Handbook for Effective Management and Workout of MSME NPLs

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Glossary of Technical Terms

Average credit score	Borrower's average credit score in the banking system, as provided by the BoS's Central Credit Register.
Bad bank	An entity that is created in order to manage NPL exposures separately from the bank's core business.
Balloon payment	Interest paid regularly together with only small repayments of principal so that the bulk of the loan is payable upon maturity.
Bullet payment	Principal and interest paid at maturity.
Collateral enforcement	The exercise of rights and remedies with respect to collateral that is pledged against a loan.
Conditional debt forgiveness	A bank forfeiting the right to legally recover part or the whole of the amount of an outstanding debt upon the borrower's performance of certain conditions.
Cooperative borrower	A borrower which is actively working with a lender to resolve his non-performing exposure.
Cure rate	The percentage of loans that previously presented arrears and, post restructuring, present no arrears.
Covenant	A covenant is a borrower's commitment that certain activities will or will not be carried out.
EBITDA (earnings before interest, taxes, depreciation and amortization)	Valuation metric for comparing the income of companies with different capital structures.
Early warning indicators	Quantitative or qualitative indicators, based on liquidity, profitability, market, collateral and macroeconomic metrics.
Key performance indicators	Indicators through which bank management or supervisor can assess the institution's performance.
Loan to value ratio	Financial ratio expressing the value of the loan compared to the appraised value of the collateral securing the loan
Management information systems	Risk management information systems to gather and report relevant data at the unit and bank-wide level.
Material exposure	A relatively large exposure that should require more attention (time, depth, expertise) from the bank's staff during workout process.
Mitigating measures	Measures proposed by a bank to a borrower in order to reduce his credit risk or increase the collateralization of exposure.

Non-cooperative borrower	A borrower which is not showing signs of cooperation with a bank to resolve his non-performing exposure.
Non-performing exposures	Sum of non-performing loans, non-performing debt securities, and non-performing off-balance sheet items. May be calculated at level of individual borrower or on a bank-wide basis.
Non-performing loans	Loans classified in Categories D and E (according to the BoS "Regulation on the assessment of credit risk of banks and savings banks") and/or more than 90 days-past-due payments.
NPL strategy	A comprehensive and time bound strategy to deal with NPL stock, prepared by a bank.
Restructuring (forbearance)	An agreement between the lender and the borrower to modify the terms of loan contract so as to enable eventual repayment.
Restructuring plan	A document containing the measures to be taken in order to restore borrower's viability.
Risk management system	A centralized system that allows a bank to holistically monitor bank's risks, including credit risk.
Servicing platform	Infrastructure necessary for effective monitoring and collection of NPLs. It includes the IT system to manage data, call center, restructuring unit, and back-office. The infrastructure may be housed either in the bank or in an independent service provider.
Statute of limitations	A defense that may be asserted by a borrower to defeat collection actions brought against him by creditors after the appropriate time has elapsed.
Tunneling	An illegal business practice in which a majority shareholder or high-level company insider directs company assets or future business to themselves for personal gain.
Viability analysis	An assessment of borrower's ability to generate adequate cash flow in order to service outstanding debts.
Watch-list exposures	Exposures that have displayed characteristics of a recent increase in credit risk which are subject to enhanced monitoring and review by a bank.
Workout unit	A bank's operational unit in charge of handling problematic exposures.

Abbreviations

AJPES	Agency for public legal records and related services
AMC	Asset management company
AQR	Asset quality review
BoS	Bank of Slovenia
CEO	Chief executive officer
CFO	Chief financial officer
CRO	Chief risk officer
DPD	Days past due
DSCR	Debt service coverage ratio
EBITDA	Earnings before interest, taxes, depreciation and amortization
EC	European Commission
ECB	European Central Bank
EU	European Union
EWS	Early warning system
FV	Future values
GDP	Gross domestic product
GURS	Surveying and Mapping authority under the Ministry of the Environment and Spatial Planning
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
KPI	Key performance indicator
LTV	Loan to value
MIS	Management information system
MRA	Master Restructuring Agreement
MSME	Micro, small and medium enterprise
NPE	Non-performing exposure
NPL	Non-performing loan
NPV	Net present value
PIK	Payment in kind
PV	Present values
RFP	Request for proposal
RICS	Royal Institute of Chartered Surveyors
RM	Risk management
SBA	Slovenian Banking Association
SME	Small and medium enterprise
SPV	Special purpose vehicle
SRSS	Structural Reform Support Service
SSA	Standstill Agreement
SURS	Statistical Office of the Republic of Slovenia
SWOT	Strengths, weaknesses, opportunities, threats
WB	World Bank
WO	Workout officer
WU	Workout unit
ZGD	Slovenian Company Law

Introduction

This document has been prepared by the World Bank (WB) at the request of the Bank of Slovenia (BoS) and in consultation with Slovenian banking industry, under a technical cooperation project funded by Structural Reform Support Service (SRSS) of the European Commission (EC). The overarching purpose of this work is to support the BoS and the Slovenian banking sector in their ongoing efforts to accelerate the resolution of a large volume of non-performing loans (NPLs) associated with micro, small and medium-sized enterprise (MSME) sector.

Context of this Handbook

The MSME sector (i.e., companies and individual entrepreneurs as defined by Article 55 of the Company Law (ZGD-1) plays a critical role in the promotion of economic growth and employment in Slovenia, where the MSME sector accounts for more than 99 percent of all companies, generates approximately 67 percent of total revenue, 55 percent of value added, and employs around 70 percent of active labor force.

Despite its importance for the overall economy, the Slovenian MSME sector is highly over-indebted and responsible for the majority of banks' NPLs. While the attention of banks and the regulator was until recently centered on large corporate cases, a large portion of problematic MSME exposures remains to be addressed. According to the official BoS data as of mid-2016, more than 70 percent of remaining banks' NPLs (by volume) are associated with MSME sector, totaling EUR 1,5 billion (around 4 percent of GDP). These levels act as a major drag on the banks' capital, earnings, and ability to generate new lending, while at the same time depress private investment and prospects for new growth and job creation. It is thus imperative to accelerate the process of balance sheet repair and NPL resolution, with an increased focus on the MSME sector.

In line with EC recommendations in this area, the BoS' current strategy lists MSME NPL resolution among the key policy priorities, and follows a two-pronged approach to facilitate the process. On the one hand, banks are now required to present for regulator's review specific, time-bound plans for reducing MSME NPLs as part of their strategies for managing problem loans. On the other hand, SBA and BoS issued at the end of 2015 the Restructuring Guidelines for Micro, Small and Medium-Sized Companies (henceforth, the Guidelines), extending methodological advice to banks on: (i) optimal institutional set up for MSME NPL restructuring; (ii) diagnostics for the purpose of determining the viability of borrower's business model; (iii) possible workout strategies for various categories of borrowers.

This Handbook aims to help operationalize the Guidelines by providing further operational guidance to banks on how to organize the various stages of MSME NPL workout process. The Handbook seeks to reflect the international and EU best practice on dealing with MSME NPLs. In this regard, an effort was made to make the document fully consistent with the relevant provisions of the Draft Guidance on Non-Performing Loans[1], published by European Central Bank (ECB) for public consultation in September 2016.[2]

The Handbook also seeks to take into account the specifics of Slovenia's economic and banking sector structure and the extensive experience accumulated by Slovenian banks in dealing with their NPL

[1] https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl/npl_guidance.en.pdf

[2] It is anticipated that the final version of ECB Guidance will form the basis for regulating the NPL management by SSM-supervised banks, and, at the discretion of national regulators, by other commercial banks in specific jurisdictions.

portfolios in general, and with the MSME sector in particular. The Handbook is based on Slovenia's existing legal, regulatory and institutional framework for MSME resolution and does not make any systematic effort to identify the possible obstacles to efficient and timely NPL resolution that might still exist in this broader framework, or to propose potential improvements which would be outside the banks' sphere of control. The WB is deeply grateful to representatives of the banking community and other stakeholders who generously shared the information and lessons learned from the NPL resolution process to date.

Handbook Applicability

MSMEs present a specific set of challenges that make NPL resolution more costly and riskier than for large firms. These challenges include the very large number of firms involved and the small size of their exposures, the lower reporting requirements and lack of audited financial statements, as well as the relatively weak capacity of borrowers. Jointly considered, these factors determine the necessity of a tailored approach to MSMEs that is different to the approach adopted for larger corporates. This Handbook intends to develop such approach by building and expanding on the Guidelines' provisions by offering practical advice to banks' management and personnel on how to standardize and streamline the process. The implementation of recommended practices is expected to significantly speed up the resolution process, reduce operational expenses for banks and borrowers, and raise the frequency of successful restructurings.

The Handbook's primary target audience is the management and staff of the banks' Workout Units specializing in the MSME portfolio. The Handbook is also expected to be of interest to the senior management of commercial banks, as it seeks to establish optimal and cost-efficient institutional arrangements and policies aimed at reducing the level of NPLs. Certain portions of the Handbook could also be of use to the management and staff of risk management, loan origination, and legal departments involved in the identification of NPLs, the preparation of bank's NPL reduction strategy, and the restructuring of problematic MSME borrowers at various stages of the workout process. Finally, the MSME borrowers may also benefit from a detailed description of various workout options and procedures (including templates), assuming the banks choose to make this information available to the public, which is highly advisable.

Like the Guidelines, the Handbook is non-binding for commercial banks to follow. At the same time, the BoS and the SBA expect that the banks make full use of relevant provisions in managing and resolving MSME NPL portfolio, so as to contribute to rapid, efficient and transparent resolution of MSME indebtedness. The BoS may issue further supervisory guidance or instructions in this regard.

Structure of the Handbook

The document structure follows the life cycle of MSME NPL management, and is comprised of the following eight chapters, with three appendices.

- Chapter I discusses the best practices for prevention and timely identification of NPLs, with the focus on bank's early warning system.
- Chapter II describes the internal institutional arrangements for managing MSME NPLs portfolio, and relevant operational policies, including the recommended timetable and sequence of steps in workout process.
- Chapter III proposes the methodology for early segmentation of MSME NPLs into smaller categories on the basis of exposure size and various other characteristics, including the initial assessment of borrower's viability.

- Chapter IV covers essential preparations for workout process, including collection of information from the borrower, assessment of bank's legal rights and remedies, and valuation of collateral.
- Chapter V proposes the methodology for in-depth financial and business viability assessment of the borrower.
- Chapter VI describes the potential workout strategies for various categories of borrowers, and the methodology for choosing the strategy that would lead to the maximum recovery value.
- Chapter VII discusses the negotiations process and the documentation of restructuring process.
- Chapter VIII describes the monitoring of restructured loans and the bank's actions when the restructuring fails.

- Appendix 1 presents historical data for select financial ratio in major sectors of the Slovenian economy.
- Appendix 2 explains the rules applicable to determine the costs incurred in collecting on a non-performing loan in Slovenia through two broad legal solutions, i.e., bankruptcy and enforcement.
- Appendix 3 contains templates for: (i) checklist to be used by MSME borrowers in preparation for workout process; (ii) standstill agreement for MSME borrowers; and (iii) indicative time table for restructuring/forbearance process.
- Appendix 4 presents several detailed case studies of NPL workout involving MSME borrowers, broadly based on (anonymized) information provided by the banks.

For easy reference, the below table presents the list of key ratios, principles and methodologies applicable to MSME NPL restructuring, introduced in this Handbook.

Timeline for Early Warning System	Chapter I. Section 2.4	p. 17
Criteria for transfer to workout unit	Chapter I. Section 2.5	p. 18
Timeline for NPL management	Chapter II. Section 5.1	p. 31
Criteria for initial portfolio segmentation	Chapter III. Section 2.1	p. 34
Criteria for initial viability assessment	Chapter III. Section 2.2	p. 35
Signs of non-cooperative borrower	Chapter IV. Section 1.1	p. 38
Requirements for collateral validity	Chapter IV. Section 2.2	p. 39
Principles of collateral valuation	Chapter IV. Section 3	p. 41
Financial ratios for in-depth viability assessment	Chapter V. Section 2	p. 44
Cash flow analysis	Chapter V. Section 2.6	p. 48
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Short term restructuring options	Chapter VI. Section 2.1	p. 57
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NPV analysis of workout options	Chapter VI. Section 3	p. 62
Principles for communicating with the borrower	Chapter VII. Section 3	p. 71
Principles for resolution of disputes	Chapter VII. Section 4	p. 71
Criteria for treatment of restructured loans	Chapter VIII. Section 1	p. 74

Chapter I. Problem Loan Prevention and Identification[3]

Restructuring Guidelines for Micro, Small and Medium-sized Companies

II.a - Timely identification of debtors experiencing business difficulties, identification of the reasons for them and appropriate allocation of debtors into individual organizational units are the key conditions for rapid, efficient and thorough restructuring. In the case of SMEs, the relationship between the bank and the company is most often more personal than in the case of large corporates, which is why the bank should guarantee objective treatment by applying the following guidelines<…>.

