%	18%	49%	59%	74%	39%	22%	42%
Russia	78%	65%	16%	51%	56%	75%	39%	26%	33%
Slovakia	78%	66%	17%	51%	56%	75%	39%	26%	30%
Slovenia	78%	65%	17%	51%	55%	75%	39%	26%	29%
Tajikistan	79%	57%	38%	59%	57%	73%	45%	38%	6%
Turkey	79%	65%	17%	50%	56%	76%	39%	26%	26%
Tunisia	79%	65%	17%	50%	56%	76%	39%	26%	27%
Ukraine	79%	66%	17%	50%	56%	76%	39%	26%	26%

Scaling:

Almost never: 0%

Infrequently: 25%

Sometimes: 50%

Frequently: 75%

Very Frequently: 100%

Collateral required in 2004

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Top three types of assets which banks take frequently as collateral for lending

2004	Land	Buildings	Real estate and land	Vehicles	Other tangible movable property (e.g., business equipment)	Equipment and vehicles	Inventory	Accounts receivable	Financial collateral (such as cash and securities)	Personal guarantees	Other assets	No assets (that is, an unsecured loan)
Albania	75%	85%	80%	30%	45%	38%	20%	15%	65%	20%		5%
Belarus	10%	70%	40%	60%	75%	68%	75%	40%	30%	60%		10%
Bosnia and Hercegovina	35%	80%	58%	45%	50%	48%	20%	30%	50%	90%		20%
Bulgaria	75%	80%	78%	50%	50%	50%	60%	75%	55%	80%		10%
Croatia	70%	90%	80%	55%	30%	43%	25%	80%	100%	65%		30%
Czech Rep	35%	70%	53%	25%	50%	38%	45%	80%	60%	45%		35%
Estonia	65%	65%	65%	65%	60%	63%	50%	45%	55%	60%		20%
Hungary	25%	35%	30%	20%	15%	18%	20%	25%	30%	15%		15%
Kazakhstan	80%	85%	83%	70%	70%	70%	40%	30%	80%	15%		10%
Latvia	70%	95%	83%	80%	60%	70%	60%	50%	35%	50%		5%
Lithuania	50%	50%	50%	30%	40%	35%	45%	25%	25%	45%		15%
Moldova	85%	105%	95%	50%	70%	60%	55%	40%	65%	35%		20%
Poland	75%	80%	78%	65%	85%	75%	75%	85%	85%	75%		40%
Macedonia	20%	80%	50%	65%	65%	65%	30%	15%	85%	85%		0%
Romania	80%	90%	85%	50%	55%	53%	55%	65%	50%	65%		5%
Serbia Montenegro	55%	95%	75%	25%	40%	33%	35%	45%	85%	60%		15%
Russia	30%	50%	40%	50%	55%	53%	55%	35%	45%	65%		15%
Slovakia	25%	35%	30%	5%	15%	10%	10%	15%	40%	45%		20%
Slovenia	55%	80%	68%	20%	35%	28%	30%	55%	60%	85%		45%
Ukraine	30%	80%	55%	70%	70%	70%	65%	50%	55%	50%		30%

Scaling:
Almost never: 0%
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BEPS Case Study – Restructuring / Workout

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- In 2012, banks were invited to consider the following scenario:

  - 5 year EUR 200,000 term loan to a manufacturing business, repayable in full upon maturity
  - Loan secured on an office building (not pledged for any other loans)
  - Several months ago the business lost one of its largest clients and, as a result, has not made any of the required monthly interest payments
  - Loan falls due for repayment in 2 years

- **ALL banks** across **32 jurisdictions** surveyed confirmed they would generally seek a restructuring on a consensual out of court basis
- Aggregated estimated timeframe for banks trying to reach an agreement with borrower not long: majority cited **1-2 months**
- Typical time period of any maturity extension: **20 months** on average - longest maturity extensions cited for *Bosnia*, *Tunisia*, *Czech Republic* and *Egypt*

Banks' awareness of judicial reorganisation

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Is judicial reorganisation permissible in your jurisdiction?

All 'Yes': *Belarus, Lithuania, Morocco, Montenegro, Slovakia, Slovenia, Turkey, Tunisia*

Majority 'Yes': *Bosnia, Bulgaria, Estonia, Croatia, Hungary, Macedonia, Mongolia, Poland, Romania, Serbia, Ukraine*

All 'No': *Russia*

Majority 'No': *Jordan, Kazakhstan*

All 'Don't Know': *Armenia, Azerbaijan, Georgia*

Majority 'Don't Know': Tajikistan

Morocco and *Tunisia* ('**Yes**') – French inspired 'rescue' procedures (*règlement amiable* and *judiciaire*)

Turkey ('**Yes**'): Swiss inspired law and 'stay of bankruptcy' open to abuse (very few successful restructurings)

Bulgaria (Majority '**Yes**'): Reorganisation plan exists in text of law

Russia ('**No**') : Final restoration and external management (aimed at debt repayment/ restoration of solvency)

