In the recent economic downturn, there has been an increasing recognition among financial sector participants of the need for robust debt enforcement and restructuring systems. In this article Frederique Dahan, a security transactions specialist, and Catherine Bridge, an insolvency and restructuring specialist, both from the EBRD’s Legal Transition Programme Financial Law Unit, discuss some key questions concerning debt enforcement trends and practice in the EBRD region. Drawing on data from the EBRD’s recent Banking Environment and Performance Surveys (BEPS), they provide insights into the challenges of enforcement in times of economic and financial crisis in the EBRD region.
Frederique Dahan: Unfortunately, it is not easy to get a clear overview of how financial institutions are handling non-performing loans and resolving issues with defaulting debtors. Data are typically not publicly available, and of course there is some sensitivity around these issues, especially during times of capital constraints and stress testing from regulators and parent banks. Nevertheless, the EBRD has developed a survey that provides a very interesting (and, to our knowledge, unique) insight into banks’ lending policies and practices, as well as banks’ perceptions of the legal system in their respective jurisdictions.  

When the 2008-09 financial crisis hit the region, how well developed were the legal frameworks, especially with regard to the enforcement of creditors’ rights?  

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What do we know about enforcement practices in the region where the EBRD operates?

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1 Developed and run in 2005, and again in 2012, the BEPS survey was conducted through face-to-face interviews with senior bank officials. The BEPS survey covers a broad spectrum of topics, including data on credit and deposit activities, risk management techniques and perceptions of the regulatory environment. Full results of the BEPS survey are available online at: www.ebrd.com/pages/research/economics/data/beps.shtml.
prompt realisation of assets at market value. Because the judiciaries in the countries where EBRD operates are typically over-stretched, and judicial enforcement means can be inflexible, legislators in the EBRD region displayed an increasing willingness to permit out-of-court enforcement (either by creditors or with the oversight of quasi-public institutions or professionals, such as notaries). Surveys conducted by the Legal Transition Team on security enforcement, in 2003 and 2007, found that these new out-of-court modes of enforcement were working. But these surveys were conducted in benign times. From 2009 onwards the landscape was radically different.

**Catherine Bridge:** By the time of the financial crisis, the majority of insolvency law systems in the EBRD region provided for a moratorium on the enforcement of security following the opening of insolvency proceedings, and often also for any secured assets to be sold within the course of the proceedings. Interestingly, no real distinction appears to have been drawn in respect of the nature or type of insolvency proceedings, and whether such proceedings were aimed at restructuring (reorganisation) or liquidation. Furthermore, the recognition of insolvency as a (temporary) barrier to creditor-led security enforcement appears to have strengthened in the period before the financial crisis. A 2003 EBRD insolvency assessment found that just over half (16) of the countries assessed extended the moratorium on insolvency to include secured creditors. Yet by the time of the 2009 EBRD insolvency assessment, in over two-thirds of countries surveyed, an automatic moratorium or stay arose on the opening of the insolvency proceedings, preventing the enforcement of security. Enforcement in a distressed, insolvency scenario can be highly value-destructive, and many insolvency law frameworks during the financial crisis have proved to be particularly ill-equipped insofar as judicial restructuring is concerned. Consequently, many commercial insolvency law reforms over the last five years have focused on improving the prospects for business rescue in insolvency by encouraging early debtor and creditor action, and widening access to existing procedures for debtors that are at risk of insolvency.