II.3 - The debtor's problems must be resolved proactively already in the phase when the exposure is still handled by the commercial unit, which is why the bank should guarantee appropriate distribution of know-how and experience between individual organizational units. Timely resolving of the debtor's problems and adopting quick decisions contribute significantly to successful restructuring.

II. 4 - The bank regularly reviews the debtors to be able to determine the method of their further treatment; it is recommended that a detailed review be carried out every 6 months. Furthermore, it should establish appropriate IT support for each debtor, depending on the records of overdue receivables and the records of the fulfilment of other conditions.

1. Early warning system as a tool for preventing NPLs

As noted in the ECB's draft Guidance on non-performing loans (NPLs), one of the keys to maintaining acceptable levels of NPLs lies in the ability to identify potential payment difficulties of a borrower as early as possible. The sooner the problem is identified, the easier it will be to remedy it. An early warning system (EWS), fully integrated into the bank's risk management system, is a crucial tool to identify and manage upcoming problems with a borrower's ability to service his debt.

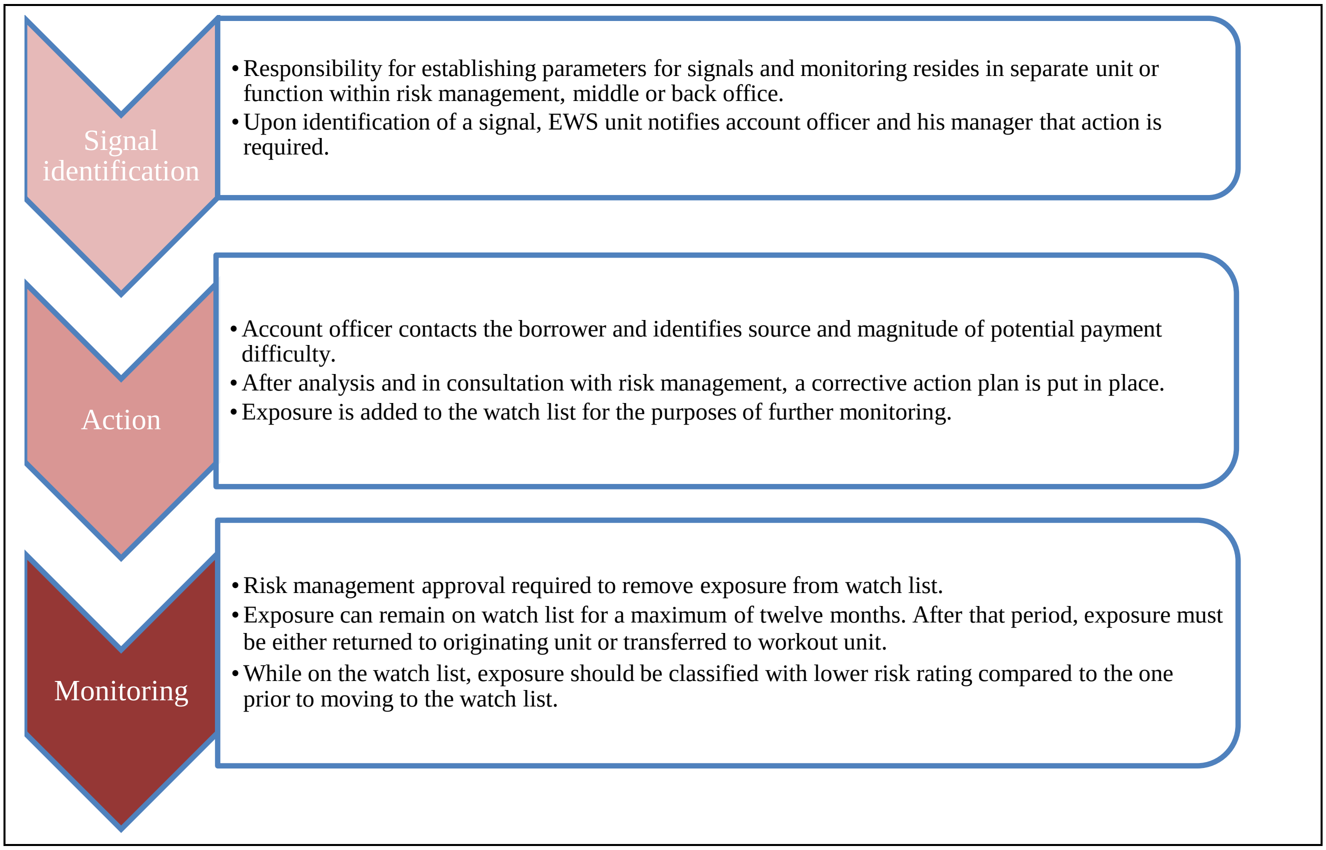
The purpose of the EWS is therefore twofold: (i) to produce an early signal of potential payment difficulties of the borrower; and (ii) to provide an effective corrective action plan at a very early stage.

2. Scope of EWS process

The EWS process is organized in three stages: identification, action and monitoring (Figure 1). Each of these stages is described in detail in the following sections (2.1 to 2.3). The timeline for implementing actions included in each of these stages is explained in section 2.4.

[3] For easy reference, relevant excerpts from the SBA/BOS' MSME Restructuring Guidelines are reproduced in various chapters of this Handbook.

Figure 1: How EWS process works



2.1 Identification

Early warning signs are indicators that point to potential payment difficulties. These indicators can be divided into five broad categories: (i) economic environment, (ii) financial indicators, (iii) collateral and behavioral indicators, (iv) third party indicators, and (v) operational indicators. The main aim of this list is to produce a comprehensive set of signals that provides the bank an opportunity to act before the borrower's financial condition deteriorates to the point of default. Each of these categories is further explained in sections a) to e) below.

The process of accurately diagnosing the financial condition of a borrower based on the criteria explained in this section is complex and not subject to standardization. It is the responsibility of the specialized EWS unit (or function within the risk management department, middle or back office (henceforth in the text, EWS unit)) to interpret the signals received from a borrower and determine whether that borrower should be included in the watch list for further corrective action. In most cases, such decision will involve the identification of groups of signals that validate one another. Taken alone, most signals are too ambiguous/inconclusive to predict financial distress, but when a holistic approach is adopted the EWS unit may decide that the combination of certain signs anticipates serious financial distress.

Determining what combination of signs triggers the obligation to submit a borrower to the watch list requires good knowledge of the industry and some subjective judgment. In most cases, the specialized unit will have to identify very subtle warning signs that reinforce others in arriving at a judgment. These subtle signs are typically based on personal contacts between the bank and the borrower, especially in the context of MSMEs.

For example, a trigger for the transfer to the watch list could be a signal received from only one substantial indicator, such as Debt/EBITDA above 5, or LTV above 80. However, the transfer may also be triggers by the combination of less significant indicators, e.g., increase in general unemployment rate, increase in days of receivables outstanding, or frequent changes of suppliers. In addition, signals received from at least two less significant indicators could trigger a deeper review of the borrower's financial health.

The bank may expand the list of substantial indicators based on the findings from the database and back testing results. For the purpose of simple signaling approach (using one or multiple indicators with specific thresholds), the bank has to define trigger points for creating signals based on good practice and analysis of historic data. In case of availability, a differentiation between the thresholds for different economic sectors would be a good practice. The bank should apply a **prudent approach** when selecting specific thresholds for particular indicators.

Criteria for the inclusion in the watch list should be applied at individual level or at portfolio level. For example, if real estate prices fall by more than 5 percent on an annual basis, the group of exposures that has real estate as collateral should be identified, and a review should be done to determine if the collateral value is adequate in the light of price adjustment. Collateral evaluation should be done in accordance to the framework described in Chapter IV of this Handbook. In cases where it is no longer sufficient, a bank should take corrective action to improve collateral coverage.

An additional factor that should be considered in managing an EWS is the concept of materiality. Implementation of EWS is time-consuming and requires substantial resources and staff. For this reason, a bank may define a level of average exposure size in the NPL portfolio and determine that all exposures above this indicator are material and require more attention from the bank. The main principle behind this concept is to give a higher level of attention, scrutiny, and resources to material cases.

a) Economic environment

Indicators of the overall economic environment are very important for early identification of potential deterioration of the loan portfolio. Their importance stems from the fact that they can point to the likely economic downturn. As such, they are a powerful determinant of the future direction of loan quality[4], influencing not only the individual borrower's ability to pay his obligations but also collateral valuations. Table 1 below provides major indicators that should be monitored to identify potential debt servicing difficulties early on.

Data sources for these indicators should be the bank's internal economic forecasts or alternatively (e.g., in case of smaller banks) forecasts of respected forecasting institutions in the country or abroad.[5] Indicators of economic environment are especially relevant for predicting the future payment ability of individual entrepreneurs and family business owners (micro enterprises) who are unlikely to produce audited financial statements which can be analyzed for financial indicators. Given the broad nature of these indicators they should be monitored continuously using information collected on a monthly or quarterly basis. When a downturn is signaled, a more thorough review of those segments of the portfolio that are most likely to be affected should be undertaken.

[4] ECB econometric analysis suggests that real GDP growth was the main driver of nonperforming loan ratios during the past decade. https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1515.pdf?acd1786abd6d2bd9b992504c6d714c7b IMFreached a similar conclusion: https://www.imf.org/external/pubs/ft/wp/2013/wp1372.pdf

[5] Bank of Slovenia, independent think tanks, IMF, ECB, EC.

Table 1: List of potential economic environment indicators

Indicator	Description
Economic sentiment indicators (early indicator on monthly basis) or GDP growth	Economic growth directly influences borrowers' (company and individuals) ability to generate cash flows and service their debts. Major changes in economic sentiment indicators and consequently growth forecasts should serve as a key flag for certain loan groups (retail, real estate, hospitality sector). In most cases, GDP growth has a good correlation with the prices of real estate. In forecasted economic contraction, horizontal adjustments to real estate valuations (all assets classes) should be made.
Inflation/deflation	Above average inflation or deflation may change consumer behavior and collateral values.
Unemployment	Increased unemployment rate indicates a potential adjustment in purchasing power of households, thus influencing businesses' ability to generate cash flows to service their outstanding liabilities. Non-elastic consumption components (e.g., food, medicine) will be less sensitive to this indicator than elastic ones (e.g., hotels, restaurants, purchase of secondary residence and vacationing).

b) Financial indicators[6]

Financial indicators (Table 2) are a good source of information about the companies that issue financial reports. However, it is not sufficient to rely only on annual financial reports. To ensure that warning signal are generated in a timely manner, the bank should require more frequent interim financial reporting (e.g., quarterly for material exposures and semi-annual for all others).

Data sources for financial indicators may be either company financial statements received directly from the borrower or downloaded from the AJPES data base[7]. The analysis of these indicators should not be limited only to ratios *per se*. Rather, it should incorporate the trends of the variables included in the nominator and denominator of the indicator as well as changes over time. Depending on reasons behind the change in a ratio (changes in nominator or denominator), different remedies (corrective actions) should be applied.

For example, an increase in debt/EBITDA ratio could be due to (i) an increasing debt level, or (ii) a decrease of EBITDA. In the first case, an appropriate corrective action could be the pledge of additional collateral. In the second case, it could be a short term or permanent phenomena and corrective actions could range from light restructuring to a more comprehensive restructuring of the obligations as part of the workout process (see Chapter 6 for more details). Financial indicators should be monitored continuously based on quarterly financial statements for material exposures and on semi-annual basis for others.

[6] It should be noted that there is a limited value in financial ratios in times of economic shocks (recessions) because: (i) previous business model might not work and cash flow generation should be adjusted to new environment; and, (ii) previous indicators have small explanatory power for future developments and cash flow generation capabilities. The most reliable indicator in such situations is the firm's ability to generate sustained cash flows.