Jordan (Majority '**No**'): Limited 'pre-bankruptcy' and 'post-bankruptcy settlement

Banks' expectations of judicial reorganisation

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Banks were asked about the conclusion of a reorganisation agreement in bankruptcy/ insolvency proceedings (based on previous scenario):

(1) Typical Duration

Estimates of duration required to reach an agreement varied considerably – 10 out of 32 countries '*didn't know*'; longest periods cited in *Moldova, Bosnia, Ukraine, Poland (average 12 months), shortest in Morocco, Croatia and Montenegro (less than 1 month)*

(2) Typical Maturity Extension

Diverse estimate for extension of maturity – 10 out of 32 countries '*didn't know*': longest periods cited were in *Moldova, Bosnia, Estonia* and *Lithuania* (average 40 months)

(3) Compulsory Reduction of Debt Principal

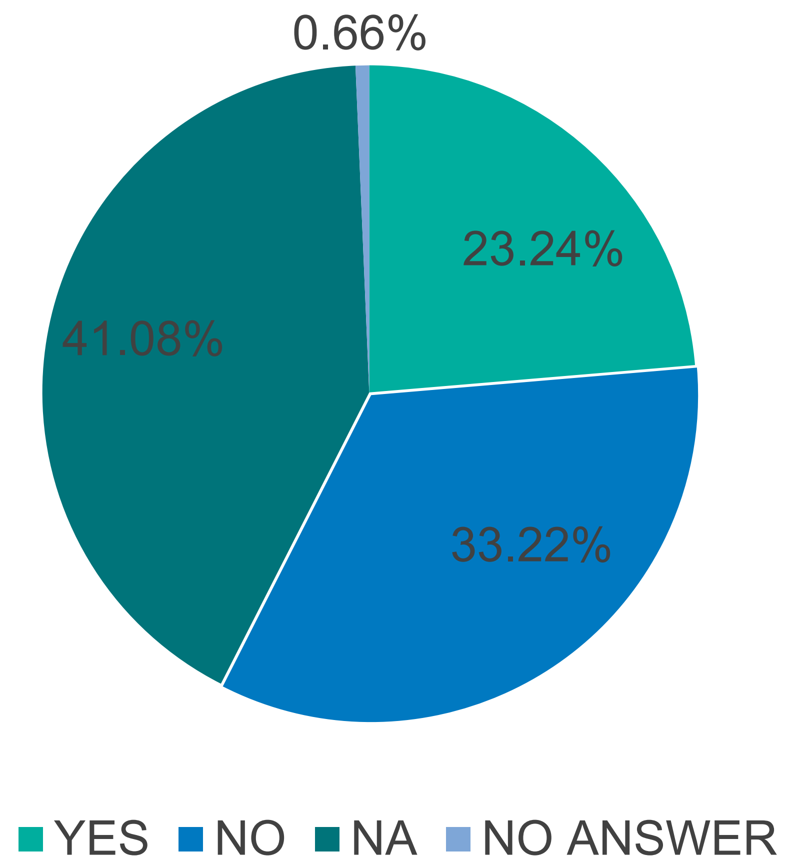
Very mixed data in responses from participants – 10 countries majority 'No', 11 countries majority 'Yes', 8 majority 'don't know' or 'N/A'

(**4) Voluntary Reduction of Debt Principal**

Minority of countries (6) responded positively: majority 'Yes' in *Czech Republic, Hungary, Morocco, Poland, Slovakia and Slovenia;* 14 responded '*No*' and 9 '*N/A*' (Croatia and Tunisia which said 'Yes' to Qu. 3 said 'No' to a voluntary reduction)

Reduction in principal and cram down

- Cram down: procedure by which a debtor and/or the majority of its creditors (or a class of creditors) can force acceptance of a restructuring plan despite objections of dissenting minority of creditors
- Cram down procedures usually, if not always, require certain tests to be met
- Implication all creditor classes including secured (traditional compromise procedures e.g. *Slovenia*, *Jordan*, *Egypt*)
- Difficulties of legislators:
  - Pre-definition of classes by law or case by case (judicial discretion)?
  - Scope of procedure (principal/ interest/ maturity)?
  - Fairness hearing/ judicial scrutiny?



Concluding observations

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- Banks' perception of legal enforcement mechanisms was already negative in 2004, *but it has worsened in some countries*
- Negative perceptions exist even in countries that have out of court enforcement mechanisms
- The crisis appears to have had an *impact on acceptance of loans applications and supporting collateral* and, more generally, on the *collateral requirements for SME lending*
- Banks appear unanimously to seek a consensual solution to a borrower's financial difficulties in the first instance
- Awareness of banks of judicial reorganisation procedures is mixed and some countries do not have a working reorganisation culture
- Banks (74% surveyed) *unwilling* to accept or recognise the possibility of a reduction in principal… yet continuous 'amend and extend' approach can result in zombie borrowers as well as zombie banks