**Frederique Dahan:** The BEPS surveys shed very interesting light on the overall perception by banks of the effectiveness of the security enforcement system in their respective jurisdictions, especially when the results for 2011 are compared with those of 2004. In 2011, banks in a majority of countries either disagreed, or neither agreed or disagreed, with the statement that the law provides for an efficient enforcement of pledges – exceptions to this were in Belarus, Estonia, Georgia, FRY Macedonia, and Turkey, where banks were generally more positive. The same picture emerged regarding the enforcement of mortgages, with the exceptions of Estonia, Georgia, Jordan, FRY Macedonia, Slovakia and Turkey. However, pledge enforcement was already perceived as problematic in Albania, Belarus, Bosnia, Croatia, Serbia, and Russia in 2004. Similarly, banks were quite positive about mortgage enforcement in 2004, in Estonia, Latvia and Ukraine, but had a negative opinion of the law concerning the enforcement of mortgages, in Albania, Belarus, Bosnia, Bulgaria, Croatia, Czech Republic, Hungary, Lithuania, Romania and Russia. So, it seems that banks’ perceptions of the enforcement system has worsened since the financial crisis, probably because of the bad experiences that banks had when trying to enforce their security interests. However, the awareness of banks of problems with enforcement existed before the crisis. Countries where we see a real shift in the perception of pledge and mortgage enforcement, from positive to negative are: Moldova, Poland, Slovenia, and Ukraine, and to a lesser extent in Kazakhstan and Slovakia. Therefore, the reforms of secured transaction regimes do not seem to have delivered the efficiency that was expected, although, of course, we cannot be sure that banks’ lack of confidence in the legal mechanisms revealed by the BEPS survey for 2011 was not also due to other, non-legal, flaws, such as the lack of markets for assets and general depreciation in asset values.
Catherine Bridge: Although this varies greatly from case to case, in most countries banks appear to attempt first a restructuring of the loan before going down the enforcement route, since enforcement is often neither straightforward nor efficient. Enforcement still requires a certain level of court involvement in many countries where the EBRD invests, and these proceedings can, of course, precipitate insolvency proceedings, which can then block the entire enforcement process. As alluded to by Frederique, market conditions are a significant concern for banks at present, and these conditions may have reduced the appetite of certain banks for enforcement – where the market for the relevant secured asset is illiquid or depressed, it is, of course, less likely that banks will be able to find willing buyers and realise the full value of their security in order to cover their exposures and any related sale costs. In the BEPS survey for 2011, all 611 banks surveyed across 32 countries where the EBRD invests confirmed that they would seek a consensual restructuring as a first resort. This was in the context of a hypothetical case study, in which banks were asked to consider a restructuring scenario where the borrower had lost one of its largest clients and, as a result, was not able to make any of the required monthly interest payments under the loan agreement. The responses from banks surveyed in the EBRD region are not significantly different from the responses of many banks in western Europe – rather than pulling the enforcement trigger and realising an immediate loss of value, many banks have simply amended and extended their loan facilities and have waited for the crisis to pass.

Frederique Dahan: Bank lending has been affected by a number of factors, starting with more stringent capital requirements. But there may also have been a retreat by banks from lending because of the way in which poor enforcement mechanisms have undermined the value of collateral. Although we do not have hard data to support this hypothesis, the BEPS survey shows that the rate of rejection of loan applications for lack of acceptable collateral increased between 2004 and 2011. In 2004 the most frequent reason cited for rejecting a loan application was a lack of cash flow or profitability of the borrower. The lack of acceptable collateral was cited as the most-frequent reason for rejecting a loan application by Belarus, Bosnia, Latvia and Russia, while it was also cited as a frequent reason by Bulgaria, Croatia, Kazakhstan, Lithuania and Serbia. However, by 2011, the lack of adequate collateral was cited as a frequent reason for rejecting a loan in all counties where the EBRD invests, with the exception of only Egypt, Mongolia and Tajikistan. In other words, banks seem to have reverted to a more conservative lending approach, which is collateral- rather than cash flow-based.

Catherine Bridge: Lack of liquidity and therefore low levels of bank lending is certainly a critical issue in most countries where the EBRD invests at present, particularly in the context of restructurings, where, without liquidity or fresh money, many borrowers find it very difficult to make the necessary investments in their businesses to generate profit. Sometimes, the reluctance to put in fresh money can be driven by legal impediments, such as claw-back or avoidance provisions in insolvency laws that would place that fresh money at risk, notwithstanding a valid underlying commercial purpose. To date, we have not seen significant steps in the EBRD region towards the statutory recognition of the priority of fresh money in insolvency proceedings of a reorganisation nature. Such recognition has been seen as important in jurisdictions such as the United States, in terms of encouraging the entry of fresh money at this difficult juncture.
Has the crisis affected the kind of security or collateral taken by banks? Do you see any regional differences or trends?

**Frederique Dahan:** Indeed, the BEPS survey shows an unequivocal trend. In 2011, in all countries surveyed, banks most-frequently require real estate and personal guarantees as security. The only countries to report a slightly different lending approach were Belarus (where collateral over equipment and vehicles and inventory is more common), Egypt (where banks take a more diverse range of collateral, and are frequently prepared to lend to small and medium-sized enterprises unsecured), and Lithuania (which also has a more diverse range of collateral). This is to be contrasted with 2004, where the range of collateral taken by banks was much wider. For instance, in Poland, banks frequently took security over all types of assets, while in Hungary and Lithuania, banks reported less-frequent collateral taking. We see a shift of banks towards more traditional types of security. Whether this a permanent change or a mere swing of the pendulum is too early to say.