[7] Agency of the Republic of Slovenia for Public Legal Records and Related Services (AJPES) http://www.ajpes.si/?language=slovene

Table 2: List of potential financial indicators

Ratios	Thresholds
Debt/EBITDA	Prudent ratio should be used for most companies (e.g., < 3), with somewhat higher threshold possible for sectors with historically higher ratios.
Capital adequacy	Negative equity, insufficient proportion of equity, or rapid decline over a certain period of time.
Interest coverage – EBITDA/ interest and principal expenses	This ratio should be at least above 1,1[8].
Cash flow	Large decline (30 percent) during reporting period, or negative EBITDA.
Turnover	Decrease in turnover, loss of substantial customer, expiry of patent.
Changes in working capital	Lengthening of days in sales outstanding and days in inventory.
Increase in credit exposure to customers	Lengthening of days in receivables outstanding. Sales can be increased at the expense of deteriorating quality of customers.

c) Collateral and behavioral indicators

This group of indicators (Table 3) includes signals about potential problems with collateral adequacy or behavioral problems. Most of these signals should be monitored at a minimum on a quarterly basis with more frequent monitoring of occupancy rates and real estate indexes during downturns.

Table 3: List of potential collateral and behavioral indicators

Indicator	Description
Loan to value (LTV)	LTV > 100 indicates value of collateral is less than loan amount outstanding. Reasons for this could be that collateral has become obsolescent or economic conditions have caused rapid decrease in value. To be prudent, the ratio should be below 80, to provide adequate cushion to cover substantial cost associated with collateral enforcement[9]. For further discussion of good practices in collateral valuation please refer to Chapter 5 of this Handbook.
Downgrade in internal credit risk category	Annual review of borrower's credit profile reveals shortcomings.
Credit card loans	Delay in settling credit card loans or increasing reliance on provided credit line (particularly for micro companies and individual entrepreneurs).

[8] ECB AQR manual - https://www.bankingsupervision.europa.eu/ecb/pub/pdf/assetqualityreviewphase2manual201403en.pdf

[9] The World Bank Doing Business index shows that the average cost of collateral enforcement is close to 13 percent in Slovenia (http://www.doingbusiness.org/data/exploreeconomies/slovenia#enforcing-contracts)

Breaches of contractual commitments	Breach of covenants in loan agreement with bank or other financial institutions.
Fall in hotel occupancy rates	Relevant for hotel industry.
Fall in office/shop occupancy rates and rental prices	Relevant for commercial real estate projects.
Real estate indexes	Bank should monitor real estate indexes[10] in adequate granularity. Depending on collateral type (commercial or individual real estate) the bank needs to establish reliable, timely, and accurate tracking of changes in respective values. Decline larger than 5 percent on annual basis (y/y) should create a flag for all exposures that have similar collateral. At this stage, the bank should review if LTV with the new collateral value is adequate.

d) Third party information

The bank should organize a reliable screening process for information provided by third parties (e.g. rating agencies, tax authorities, press, and courts) to identify signs (Table 4) that could lead to a borrower's inability to service its outstanding liabilities. These should be monitored on a daily basis so that they can be acted on immediately upon receipt of the information.

Table 4: List of potential third party information indicators

Indicator	**Description**	**What and where to watch**
Increase in tax liabilities	Substantial increase in tax rates or borrower has unpaid tax liabilities to tax authorities.	Press. Information provided by tax authority.
Significant negative information	Negative press coverage, reputational problems, doubtful ownership, involvement in financial scandals.	Media.
Insolvency proceedings for major supplier or customer	May have negative impact on borrower	Information from courts and other judicial institutions.
Decrease in average credit score in the banking system	As of September 1, 2016 BoS Central Credit Register provides banks with borrower's average credit score in the banking system (for legal entities).	BoS Central Credit Registry

e) Operational indicators

In order to capture potential changes in company's operations, a close monitoring of frequent changes in management and suppliers should be arranged.

[10] Real estate indexes provided by the Ministry of the Environment and Spatial Planning (GURS) - http://www.gu.gov.si/en/

Table 5: List of potential operational indicators

Indicator	Description	What and where to watch
Frequent changes of suppliers	Too frequent changes of suppliers could indicate potential problems with payments.	Discussions with company.
Frequent changes of senior management	Often rotation of senior management, particularly CEO, CFO, CRO, could indicate internal problems in the company.	Annual report and discussion with company.
Change of the ownership	Changes in ownership or major owners (stakeholders or shareholders).	Public registries and media.
Major organizational change	Restructuring of organizational structure (e.g., subsidiaries, branches, new entities or daughter companies).	Public registries and media.

It is important to note that the proposed categories and indicators presented above are not exhaustive. Each bank should work to create a solid internal database of these and other indicators which should be utilized for EWS purposes. The indicators from the database should be back tested in order to find out the indicators with the highest signaling power. For this purpose, indicators should be tested at a different stages of an economic cycle.

2.2 Corrective action

Once an early warning signal is identified, based on the criteria explained above, the credit risk management department refers the potentially problematic exposure to the account officer in charge of the borrower's relationship. The account officer then contacts the borrower to determine the cause and severity of the signal. At this stage, the borrower is included in a 'watch list' and classified in a lower rating than "ordinary" customers. After several rounds of communications with the borrower, the loan officer, in cooperation with risk manager, should decide on what are the further follow-up actions required. There are two potential scenarios: (i) the exposure remains performing while on the watch list and will be brought back to regular exposures after some time, and (ii) credit quality of the exposure continues to deteriorate and it is transferred to the bank's Workout Unit (WU).

While on the watch list the bank should decide on, and seek in implement appropriate corrective actions in order to mitigate further worsening of exposure's credit quality. Corrective action might include: (i) securing additional collateral or guarantee; (ii) strategic review of company's business model (e.g., if recession is approaching, a company should refocus from demand-elastic products to non-elastic ones, or target export markets); or (iii) ensure the borrower reviews expenses and introduces cost cutting measures.

To ensure its effectiveness, the following principles should be incorporated into the EWS process:

- A signal received from a borrower should trigger the review of all exposures to such borrower as well as related parties.
- Exposures can only be removed from the watch list with the approval of the credit risk management department.
- All actions, together with identity of the responsible officer as well as the date the action was taken, should be recorded in the IT system and stored (for at least 5 years) to provide an audit trail.
- Timetables for action deadlines and level of monitoring should incorporate the materiality principle, i.e., shorter deadlines and more intensive monitoring for exposures of material importance.

2.3 Monitoring

Once increased credit risk is identified, it is crucial for the bank to follow up on the signal received as soon as possible, and develop a corrective action plan to preempt potential payment difficulties. The intensification of communication with the borrower is of utmost importance. The action plan may be as simple as collecting missing information such as an insurance policy or as complex as initiating discussions on a multi-bank restructuring of the borrower's obligations. While the customer remains on the watch list, bank's primary contact with the customer remains the account officer, although his manager as well as risk management are expected to take a more active involvement in the decision and action process for larger, more complex exposures. While on the watch list, the borrower should be classified in a lower rating than "ordinary" customers.

All exposures in the bank's portfolio should be subject to the EWS described above. This applies to performing exposures that never defaulted, but to restructured exposures as well. The principles of monitoring restructured exposures remain the same as in the previously described EWS. The difference is in acting manager – the restructured exposure remains in the workout unit until it is cured (see Chapter 8 for further discussion of treatment of restructured loans).

2.4 Timeline

For EWS to be effective, clear deadlines for actions should be in place, and consistently enforced (see indicative timeline in Table 6). The main benefit of the system is its ability to identify and resolve potential problem at an early stage, thus prompt action is essential.

The level and timing of the monitoring process should reflect the risk level of the exposure. Larger loans should be monitored more closely and senior staff and management should participate in the process. Smaller loans should be followed by less senior staff within the institution, with the results reported to the management.

Table 6: Indicative timeline for EWS operation

Action	**Who acts**	**Timeline (in days from signal received)**	**Description**
Signal received	Account officer		
Follow up with the borrower and report with analysis	Account officer	Max 3 working days for material exposure and 5 working days for others.	Credit officer contacts borrower, determines reasons, and provide analysis.
Decision on further actions	Account officer & manager Risk manager, EWS manager	Max 6 working days for material exposure and 10 working days for others.	Decision for exposure to be: (i) put on watch list and potential request for corrective action; (ii) left without action or mitigating measures; and (iii) transferred to workout unit.
Review of watch list	Risk manager, EWS manager	Every 1 month for material exposures and 3 months for others, the list is reviewed and amended, if needed.	Risk manager monitors performance of the borrower and agreed mitigation measures. If needed, takes decision to transfer to workout unit.

Final decision	Risk manager, EWS manager	Maximum time borrower can remain on watch list is twelve months	Borrower can be on watch list only on temporary basis. after twelve months a final decision should be taken, i.e., loan either removed from watch list (if problems are resolved), or transferred to workout unit.

Restructuring Guidelines for Micro, Small and Medium-sized Companies

II.a.1 - The bank should define clear and objective criteria for handing over a debtor to the workout and legal support unit, as well as the criteria for returning the client back to the commercial unit for regular management. The commercial unit and the workout and legal support unit must be completely separated in terms of functional, organizational and personnel issues.

2.5 Establishing criteria for transfer to workout unit

Banks need to establish clear and objective time-bound criteria for the mandatory transfer of loans from the originating unit to the WU. While corrective actions should be taken as soon as a problem is identified, if the problem cannot be solved within a reasonably short period, the loan should be transferred to the WU for more intensive oversight and resolution. Allowing seriously past due loans to remain within the originating unit perpetuates the problem, leads to increased NPL levels within the institution, and ultimately results in a lower collection/recovery rate.

90 days past due (dpd) should be the most common trigger for mandatory transfer. Additional criteria may include: debt to EBITDA ≥ 8, net loss during any consecutive twelve-month period ≥ 33 percent of equity, attachments to bank accounts, length of time on watch list (e.g., more than twelve months), or at least two unsuccessful prior restructurings. The decision to transfer a loan to the WU should be based on an educated judgement that the exposure will not be repaid in time, in full and urgent action is needed in view of the borrower's deteriorating situation. The above-mentioned criteria can give a clear signal that: (i) debt level is unsustainable; (ii) equity of a company has been severely depleted; or (iii) previous restructurings were not successful, and more drastic measures should be applied.

Exceptions to this policy should be rare, well documented in writing, and require the approval of RM. The most common justification for an exception is that the loan is well secured and in the process of collection. This means that the source of payment has been identified, its funding verified and the closing date is imminent (within two weeks). Copies of commitment letters, verification of closing dates and source of funds, etc. should be obtained as part of the approval process.

3. EWS structure and institutional arrangements

3.1 Structure of EWS within the Bank

To ensure independence of the process, achieve a holistic approach to credit risk monitoring, and prevent conflicts of interest, the EWS should operate outside of the loan originating unit. Best practice indicates that the EWS specialized unit should be housed within the credit risk management department as a separate unit but fully incorporated into the bank's regular risk management processes. Since an effective EWS requires an operational IT system that draws all information available about a particular borrower, EWS benefit from being part of the bank's internal credit rating system that already contains information about the borrower. The bank should allocate enough staff and financial resources to keep the system operational and effective.

The operation of the EWS should be governed by written policies and procedures, including time thresholds for required actions, approved by the Management Board of the bank. They should be subject to annual review and reapproved by the appropriate management body to incorporate: (i) required changes identified during previous operational periods; and (ii) regulatory amendments. Additionally, independent quality assurance (e.g., review of the process by external expert) should be considered.

3.2 Institutional arrangements

Policies and procedures should clearly spell out the roles and responsibilities of all parties involved in the EWS process. Table 7 below illustrates such an approach.

Table 7: Institutional arrangements for effective EWS

Unit	Responsibilities
EWS Unit	• Management of EWS tool, coordination of the process and responsibility for the watch list. • Responsibility for the quality of the data in EWS. • Monitoring of the automatic flagging system, updating of data/indicators, and appropriate notification of account officer in charge of exposure. • Preparation of a list of potentially doubtful borrowers. • Approval of changes to borrower status proposed by risk managers, in consultation with respective account officer. • Approval and updating of appropriate mitigating measures proposed by risk managers, in consultation with respective account officer. • Collaboration with risk managers in the preparation of reasons for payment difficulties. • Monitoring of implementation of strategies and measures adopted. • Preparation of the monitoring report.
Risk Managers	• Proposals for borrower's credit status, in cooperation with respective credit officer. • Proposals for risk mitigation measures for watch list borrowers, in cooperation with respective credit officer. • Review/update of borrower's credit ratings. • Analysis of borrower's financial position and identification of payment difficulty reasons. • Monitoring of the implementation of strategies and measures adopted.
Account Officers	• Receive an automatic flag from EWS on potential payment difficulties. • React immediately to the signal by contacting borrower. • Acquire an explanation and data from the borrower and record this information into system. • Organize meetings with other units as necessary.

	• In cooperation with risk managers, provide proposal for customer status (ordinary treatment, watch list, resolution) and potential mitigation measures. • Ensure that collateral valuations are up-to-date and correct.

3.3 Reporting

All actions during the EWS process should be recorded in the IT system to provide a written record of decisions and actions taken. At a minimum, the system should record: (i) time the action was taken; (ii) name and department of those participating/approving the actions; (iii) the reasons for actions taken; and (iv) the decision of the appropriate approval authority, if applicable.

The watch list should include, at a minimum, the following information: (i) details of exposure, (ii) is it part of a group or related party, (iii) material or non-material exposure, (iv) date added to the list, (v) reviews taken (including time stamps) and outcomes, (vi) mitigation measures, and (vii) reasons for inclusion in the watch list.

The watch list (or at least material exposures on it) should be presented monthly to risk committee only or in parallel with credit committee for information purposes and potential action. For major cases, the bank's Management Board must be included in the decision-making process. The Management Board should also receive monthly: (i) a detailed list of material exposures for information; and (ii) aggregate figures for the exposures on the watch list. Information about the borrower/group in potential payment difficulties must be disseminated widely and promptly within the banking group, including branches and subsidiaries.

4. Summary of key good practices

For EWS to be efficient and serve the purpose of flagging as early as possible a borrower's potential payment problems, it should adhere to the following good practices:

- The system should be independent from the commercial credit department of the bank.
- EWS should operate on the IT platform that is integrated into bank's risk management system.
- The system should record details of actions taken, involved parties, and record the time the actions were taken. In addition, it should easily be able to produce different reports for analytical and managerial purposes.
- Triggers (indicators) for early warning signals should be comprehensive and should flag potential problem as early as possible.
- EWS should trigger timely and enhanced communication with the borrower to find the most appropriate solution for potential liquidity or solvency problems.
- EWS unit may use the materiality factor when designing appropriate timeframes for completion of corrective actions.
- Monitoring and corrective action should be applied at the level of a group of connected borrowers.
- Information about doubtful borrowers/groups must flow freely within the banking group.

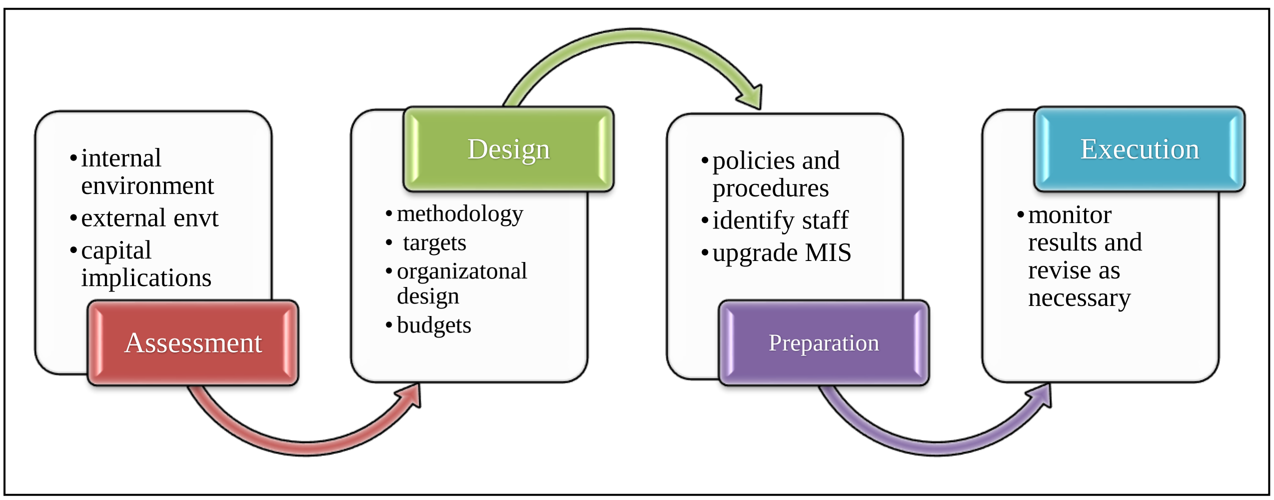
Chapter II. Strategy and institutional arrangements for resolution of MSME NPLs

The bank's goal in the resolution process should be to reduce non-performing assets as fast as possible in order to: (i) free up money and capital for new lending; (ii) reduce the institution's losses, and return assets to earning status, if possible; (iii) generate good habits and a payment culture among clients; and (iv) help maintain a commercial relationship with the client by conducting a responsible resolution process. To ensure that this goal is met, each bank should have a comprehensive, written strategy for management of the overall NPL portfolio, supported by time-bound action plans for each significant asset class, including MSMEs. The bank must also put in place and maintain adequate institutional arrangements for implementing the strategy.

1. Developing and implementing a strategy for MSME NPL reduction

The NPL reduction strategy should lay out in a clear, concise manner the bank's approach and objectives (i.e., maximizing recoveries, minimizing losses) as well as establish, at a minimum, annual NPL reduction targets over a realistic but sufficiently ambitious timeframe (3 to 5 years for the MSME portfolio). It also serves as a roadmap for guiding the internal organizational structure, the allocation of internal resources (human capital, information systems, and funding) and the design of proper controls (policies and procedures) to monitor interim performance and take corrective actions to ensure that the overall reduction goals are met. Figure 2 lays out the four key steps required to design and implement an effective NPL reduction strategy. Please refer to the ECB's Draft Guidance document for a detailed discussion on the requirements for developing an effective NPL reduction strategy.

Figure 2: Key steps in implementing an effective NPL reduction strategy



1.1 Assessment

Before a bank can begin to put together its MSME NPL reduction strategy, it must conduct a comprehensive assessment[11] of the operating environment for resolution. This includes

[11] Much of this work may be done on a bank-wide basis and then made available to the managers of specific assets classes such as MSMEs to be incorporated, as appropriate, in their individual strategies.

assessing its internal operating environment, the external climate for resolution, and the impact of various resolution strategies on the bank's capital structure. The purpose of this self-assessment is to provide management with a full understanding of the severity of the problems together with the steps that need to be taken to correct the situation. Key issues to be assessed under each of the three components include:

- Internal operating environment assessment focuses on determining the full scale and drivers of the MSME NPL problem; the identification of which resolution tools are most appropriate under the present circumstances; and the internal capacity to handle the resolution process focusing on human resources (both numbers and required expertise), decision making process, and MIS capabilities.

- The external assessment focuses on understanding the macro environment and how it will impact resolution activities. Key areas of consideration include: the broad macro- economic outlook as well as how it will impact significant segments of the MSME portfolio such as transportation or firms that sell goods or services to the real estate industry; the expectation of key external stakeholders (shareholders, regulator, etc.) regarding acceptable levels of NPLs; the local and international market for asset sales; the availability of third-party asset servicers; and, the impact of tax, regulatory, and judicial frameworks on the resolution process.

- The third component of the assessment focuses on the capital implications of the NPL resolution strategy.[12] Banks should not only consider capital levels and trends but should also dynamically model, under different economic scenarios, the capital implications of various NPL strategies being considered. For example, banks can use the stress test methodology and existing infrastructure to relatively quickly model such effects on their capital ratios. If capital is likely to constrain resolution activities, management should consider raising additional capital to enable timely clean-up of NPLs from the balance sheet.

1.2 Design

Upon the completion of the assessment, the actual design of the NPL strategy begins. Options to be used to resolve NPLs are identified; specific targets for NPL reductions established, together with performance indicators; and an operational plan detailing how the NPL reduction strategy will be implemented over both short and medium/long term is developed.

Broadly speaking, a bank has four options for dealing with its NPLs: (i) restructuring/forbearance; (ii) active portfolio reduction (sales or write-offs); (iii) change in exposure type (debt-to-equity or asset swaps or collateral repossession); or (iv) legal recourse (bankruptcy or enforcement) (see Chapter 6 for a detailed discussion of these approaches). The bank should mix and match these approaches in its NPL reduction strategy based on borrower profiles provided by a granular segmentation of the portfolio (see Chapters 3 and 5).

Before setting targets, the bank should have a clear view of what a reasonable level of MSME NPLs (as percent of total MSME loans outstanding and percent total loans outstanding) should be on a longer-term basis. As recommended by ECB Guidance note on NPLs, this target ratio should be based on international available best practices and standards, but also take into account the country circumstances. Specific targets for the absolute reduction in gross MSME NPLs should be established by time horizon, i.e., short (1 year), medium (up to 3 years) and long term (up to 5 years). These targets should be built from the bottom up by projecting both cash and non-cash reductions resulting from the application of each of the

[12] This work is usually done on a bank-wide level, but MSME management needs to be aware of and actively manage the impact of its activities on the bank's capital level.

four resolution options (restructure; disposal; collateral conversion; and legal proceedings). This includes cash collections from regularly scheduled payments on restructured loans; sale of repossessed real estate or other assets including sale of equity stakes; sale of individual loans or portfolios; proceeds from enforcement or bankruptcy proceedings; as well as non-cash collections from upgrades to performing status and/or transfers back to originating unit.

The strategy should also identify key performance indicators (KPIs) to aid in monitoring overall performance, and outline a corrective action process to be followed when an indicator shows significant variances from plan. KPIs may include, but are not limited to:

- Number and value of exposures which have not been transferred to workout unit.
- Number and value of exposures for which financial analyses and business viability studies have been completed.
- Number and value of Standstill Agreements (SSAs) approved and signed.
- Number and value of restructuring agreements and MRAs in preparation.
- Number and value of restructuring agreements and MRAs fully effective (i.e., documented and booked on loan system).
- Number and value of exposures paid in full (absolute value and as a percentage of total collections) by payment source, i.e., cash, collateral repossession, debt to asset or equity swap, or asset sale.
- Number and value of exposures returned to performing status.
- Type of restructuring/forbearance implemented and re-default rate.
- Number and value of exposures in legal proceedings by type of legal action (enforcement or insolvency).

The NPL strategy must be supported by a detailed plan clearly showing how the bank will integrate the strategy into its operations. At a minimum it should include:

- Clear definition of all steps to be taken to resolve a MSME exposure together with time-bound targets for completing such actions.
- Governance arrangements establishing responsibility for and monitoring of specific activities, including clear delegation of all approval authorities.
- Quality standards to ensure successful outcomes.
- Staffing and resource requirements, including internal and external expenses needed for running a workout unit. This should include cost of appraisals, expert valuations, legal costs, insurance and security costs which may or may not be reimbursable by the borrower.
- Capital budget for any required technical infrastructure enhancements, additional space requirement, etc.

1.3 Preparation

Once the strategy document has been approved by the Board, preparation for implementing the strategy begins. All required policies and procedures are prepared or revised; staff are identified; MIS is upgraded; space located, and furnishings and equipment purchased or moved.

1.4 Execution

The final stage involves the actual implementation of the plan within the bank. Significant emphasis should be placed on communicating to staff the key components of the strategy, particularly if the strategy involves sweeping changes to the existing organizational structure, existing policies and procedures, layoffs or mandatory transfers to WUs. Staff involved in the workout process should be provided with clear individual and team goals. Very importantly, all units should be provided with budgets that fully reflect the actual costs of implementing the NPL strategy.

Once the strategy is in place it should be closely monitored to ensure it is delivering the expected results. Variances should be identified and prompt corrective action taken to ensure longer term goals and targets are met. Best practice requires that the strategy be reviewed at a minimum on an annual basis. If properly designed, it should not require wholesale changes to the broad parameters of the plan. Appropriate changes are generally a reflection of changes in the external environment such as the development of an active asset disposition market which would allow more emphasis to be placed on portfolio sales or on third party asset servicers. Collection targets and budgets will require substantial annual revisions, and policies and procedures should be revised as necessary.

2. Structuring the workout unit

Effective management of NPL resolution requires that the bank establish a dedicated department or unit to handle these cases. The BoS has recognized the importance of such units by mandating their creation[13] as permanent units within the bank's organizational structure reporting directly to the Risk Management function rather than the loan originating units. The rationale for creating an independent unit for dealing with NPLs includes the elimination of potential conflicts of interest between the originating officer and the troubled borrower, and the use of dedicated workout staff and management. The segregation of duties includes not only relationship management (negotiation of the restructuring plan, legal enforcement, etc.) but also the decision-making process as well as support services (loan administration, loan and collateral files, appraisers, etc.) and technical IT resources.