**Catherine Bridge:** Financial restructurings typically take the form of a rescheduling of principal and/or interest payment dates; that is, pushing out the overall term of the debt. In cases where the borrower is significantly overleveraged, restructurings may also look to lower the overall debt burden to a sustainable level, either by cutting interest or, more radically, reducing principal (the so-called “haircut”). Additionally, in an illiquid market, banks are also looking to debt for equity swaps, frequently as an alternative to a haircut on their loan, as this enables them to benefit from any future equity upside when the market recovers. In the EBRD region it appears, unsurprisingly, most common for banks to extend the overall term of the loan when restructuring. There is a general unwillingness among banks in many countries where the EBRD invests to agree to any voluntary reduction in principal; often there are internal constraints within the bank, as well as potential accountability of employees. In the BEPS survey for 2011, only in very few countries (six out of 32) did a majority of banks say that they would consider a voluntary reduction of principal. Banks in most countries said that they would either not agree to a voluntary reduction of principal (14) or that a voluntary reduction of principal was non-applicable (nine). Extension of loan maturities and reduction of interest margins – both of which still can make the loan much more expensive for the bank to carry on its books – are not perceived to be as problematic as a reduction in debt principal.

To what extent are banks willing to negotiate the terms of a financial restructuring with distressed borrowers? What kinds of measures will they typically consider?

**Catherine Bridge:** Management awareness appears to depend very much on the country and the prominence of judicial reorganisation or restructuring, and how widely this mechanism is used. In some countries – specifically Morocco and Tunisia, which have French law-inspired judicial reorganisation procedures – banks appear to be fully aware of reorganisation in insolvency, perhaps since many such procedures favour debtor reorganisation and limit creditor rights, particularly in respect of enforcement of security. In countries where the BEPS survey revealed a low level of awareness of judicial reorganisation among senior bank officials (such as in Russia), this may be due to the fact that this is rarely used in practice. A number of countries where the EBRD invests still have very liquidation-focused insolvency systems. Judicial reorganisation procedures may exist on paper but for a number of reasons – including cultural, legal and, often, institutional – there is a failure to
encourage reorganisation or restructuring within insolvency. Of course, judicial reorganisation is often very difficult to achieve because of the vulnerabilities of the business within insolvency proceedings. Judicial reorganisation is also a developing area, and stakeholders in a number of countries have been required to familiarise themselves with completely new reorganisation-type insolvency procedures, including those aimed at pre-insolvency reorganisation, such as the recently introduced Croatian Pre-Bankruptcy Settlement Act or the Serbian Consensual Financial Restructuring Act.

Frederique Dahan: Yes. Banks’ perceptions of legal enforcement mechanisms were already negative in some cases in 2004, but it has worsened in some countries. Thus, more work will be needed in this respect. Furthermore, negative perceptions exist even in countries that have adopted out-of-court enforcement mechanisms, demonstrating that these mechanisms are not always viable and may need re-visiting. The financial crisis also appears to have had an impact on the acceptance of loan applications and supporting collateral and, more generally, on the collateral requirements for SME lending. It is difficult to counteract this retreat when financial institutions become bearish, but this also points to the need to develop other sources of capital for SMEs – perhaps private equity or, for the larger medium-sized enterprises, even capital markets.

Catherine Bridge: As mentioned earlier, the financial crisis has revealed real weaknesses among many EBRD countries regarding reorganisation/restructuring within insolvency, and also in the capacity of the courts, and these issues can undermine attempts to introduce more flexible legislation, which would require a certain element of court discretion; for example, determining creditor classes and the overall fairness of a reorganisation plan. Insolvency tends to be a judicially driven process in the EBRD region, and courts have struggled to handle the growing volume of insolvency cases. Consequently, some countries have attempted to develop restructuring frameworks outside of the courts. For example, in Serbia, the National Chamber of Commerce and Industry was used as an institutional mediator in restructuring cases; while in Croatia, regional “Financial Agencies” (administrative agencies that deliver a wide range of services to corporate and retail customers) were used as a first stage for pre-bankruptcy settlement proceedings. These initiatives are relatively new and, with time, may be helpful, but they cannot replace existing insolvency procedures and the need to strengthen the capacity of the courts.

Catherine Bridge: The financial crisis has brought insolvency and restructuring, as well as security enforcement, to the fore, and has shown how important it is to have proper insolvency and secured transaction legal frameworks. These frameworks form part of the overall investment climate, and are likely to be considered by every prudent investor undertaking a transaction in a particular jurisdiction. The Bank’s focus continues to be two-fold: providing technical advice and assistance on the legal framework itself; and strengthening the institutional players and professionals at the heart of the proceedings. In respect of insolvency matters, the Bank is taking a particular interest in pre-insolvency, out-of-court, initiatives, given the need to act early to resolve financial distress and preserve value. This opens up the possibility of new partnerships with central banks and other players, aimed at promoting out-of-court reorganisation.

Were any lessons learned from the EBRD’s perspective?

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How will these lessons shape EBRD policy dialogue and technical assistance?

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