The exact organizational structure of the workout unit varies greatly depending upon the circumstances each individual bank faces. Larger banks dealing with a significant number of NPLs are likely to establish several separate WUs or create sub-divisions within a single WU to handle different asset classes such as real estate, large corporates, MSMEs, or retail loans. Smaller banks may have to follow a simpler structure where an individual officer in a single WU may handle a wide variety of borrowers.

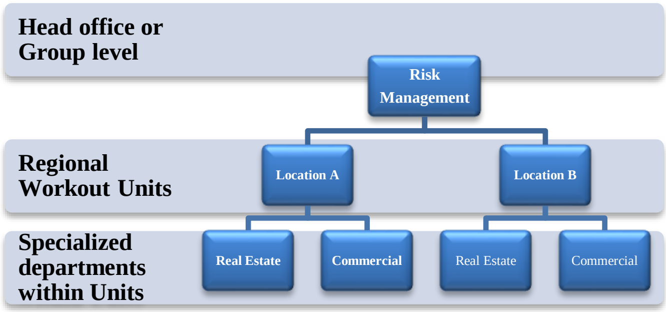
2.1 Centralized vs. Decentralized workout units

Workout units may either be centralized or decentralized. In a centralized approach, the workout unit is in one location, generally the head office, and handles all NPLs regardless of their originating location. This choice is most appropriate for most Slovenian banks given the more local nature of their business and the relative ease of travel within the country. For those banks which serve a wide geographical area requiring extensive travel to reach the customers, or which lend in multiple countries where there are distinct differences in legal practices or portfolio composition, a decentralized approach with one or more regional workout units may be more appropriate. Figures 3 and Figure 4 illustrate the structure of centralized and decentralized workout units.

[13] Section 3.3 of Regulation on Internal Governance Arrangements, the Management body and the Internal Capital Adequacy Assessment Process for Banks and Savings banks, Official Gazette of the Republic of Slovenia, No. 49/16 of 8 July 2016 – additions (in force since 9 July 2016).

Figure 3: Centralized workout unit

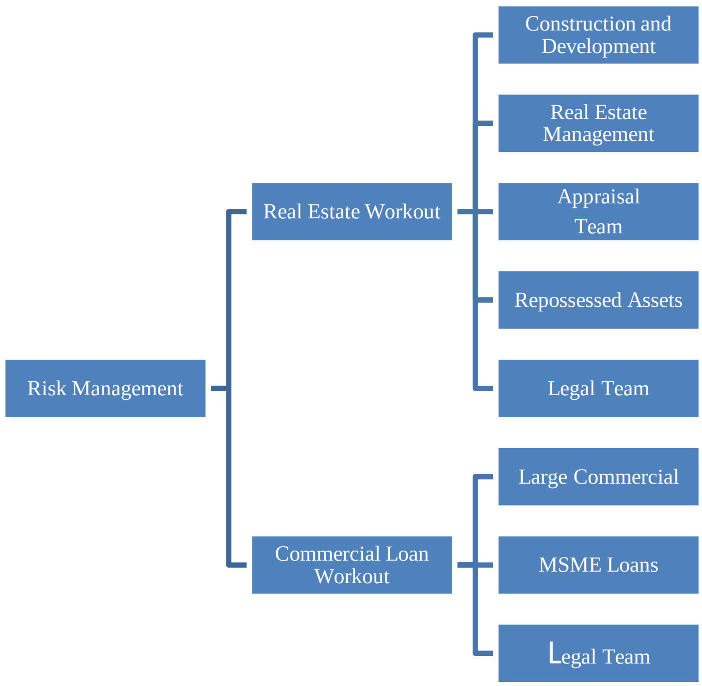
Figure 4: Decentralized workout unit



2.2 Hybrid organizational structures

In practice, most banks tend use a hybrid structure. Good practice advocates that those loans or functions which require specialized expertise (i.e., real estate construction, development, and management of repossessed collateral) be segregated in separate units under the overall direction of Risk Management. Smaller banks with more limited resources are more likely to choose a more centralized approach where all problem loans are handled in one unit. In these cases, management may choose to assign one or more officers with specialized expertise to handle such loans or functions such as management of repossessed assets. Figure 5 illustrates this more hybrid approach where the bank has chosen to establish separate units to handle real estate related loans and commercial loans. Within each of these units, there is then further specialization by type and size of loan. Legal and appraisal teams are also embedded directly into the workout units for greater efficiency, cooperation and coordination.

Figure 5: Hybrid approach to decentralization within centralized unit



2.3 Bad banks

Some banks may choose the further step of transferring NPLs, together with all related support staff, into a legally separate entity[14], the so called "bad bank".[15] This treatment has the advantage of removing the NPLs from the balance sheet of the bank thus restoring investor and depositor confidence. It allows the bank management to focus on returning the bank to profitability through new lending, and maximizes value of bad assets through professional, focused management. It comes, however, with a significant cost. The NPLs must be written down to market value prior to transfer to the bad bank. This crystalizes the losses on the bank's balance sheet which could require raising new capital. The bad bank also needs its own funding, separate organizational structures and IT systems, and doubles the effort needed to comply with regulatory requirements. Therefore, the bad bank should be considered as a measure of last resort, to be considered only when the size of NPL portfolio is very large relative to bank's balance sheet and/or other measures to deal with NPLs "in-house" have proven ineffective.

3. Staffing the workout unit

3.1 Skills required

Ideally, the managers of the WU, their team leaders and workout officers should be highly qualified professionals with demonstrated track record in NPL resolution. These individuals, however, may not exist at the time a workout unit is first established or as NPLs begin to increase rapidly. Management will then need to reassign large numbers of relationship officers[16] to the workout unit generally with the understanding that they will be returned to the lending unit as soon as the workflow permits. Key training needs are likely to include the proper evaluation of business prospects and projections, operational cash flows, and collateral valuations, discounted cash flow analysis, proper regulatory treatments, and a basic review of local and IFRS accounting rules.

Not all lending officers are suited for this type of work, either by skill level or temperament. Successful workout officers have strong analytical skills, enjoy the challenge of the restructuring process, and work well under pressure. By nature, they are detail oriented and creative but willing to work within the limitations imposed by the workout process. They have strong negotiating skills, are comfortable saying "no" when warranted, and are not easily intimidated by the borrower. Many good lending officers cannot make the transition from the more customer oriented focus of the lending unit to the more restrictive environment of the workout department. In this case, management must be willing to transfer the officer back to his original unit or allow him to leave the bank.

3.2 Remuneration

Retaining experienced workout officers is a challenge. As the number of problem loans is reduced substantially, officers begin to look for their next position. It is difficult to match compensation with incentives, particularly as the numbers of problem loans are reduced substantially and these officers begin to become concerned that they are working themselves out of a job. If compensation is based on cash recoveries, officers may choose to optimize their own short-term income at the expense of longer-term profit maximization for the bank. Conversely, basing compensation on a reduction in volume of non-

[14] The bad bank must be a legally separate entity from the bank to avoid consolidation in the bank's financial reports.
[15] In the case of Slovenia, the authorities have gone one step further in terms of establishing a centralized public AMC. It is understood however that this entity will continue managing the larger corporate NPLs, and does not plan to take over large volume of MSME exposures from banks.
[16] When assigning caseloads, care must be taken to ensure specific workout officers are not handling the same loans as they did in the origination unit.

performing loans may lead to improper restructuring or the bankruptcy of otherwise viable companies as officers seek to reduce the numbers by the quickest means possible. The staff may also be reluctant to employ the full range of restructuring options (particularly with respect to debt forgiveness) without provisions to indemnify them for costs and provide legal counsel to defend them in case legal charges are brought against them.

3.3 Outsourcing

To overcome these challenges, some banks have made use of outside professionals to fill skill gaps or provide "knowledge transfer". Investment advisors, consulting firms, insolvency practitioners, and temporary contract workers are just a few of the resources available. The types of services they can provide are varied as well and range from short term assignments to analyze a specific topic to more complex assignments such as the design of the institution itself or providing loan workout manuals and/or staff training. They are most helpful in providing guidance on the design and conduct of loan sales.

The bank may also consider outsourcing all or part of the recovery process to independent asset servicing firms. As the sale of NPL portfolios becomes more common, the asset servicing industry will begin to develop. Many contractors will have excess capacity on their servicing platforms and will be willing to manage loan portfolios for banks for a fee (usually consisting of a base fee to cover fixed costs and a variable fee or incentive based on performance). This may provide a welcome opportunity for a bank to reduce its workout unit staffing levels and return to more normal operations.

In this structure, the loans remain on the books of the bank and the bank remains obligated to ensure that they are managed in accordance with the bank's policies and procedures, and applicable regulations. The contracts for such services need to be carefully drafted to ensure the proper level of delegation of authority to the contractor, a clear statement of expectations, and clear and unambiguous fee structure. When using this technique, the workout unit consists largely of the risk managers and contract managers. The risk managers ensure that all restructuring proposals and required actions are documented in accordance with the bank's standards and manage the internal approval process within the bank. Contract managers, frequently from the legal department, ensure that all terms of the contract are met and that billings from and payments to the service provider are correct.

All outside service providers should be hired through an open, transparent bidding process with a Request for Proposal (RFP) that clearly defines the scope of the work and the expected outcome. The RFP should also make it clear if the firm will be chosen solely on the basis of its price or if the bank will also take other, more "quality based" criteria into consideration. If this is the case, these criteria should be fully disclosed together with the respective weights that will be assigned to each factor in the evaluation process. The contract would need to be carefully drafted to ensure that all terms, conditions and deliverables are clearly defined and that there is a clear and unambiguous fee structure. In addition, loan service contract must contain a clear statement of which actions, if any, the loan servicer may approve directly, as well as the process to be used to seek the bank's approvals if necessary.

3.4 Assigning workloads

Restructuring Guidelines for Micro, Small and Medium-sized Companies

II.b.1 - Once the bank has made a quick assessment of restructuring viability, the debtors are appropriately allocated within the units for the management of NPLs regarding the method of treatment (restructuring, collection or bankruptcy, sale of exposures), number of creditors involved, size and complexity of exposure (type of problem, corporate structure, type of collateral, type of exposure etc.). A competent account manager is appointed for each debtor and must take into account the limitations regarding the number of debtors per account manager and whether the bank would coordinate the process.

Section II.b.1 of the Guidelines recognizes the importance of quickly assigning an account manager to each borrower transferred to the WU. Banks should establish policies requiring accounts be assigned to a WO within (5) working days of their transfer. Accounts should be assigned in accordance with their materiality. That is, that the priority should be given to those accounts which represent the biggest risk to the institution either because of the size of the loan or exposure, or the risks inherent in the account[17] (e.g., political sensitivity, large multi-bank credit which requires bank to serve as coordinator, potential legal liabilities due to bank's prior actions, etc.). While there are no hard and fast rules for determining optimal caseload, it follows that the most experienced officers should be assigned fewer more complex, larger cases; mid-level officers a greater number of less complex, medium size borrowers; and, the more junior officers the smallest borrowers. Box 1 illustrates the use of this methodology to determine a preliminary estimate of required staffing levels.

Box 1: Example of estimating the required staffing for WU

The initial segmentation of Bank A's NPLs by size indicates that the workout unit will manage 300 clients, of which 60 percent represent small, less complicated exposures; 30 percent are medium sized; and 10 percent are large and complex. Applying the indicated caseloads below, the workout unit will need a total of 16 – 24 workout officers during the active restructuring phase of the workout cycle. This number then can be further refined and adjusted as more granular detail on the portfolio is gathered during the viability assessment.

Type of Case	**Officer Level**	**Recommended Average Case Load**	**Number of Cases**	**Indicated number of Officers Needed**
Large, complex	Experienced	5-7	30	6 - 4
Medium size and complexity	Mid-level	10-15	90	9 - 6
Small, simple	Junior	20 – 30	180	9 - 6
Total			300	16-24

After the active restructuring phase has been concluded and the bulk of the unit's workload is monitoring the restructured loans, caseloads of experienced and mid-level officers can be increased, and excess officers

[17] These risks should be highlighted by the originating unit during the transfer process.

returned to their original units. It is not recommended that caseloads for junior officers be increased; rather, as their skill levels improve, they should begin to assume larger cases so that more senior officers can be released.

4. Incorporating legal and support functions into workout unit

During normal times, most banks choose to have support functions housed in separate line units. However, as NPLs mount, many have chosen to integrate these functions (legal, appraisal unit, loan administration (loan booking and payment processing as well as credit and documentation files), and technical support functions) directly into the workout units to ensure greater control and easier access to these areas. Many have also chosen to physically locate risk managers and appraisal personnel within workout units as well (they continue to report directly to risk management and not the head of workout to ensure their independence). This is particularly appropriate if these functions are located off site.

4.1 The legal support

a) Organizational structure of the legal team

Banks require legal advice on a variety of matters related to the origination, management, and restructuring of loans. This includes not only documenting loan and restructuring transactions but also overseeing the collection process for those defaulted loans that could not be restructured. Banks may choose to establish their own legal team to provide these services or to outsource them to one or more local law firms.

If the outsourcing option for legal services is preferred for cost and efficiency reasons, considerations made above in respect to asset servicing firms are also applicable to the legal function. However, considering (i) the limited availability of collection and asset servicing agencies in Slovenia; and (ii) banks' preference to retain direct contact with the customer in the context of MSME loans, Slovenian banks have generally opted to rely on internal legal staff for workout process. In a relatively small country like Slovenia, where the cost and time invested in traveling to most areas of the country is limited, it seems reasonable that the legal team is centralized and all legal officers working with the Workout Unit are physically sitting together in the same place. This approach presents the following advantages:

- Legal officers are fully focused on collection activities.
- Consolidating and sharing the know-how acquired by legal officers becomes easier and more efficient, since all staff is sitting together and reporting to the same manager.
- A deeper knowledge of the client is allowed than if collection services are outsourced, which allows the institution to provide customized solutions.
- Legal officers feel more committed to the organization and its objectives.

Developing an internal legal team to support the Workout Unit does not imply that all legal work should be done internally, and in certain occasions it will be advisable that external legal counsel is brought on-board. Criteria that typically determine the need to engage external services are: (i) relevance of the case, which will be determined by the amount of the exposure that requires collection; (ii) complexity of the case, with bankruptcy cases being the most problematic, typically implying filing a range of motions to protect the institution's interest; and (iii) availability of resources, with some cases requiring an intensive allocation of resources for a short period of time that the bank cannot cope with.

Given the present high level of NPLs and to maximize the efficiency of the collection process for MSMEs, it is highly recommended that lending institutions maintain a dedicated legal team (or legal experts) within the Workout Unit to: (i) assist in the negotiation of the restructuring of those exposures that need to be addressed; and (ii) to be responsible for those exposures that require legal solutions to be collected (bankruptcy or foreclosure). It is considered good practice that the head of the legal team reports to the head of the WU, who must have an overall view and control over both the portfolio under collection and under restructuring. In addition, the head of the legal team should maintain a dotted reporting line to the head of the institution's legal department, who in turn likely reports directly to the Board of Directors. At a minimum the head and all members of the legal team need to be lawyers with experience in both the transactional aspects of lending and the collection practices. Some institutions may not have these individuals on staff, requiring them to hire from the outside.

b) Workloads

Assigning the workload of legal officers is a complicated task, as the dedication required from collection cases largely varies by the type of case and the legal stage that the case has reached. Bankruptcy cases and compulsory settlements in Slovenia require a substantial effort, especially at the beginning of the case when creditors must lodge their claims with the bankruptcy administrator and make a decision on the restructuring plan, if proposed. Conversely, mortgage enforcement cases that have reached an advanced stage require a lower level of effort. These circumstances should be taken into consideration by the head of the legal team when deciding on workloads.

For large portfolios with numerous collection cases, it is advisable that some degree of specialization is reached within the legal team and that some officers specialize in active bankruptcy cases while others specialize in enforcement of mortgages, for example. This will allow economies of scale and enable staff to become more specialized and efficient more rapidly. For MSME loans, the typical workload per legal officer could reach 20-25 cases per officer, assuming a mix of complex bankruptcy cases and relatively straightforward mortgage enforcement cases. However, these numbers depend on the amount of effort that each case will require.

4.2 Technical resources required for WU

Successful management of NPL portfolios requires a robust technical infrastructure (MIS) which centrally stores all related NPL information in a secure IT system. At a minimum, the technical infrastructure needs to provide easy access to all relevant information and documentation; efficiently process and monitor NPL workout activities; and define analyze and measure NPLs and related borrowers. ECB's Draft Guidance on NPLs provides detailed information on the requirements and outputs of a robust technical infrastructure.

Implementing and maintaining a robust technical infrastructure requires a significant commitment from management to enforce those procedures and policies which ensure that all data are complete and up-to-date. Given the importance of this function, best practice requires, at a minimum, an annual review of the adequacy of the system, including data quality. This review may be performed by either the bank's internal audit department (if qualified), or external auditors, or other qualified MIS professionals.

5. Developing a written policy manual

Restructuring Guidelines for Micro, Small and Medium-sized Companies

II.a.5 - The bank should pursue the same approach to all debtors with similar problems, regardless of the account manager in charge of individual case. Consequently, the bank should document the practices in a well-organized manner which should be shared among all account managers.

Section II.a.5 of the Guidelines recognizes the importance of adhering to a standardized approach toward all similarly situated borrowers. This requires that the bank's policies and procedures with respect to NPL borrowers be documented in a written Policy Manual.

Above all, the bank's Policy Manual should establishing a clear standard timeline for NPL management and resolution. The longer a borrower remains past due, the less likely he is to repay his loan. Successful resolution, therefore, requires that the bank recognizes the problem early on and adheres to a tight but realistic timetable to ensure that the debt is restructured, sold to a third party, or collected through legal proceedings (in the case of non-viable borrowers) in a timely manner. Table 8 presents an indicative timetable designed to ensure that restructurings are completed within 270 days of the loan becoming past due, and 180 days of transfer to the WU. The actual timetable may vary depending on the size and complexity of restructuring process. For a small borrower/small exposure, the workout process may take a month or less. For a large, complex multi-bank credit, the process may be quite contracted, and the management's approval should be sought in case the standard timeline is exceeded.

Table 8: Indicative timeline for management of a specific NPL

Days past due	Required action
5	Late payment reminder sent
30	Written notification that loan is past due
40 & on-going	Initiate direct contact with borrower to identify problem and potential solutions
90	Transfer to Workout Unit
93	Initial segmentation and preliminary viability assessment completed, and loan assigned to WO officer
95	Borrower and guarantor(s) notified in writing of transfer to WU.
100	Documentation review completed. WO requests necessary additional information and meeting with borrower (if necessary); revaluation of collateral ordered.
115	Second request for information made to borrowers who have not yet responded
130	Deadline for receiving information; decision on whether the borrower is non-cooperative is made
160	Financial and business viability assessment completed
170	Preliminary restructuring plan identified and negotiations begun
210	NPV analysis of various workout options completed
215	Restructuring plan submitted for approval
225	Restructuring plan approved by the bank
240	Commitment letter signed by borrower
270	Restructuring plan signed by borrower, booked on loan system

In addition, the Policy Manual should include a description of the following institutional policies, as applicable in different workout scenarios. <u>Please refer to the ECB Draft Guidance to Banks on Non-performing Loans for a detailed discussion of the content of each of these policies.</u>

- NPL classification and provisioning policy
- Arrears management policy
- Restructuring (forbearance) policy
- Debt recovery/enforcement policy
- Write-off and debt forgiveness policy
- Multi-bank distressed debt policy

- Collateral valuation policy
- Outsourcing/NPL servicing policy

6. Summary of key good practices

- All banks should have a detailed NPL strategy and an operating plan based on an in-depth analysis of the bank's internal capacity, the external environment (including macroeconomic forecasts as well as regulatory, judicial, legal and/or tax impediments), and capital position for all significant asset classes, i.e., real estate, large corporate, MSMEs, retail.
- Resolution options should be consistent with the strategy and include forward looking options which might not be achievable over the short term.
- WUs should be fully staffed and adequately funded to carry out their duties.
- Dedicated legal teams reporting directly to head of WU, should be embedded within WUs.
- WU policies and procedures, including the required level of approval for required actions, should be clearly documented in written form and made readily available to all WU staff.
- Clear timeline listing the standard steps and deadlines for management of individual NPLs should be approved by the bank.

Chapter III. MSME NPL Portfolio Segmentation

1. Purpose and principles of portfolio segmentation

Segmentation is the process of dividing a large heterogeneous group of NPLs into smaller more homogeneous parts. It is the essential first step in developing a cost effective and efficient approach to MSME NPL resolution. Grouping borrowers with similar characteristics allows the bank to develop more focused resolution strategies for each group. Using basic indicators of viability and collateral values, the portfolio can be broken down at an early stage by proposed broad resolution strategies (hold/restructure, dispose, or legal enforcement). Identifying broad asset classes at an early stage of workout is also helpful for efficient set up of workout units, including allocation of staffing and specialized expertise for more in-depth analysis of borrower's viability and design of final workout strategy.

The segmentation, including initial viability assessment, should be done immediately after the non-performing exposure is transferred to WU, and before the exposure is assigned to a specific workout officer. The exercise is normally performed by a dedicated team in the front office of WU.

In order to deal with the stock of MSME NPLs and with newly emerging MSME NPLs in the expedited and cost-effective manner, the bank should follow the principles of proportionality and materiality. Proportionality means that adequate resources should be spent on specific segments of NPLs during resolution process, taking into account the substantial internal costs of the workout process borne by the bank. Materiality means that more attention should be allocated to larger exposures compared to smaller exposures during resolution process. These principles should guide the allocation of financial, time and human (in terms of numbers and seniority) resources in WU.

The following specifics of the outstanding MSME NPLs portfolio in Slovenia (as of end 2015) should be taken into account when conducting a basic segmentation exercise: (i) large number of small amounts of MSME NPLs (36,5 percent) of total MSME NPL exposures are <EUR 10.000)[18]; (ii) on average, long period of days-past-due (average days-past-due in Categories D and E are 233 and 1.275 days, respectively); (iii) given the age of NPL portfolio, some exposures are already in legal proceedings; and (iv) a significant portion of MSME NPL exposures is associated with non-resident borrowers (Croatia and other Western Balkans).

A well-developed management information system containing accurate data is an essential pre-condition for conducting effective segmentation. The exercise is expected to be performed on the basis of information already contained in the loan file when it is transferred from originating unit to the WU. The problem is generally not one of too little data, but rather too much.

2. Two-stage segmentation process

It is recommended that the basic segmentation of the bank's MSME NPL portfolio is done in the following two stages.[19] The main objective is to select a smaller pool of exposures to potentially viable borrowers, which warrant the additional (substantial in case of material exposures) follow-up effort from WU, including in-depth viability analysis and re-evaluation of collateral, in order to design an appropriate workout strategy.

[18] This corresponds to less than 0.5 percent of total volume of MSME NPL exposures.

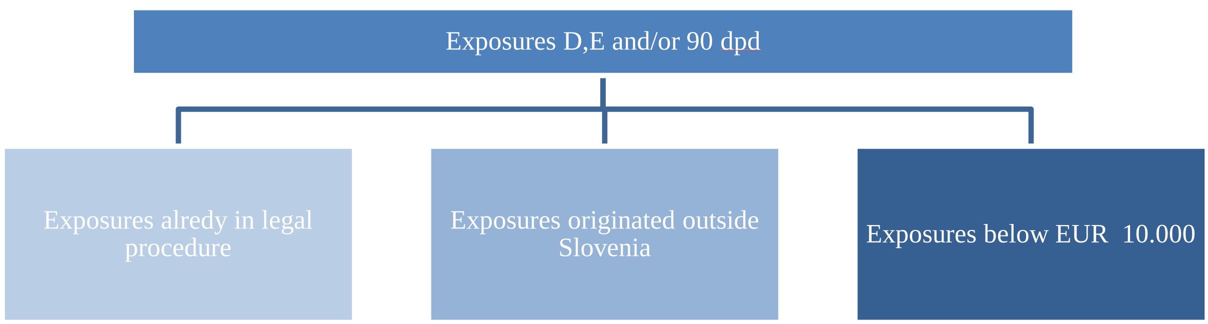
[19] The presented two-stage approach is one of many alternatives to segmentation. The bank may choose to use a different approach if deemed more appropriate for its specific NPL portfolio.

2.1 Stage one – segmenting by size, loan jurisdiction and status of legal procedures

As shown in Figure 6 below, at stage one of the segmentation process the bank should set aside the following categories of exposure:

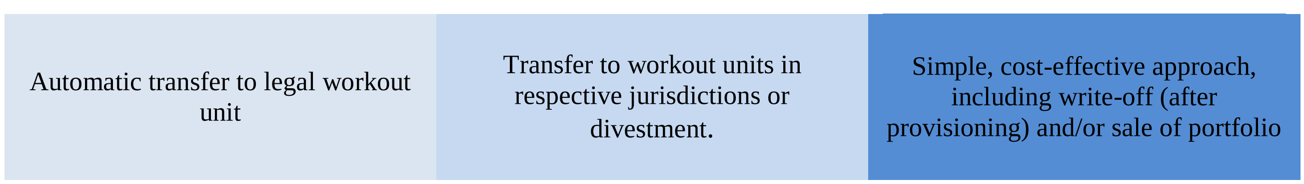
a) exposures already in legal proceedings – to be automatically assigned to the legal team working with the workout unit;
b) exposures originated outside Slovenia – to be assigned to workout units in respective jurisdictions, with serious consideration given to divesting these non-core assets to a third party;
c) micro-exposures with very small outstanding loan amounts (<EUR 10.000) – a very simple, standardized workout approach, including prompt write-off (with 100 percent provisioning) and/or sale of portfolio to a third party.

Figure 6: Stage one of segmentation exercise



Workout strategies for the above-mentioned three segments are shown in Figure 7 below.

Figure 7: Stage one of segmentation with workout strategies



The threshold for micro exposures is set at EUR 10.000 based on careful analysis of current MSME NPL portfolio, and is consistent with proportionality principle. For the bank, the cost efficiency should be one of the main guiding principles in the workout process. Given the very small expected recovery value, it does not make economic sense for the bank to allocate scarce resources to try to establish viability of these borrowers and design a customized, case-by-case workout strategy. Therefore, the bank is recommended to adopt a super-simple, cost-effective approach to micro-exposures, giving serious consideration to such options and prompt write-off and/or sale of this portfolio, based on solid business rationale.

It is important to note that, due to the position of MSME sector to the Slovenian economy, the bank should still pay close attention to micro-exposures related to individual entrepreneurs and family businesses. Such borrowers should be treated in a manner similar to retail clients, with consideration given to the strong public interest in keeping the family business alive. In this regard, the bank should consider selling such exposures only to a reputable collection company that would take into account the above-mentioned public interest.

2.2 Stage two - initial viability assessment

Following the initial segmentation, all remaining MSME NPLs (i.e., with current outstanding value above EUR 10.000, currently not in legal procedure, and originated in Slovenia) should be further screened according to two criteria: (i**) financial debt/EBITDA ratio; and (ii) loan-to-value (LTV) ratio.** Both ratios are readily available to the bank from the borrower's latest financial statements in the loan file, and should not require any additional information from the borrower.

- Debt/EBITDA ratio is used as a proxy for initial viability assessment of the borrower and reflects how leveraged the company is. After reaching a certain level, company is considered too leveraged and the risk of loan repayment in full and in time could be excessive.
- LTV ratio provides a good indication of the level of collateral against outstanding debt. It is seen as a readily available indicator that captures quantitative aspect of collateralization of the exposure, which should be an integral part of initial viability assessment. Quality of the collateral shall be further assessed during more thorough analysis done by the WU at a later stage (see Chapter 4).

The selection of thresholds for both indicators used in the initial viability assessment is based on: (i) empirical evidence from the Slovenian real estate market trends, and (ii) analysis of financial ratios of Slovenian companies (across economic sectors and time). As a general rule, debt/EBITDA ratio above 5 raises serious questions about overleveraging of the company and risks associated with it, while the ratio above 8 is not seen compatible with a viable business. Since there are specific sectors (e.g., real estate) in Slovenia where historic ratio, on average, has been above this threshold since 2007, the caps could be further modified considering the industry specifics.[20]

The threshold of 80 for LTV is considered to be a critical level for the adequate collateralization of the exposure. It should be taken into account that most of the NPLs were originated before the crisis when the collateral values were higher, particularly for real estate. Prudent lending policy requires that the bank holds adequate collateral to mitigate the credit risk undertaken. Downward price adjustment in the Slovenian real estate market between 2008 and 2015 was 37 percent for newly-built houses and 27 percent for used houses[21]. Thus there is a probability that what appeared to be an adequate collateral before the economic crisis does not satisfy sufficient collateral requirements in the current situation. Well collateralized exposures (with LTV below 80) may require a different workout strategy compared to exposures with insufficient collateral (LTV above 80). Segmentation according to LTV at this early stage is helpful for starting to consider various workout strategies described in Chapter 6.

Figure 8: Stage two of segmentation

Viable borrower LTV ≤ 80 Debt/EBITDA ≤ 5	Viable borrower LTV ≥ 80 Debt/EBITDA ≤ 5
Marginally viable borrower LTV ≤ 80 Debt/EBITDA ≤ 8 ≥ 5	Marginally viable borrower LTV ≥ 80 Debt/EBITDA ≤ 8 ≥ 5
Non-viable borrower LTV ≤ 80 Debt/EBITDA ≥ 8	Non-viable borrower LTV ≥ 80 Debt/EBITDA ≥ 8

[20] For specific industry ratios please refer to Box 2 in Chapter 5 and Appendix 1.
[21] BoS "Financial Stability Review" June 2016, page 8 (http://www.bsi.si/en/publications.asp?MapaId=784)

At this stage of the segmentation, the WU should be able to do a preliminary viability assessment aimed at sorting out exposures that are clearly non-viable. By separating them already at this stage the bank saves time and financial resources. Identified non-viable exposures should be promptly referred for legal procedure or considered for sale. The remaining pool of exposures, recognized as viable and marginally viable after the initial assessment, should be assigned to Workout Officers for an in-depth viability assessment based on additional information to be collected from the borrower and collateral re-evaluation (see Chapters 4 and 5). The differentiation on the grounds of collateral value reflected in the LTV ratio at this early stage allows the WO to receive a workout file with more granular information. It could give the WO a preliminary signal indicating where his work focus should be – on collateral in case of LTV > 80, or on cash flow analysis in case of LTV < 80. Following this analysis, a customized workout strategy is selected based on comparison of NPVs of expected recoveries under various alternative options (see Chapter 6).

2.3 Potential additional segmentation criteria

In addition to basic segmentation using exposure size, debt/EBITDA and LTV ratios, banks may choose to further segment the MSME NPL portfolio using additional borrower characteristics. These include:

- Industry and subsector of industry (e.g., real estate can be treated as a separate category with office buildings, apartments, land development, construction as sub-categories);
- Number of days past due. Higher payment interruption period could indicate higher predisposition to legal actions;
- Loan purpose (e.g., working capital, purchase of real estate, or tangible assets);
- Type of collateral (e.g., commercial or residential real estate, land plot, financial assets);
- Location of collateral;
- Interest coverage ratio (low ratio indicates problem with free cash flows);
- Other financial ratios described in Chapter 5.

<u>It should be noted, however, that segmentation into ever smaller groups is unlikely to lead to better results and may result in lost focus.</u>

3. Summary of key good practices

- Segmentation should be conducted immediately after the loan is transferred to the WU, in order reduce the cost of workout, and inform the allocation of resources within the WU.
- The overall objective should be to divide the NPL portfolio into at least two groups: (i) larger and potentially viable exposures that warrant further in-depth analysis and possible restructuring (forbearance); and (ii) micro and/or clearly non-viable exposures that should be referred for prompt legal action or considered for sale.
- Segmentation should include preliminary assessment of viability based on one or two financial indicators available in the loan file.
- Criteria and thresholds for segmentation should be clearly predefined.

Chapter IV. Preparing for the Workout Process

As the first step after receiving a new NPL, the Workout Officer must ensure that he has all necessary information about the borrower in order to make an educated decision about the appropriate workout strategy. In the best-case scenario, the bank should aim at achieving a consensual solution that satisfies the interests of both parties and results in a successful restructuring. Adopting such perspective implies not only a self-assessment of the bank's options and legal position, but also an analysis of the existing options and situation for the borrower. A comprehensive approach requires a thorough preparation process on both sides, which, if done properly, will maximize the chances of achieving a successful and mutually beneficial solution.

On the bank's side, a thorough preparation includes: (i) gathering all relevant information available on the borrower, (ii) conducting a detailed analysis of the bank's legal position; and (iii) accurately assessing the value of the collateral securing the loan. These aspects are further explained in the sections below.

Although the main beneficiaries of this Handbook are banks, it is also critical that borrowers come to the workout duly prepared and ready to work towards an amicable solution. For these purposes, Appendix 3 includes a general checklist of considerations that borrowers should address prior to engaging in negotiations. It is recommended that the banks make a similar checklist available to borrowers, both through website and when making the initial contact with the borrower in default.

1. Gathering of information about the borrower

All borrowers and guarantors should be informed promptly (within 5 business days) that responsibly for their relationship has been transferred to the WU. This notification should be in writing and contain a complete and accurate description of all legal obligations outstanding with the bank, the amounts and dates of all past due amounts together with any fees or penalties which have been assessed. Any violations of loan covenants or agreements should be clearly spelled out as well. The WO's name and contact information should be included together with a request for a meeting or phone call to discuss repayment options.

The borrower should be requested to submit the following information, preferably in electronic format:

- Information on all loans and other obligations (including guarantees) outstanding.
- Detailed contact information (mail, telephone, e-mail), including representatives, if applicable.
- Detailed latest financial statements of the company (balance sheet, income statement, cash flow statement, explanatory notes). Micro enterprises and financially less-sophisticated enterprises may submit only aggregate financial figures.
- Updated business plan, and the proposal for repayment/restructuring of debt obligations.
- Individual entrepreneurs should also submit information about the household. The two additional parameters for determining the debt servicing ability of such borrower are: (i) the borrower's family composition (number of children, number of earners in the family) to determine justified expenses[22]; and (ii) total net earnings.

[22] Justified expenses are reasonable expenses for an individual entrepreneur to provide for his family, including to cover the costs of reasonable living space.

Updated financial information, together with a detailed listing of all guarantees outstanding, if any, should be also collected from the guarantors (natural or legal persons) of loans. In addition, the bank should exercise all legal efforts to acquire additional information from other sources to form an accurate, adequate, and complete view of the borrower's debt servicing capability.

During the file review, the WO should pay close attention to identifying any other significant creditors. These may include other banks and financial institutions, tax authority, utilities, trade creditors, and loans to shareholders, related parties, or employees. Unpaid taxes, particularly those that represent social obligations, are particularly problematic. Tax authorities, by law, have a very limited ability to negotiate repayment plans for unpaid taxes and they have broad powers to place a priority lien on the borrower's property. This means that they will need to be fully repaid in the context of any debt restructuring. If the borrower's cash flow is insufficient to pay them and the banks and other creditors are unwilling to either lend fresh money or reduce their payments to provide the necessary funds, a restructuring will not be possible and the borrower will end up in a legal proceeding.

If during the file review the WO discovers that key information is missing, he should develop a corrective action plan to ensure its receipt. Much of the information will be relatively easy to request from the borrower or third party sources such as the credit bureau. Missing documentation, however, is likely to play a key role in determining which restructuring options are appropriate.

1.1 Identifying non-cooperative borrowers

At this early stage, the WO should define non-cooperative borrowers and carefully document their non-compliance. Useful criteria to be used to identify these borrowers are:

- Borrowers who default on their loans while having the ability to pay ("strategic defaulters") in hopes of receiving unwarranted concessions from the bank.
- Failure to respond either orally or in writing to two consecutive requests from the bank for a meeting or financial information within 15 calendar days of each request.
- Borrowers who deny access to their premises and/or books and records.
- Borrowers who do not engage constructively with the lender, including those that are generally unresponsive, consistently fail to keep promises, and/or reject restructuring/forbearance proposals out of hand.

As a rule, restructuring (forbearance) will not succeed with non-cooperative borrowers. Therefore, these exposures should be promptly referred for legal procedure or considered for sale to third party.

2. Determining the bank's legal rights and remedies

2.1 Review of documentation

Prior to entering restructuring negotiations with a borrower, the lending institution must prepare for these negotiations and have a very clear understanding of its bargaining position from a legal standpoint. One of the first steps to assess such position will be to carefully review the documentation and determine exactly what the bank's rights and obligations are. This review should take place within 10 days of the borrower's transfer to the WU.

This exercise will comprise a thorough review of all documents entered into with the borrower, with special emphasis on the loan agreement and the security package that was formalized when the transaction took place. An accurate assessment of the bank's rights will have a critical impact on determining the resolution strategy to be adopted.

The following is a general checklist of items that a WO should pay attention to when reviewing the documentation:

- Whether the parties to the loan were adequately described in the loan documentation;
- Whether all key documents were signed by the duly authorized persons under Slovenian law;
- Whether the loan documentation has been notarized;
- Whether the bank is in possession of all original documents;
- Whether the collateral has been duly perfected, including registration at the applicable registry (see following section);
- Whether the loan documentation included non-compliance with certain financial indicators as 'events of default', and whether these indicators have been breached;
- Whether the loan documentation included a cross-default clause and whether there are other loans that may be considered breached and/or accelerated as a result of the breach of one single loan;
- Whether there was an obligation on the bank to notify the borrower or potential guarantors of major changes in the documentation or the terms of the loan, like changes in legislation, currency, interest rates, etc.

Most of the issues included in the list above require legal expertise to be assessed correctly and it is advisable that a lawyer is included in the review process, to avoid problems later. After a careful review of the items included in the list, the WO may reach the conclusion that some deficiencies exist in the transaction documentation. In such case, the WO should avoid bringing these deficiencies to the attention of the borrower and should rather work with legal staff to develop a mitigation strategy to solve or partially reduce the risks or potential loss attached to the deficiency. These mitigation strategies may include sending notifications to third parties, registering collateral at public registries, or obtaining missing documentation. In some cases, the bank may be forced to consider a short-term restructuring (e.g., maturity extension) for the sole purpose of re-documenting the loan.

2.2 Ensuring collateral's validity

A key element that the workout officer should verify as part of the preparation of the workout is that the collateral taken at the time the loan agreement was formalized is valid and enforceable. This exercise will again require understanding and interpreting legal documents, which makes it advisable that the workout officer works closely with a lawyer from the legal team or the collections unit to verify these terms.

Collateral laws in Slovenia establish a set of obligations that need to be complied with to create a legally binding security. These requirements include:

(i) Collateral assets must be specified or specifiable for the security interest to be valid and enforceable; this is, the collateral cannot be left undetermined;[23]
(ii) a private agreement must be entered into establishing the obligation to create security[24]; this is, the main secured obligation;
(iii) a separate agreement on the creation of security (i.e., the security agreement itself);[25] and,

[23] As applicable to the non-possessory pledge (lien) on movable property (171 - Article 177 Property Code - PC, Official Gazette of RS, Nos. 87/02 and 91/13)
[24] *Zavezovalni pravni posel.*
[25] *Razpolagalni pravni posel*, although in some circumstances may be attached to the document under (ii) above.

(iv) depending on the type of asset pledged, performance of an additional act prescribed by law and aimed at ensuring third party effectiveness (typically, registration at a public registry).

If the collateral is real estate, the mortgage must be registered with the land registry. If the collateral is a movable asset, the pledge is perfected when it is either (i) transferred into the possession of the creditor/pledgee, or (ii) registered into the registry of movable assets, in the case of certain assets like automobiles and inventory. It is the WO's responsibility, assisted by a legal staff working with the WU, to go through the documents mentioned above and ensure that everything is in order before making a decision on the final strategy to be adopted.

2.3 Understanding bankruptcy and priority of claims

An "*order of priorities*" means that some creditors have precedence over others in the distribution of the proceeds collected through the sale of the debtor's assets, if bankruptcy were to take place. Understanding such order is of critical importance for workout officers, as it determines the bank's baseline for a potential restructuring. As further explained in Chapter 6, the expected recovery from the potential restructuring strategy should be compared with the expected recovery in a bankruptcy scenario, which is partially determined by other creditors' position. For this reason, the workout officer must become familiar with the particulars of the bankruptcy law through the institution's legal department or external local counsel (see Chapter 2 above).

In Slovenia, the order of priorities included in the bankruptcy law is beneficial for secured creditors, as their position is not affected by any statutory privileged claims. Indeed, secured creditors,[26] like holders of mortgages or pledges[27], remain unaffected by the opening of bankruptcy proceedings, except for the obligation to file their respective claims with the administrator. Therefore, they are entitled to preferential satisfaction of their claims up to the value of the collateral over which they hold security. The remaining proceeds should be distributed as follows[28]:

- privileged creditors, including employees' salaries and wages, taxes, compensations for work accidents, and all other claims listed in article 21 of the Insolvency Law; and,
- unsecured creditors, which rank *pari passu* among each other within a category.

2.4 Other legal aspects

In addition to the issues explained above, there are two important additional considerations that should always be borne in mind by workout officers to ensure that the legal position of the lending institution is not undermined. These issues are:

- *Statute of limitations* is a defense that may be asserted by the borrower to defeat collection actions brought against him by creditors after the appropriate time has elapsed. In these cases, it is understood that the creditor has waived his right to pursue collection of the debt if no action is brought within a certain period of time. In Slovenia, this period is 3 years.[29]
- *Avoidance actions,* which may allow creditors to claw-back debtor's assets that were previously transferred to third parties fraudulently. This is a very useful tool that may help minimize losses

[26] Upniki z ločitveno pravico

[27] This provision is also applicable to creditors with a right of separation (*upniki z izločitveno pravico*),

[28] See article 359 of the Insolvency Law.

[29] According to article 349 of the Obligations Code, applicable to Commercial Obligations.

and prevent dishonest borrowers from 'tunneling' assets out of the estate of the borrower. For these actions to be successful, the parties need to prove that the transaction resulted into either (i) the decrease of the net value of the debtor's assets, or (ii) and unfair treatment of a creditor vis-a-vis other creditors.

3. Collateral analysis

As stipulated in the ECB Guidance paper on NPL management, an accurate and up-to-date valuation of the collateral is required to prepare adequately for the workout. In particular, an in-depth knowledge of the nature of the collateral, its value, and marketability will provide useful guidance regarding the appropriate resolution strategy – either forbearance, enforcement or insolvency. Valuation of real estate and movable collateral should be done using appropriate sources of reference. Appraiser valuations or indexed valuations in case of real estate and market sources or databases for movable collateral (e.g., vehicles, equipment) should be used.

3.1 Frequency of valuation

A new collateral valuation must be obtained when a loan is classified as NPL and/or transferred to the WU, followed by least annual re-valuations thereafter. If a collateral valuation was done within the past 12 months, the property value may be indexed up to the time of transfer with a new valuation obtained thereafter on the anniversary date of the original valuation. More frequent valuations should be conducted if the property shows signs of decline in value or real estate market in general experiences significant decline.

3.2 Valuation methodology

Valuation methodologies as well as the written presentation of the results should follow European and international valuation standards.[30] All real estate collateral should be valued based on market value which is defined as: "*the estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without being under compulsion*."[31]

A market value or discounted cash flow approach, taking into account the amortization of property, can be used for income generating properties. Use of discounted replacement cost as the sole approach to valuation is not acceptable.

3.3 Use of indexing to determine collateral value

Real estate value estimates can be done either by appraisers or by mapping against indexes. For the purposes of index valuation, real estate indexes produced by the Ministry of the Environment and Spatial Planning (GURS)[32] should be used as the primary source. Alternative source of data are indexes provided by the Statistical Office of the Republic of Slovenia (SURS)[33]. Indexation should be used only for series that have adequate amount of records (in terms of time and numbers) and have proved to reflect market values. Valuations derived from index valuation do not qualify as a revaluation or an individual property valuation. Indexed valuations, however, may be used to update valuations for (exposures/loans) of less than EUR

[30] TEGOVA Blue Book (2016) and the Royal Institute of Chartered Surveyors (RICS).
[31] http://www.tegova.org/data/bin/a5738793c0c61b_EVS_2016.pdf
[32] http://www.gu.gov.si
[33] Statistični urad Republike Slovenije, http://www.stat.si/statweb

300.000 in gross value. In case the bank identifies substantial differences between GURS and SURS real estate indexes for specific market segments, the bank should seek an appraiser estimate.

3.4 Requirements for appraisers

Banks may choose to use external appraisers or directly employ qualified appraisers. The internal appraisal function should report directly to Risk Management, although it may be physically located within the real estate department, if the bank has such unit. The unit may be tasked with producing independent valuations and up-dates and/or may manage the outsourcing of valuations to external appraisers and review their work to make sure it meets the bank's standards. It is recommended that an independent external appraiser is used for valuation of the real estate collateral above EUR 1 million.

Both internal and external appraisers must meet the following qualifications: (i) be professionally competent, as evidenced by a valid license issued by the relevant authority; (ii) possess appropriate technical skills and experience valuing real estate property of the type and in the location of the property to be valued; and (iii) be familiar with any laws, regulations and valuation standards that apply to the assignment.

In addition, to avoid conflict of interest and ensure objectivity, all appraisers and their first grade relatives[34] should meet the following requirements: (i) the appraiser is not involved in the loan processing, decision making or credit underwriting process; (ii) the appraiser is not influenced by the debtor's creditworthiness; (iii) the appraiser does not have actual or potential conflict of interest regarding the result of the valuation; (iv) the appraiser does not have an interest in the property; (v) the appraiser is not a connected person to either the buyer or seller of the property; and (vi) the appraiser does not receive a fee linked to the result of the valuation.

4. Summary of key good practices

- Promptly notify borrower and guarantor(s) that exposure has been assigned to WU; provide name and contact information for the new WO.
- Promptly complete thorough review of credit and documentation files, and request missing/ additional information from the borrower and other sources.
- Determine bank's rights and remedies, including any deadlines and notification periods that need to be respected to exercise the bank's rights.
- Determine other significant creditors and how they might impact restructuring.
- Collateral valuation should be updated by certified appraisers promptly after transfer to WU, in order to establish current market value, using full valuation or reliable indexes.
- Valuation methodologies should be clearly spelled out in bank's internal documents and should follow international standards.

[34] Wife, husband, children, father, mother, sisters and brothers.

Chapter V. Financial and Business Viability Analysis

1. Purpose of financial and business viability analysis

Restructuring Guidelines for Micro, Small and Medium-sized Companies

III. The principal goal of quick and quality diagnostics is to determine if the debtor's business has good prospects on the long run or not. On this basis the bank establishes how soon (if at all), the company could repay its debt and reach a sustainable level of operation. In this process, the following phases should be applied:

1. The first part of the assessment must comprise the analysis of exposure and the analysis of the rationality of consolidation of exposure, the overview and the assessment of the quality of collaterals, the analysis of the sustainability of the business model and the ability to generate cash flow from the core activity.

2. A considerable number of companies still own large quantities of property not needed for business purposes (most often real estate or financial investments), which is why this part of the assets must first be identified and the scope of potential purchase amount to be used for the repayment of debt must be assessed.

Section III of the Guidelines recognizes the need to conduct a thorough financial and business viability analysis of MSME NPL borrowers to determine their ability to repay their obligations. This analysis serves as the foundation for making an informed decision on the proper resolution approach – restructuring (forbearance), sale to a third party, change of exposure type (debt-to-asset or debt-to-equity swap) or legal proceedings. The analysis should consist of several parts:

- A quantitative analysis of the borrower's past and projected financial performance;
- An analysis of the outstanding exposures both to the bank and other creditors, including the purpose of the credits, their repayment terms and current status, to determine the total debt burden of the company and the amount of debt that needs to be restructured;
- An analysis of the borrower's ability to generate sufficient cash flow to repay the debt;
- A more qualitative assessment of the borrower's ability to remain in business and generate sustainable cash flow

In general, the depth of analysis (in terms of documentation collected, time spent, etc.) should be proportionate both to the size of exposure and type of borrower. Small borrowers with simpler organizational structures and financial statements represent less risk to the institution. Their analysis can therefore be more streamlined. Instead, resources should be focused on developing a complete understanding of the larger, more complex exposures.

1.1 Who should conduct this analysis?

Restructuring Guidelines for Micro, Small and Medium-sized Companies

II.b.2. - The assessment of restructuring viability should be prepared by the organizational unit or the employees who have previously not been included on the loan approval process, but in cooperation with the commercial unit, in order to provide comprehensive information. During the restructuring process, individual organizational units must closely cooperate in order to successfully complete the process.

Section II.b.2 of the Guidelines require that this analysis be conducted by the WU, i.e., by staff not previously involved in the loan approval process. In most cases, the analysis will be performed by the WO. The Guidelines also recognize that the analysis may require the cooperation of several organizational units within the bank such as the originating unit for background information, the bank's internal collateral appraisers, or the legal team for guidance on issues related to enforcement or insolvency.

2. Analysis of key financial ratios

Financial ratios, calculated from data provided in the balance sheet and income statement, provide an insight into a firm's operations and are among the most readily available and easy to use indicators for determining the borrower's viability. They fall into four broad categories:

2.1 **Liquidity** ratios measure how easily a company can meet its short-term obligations within a short timeframe.

(a) **Current ratio** (total current assets/total current liabilities) measures a company's ability to pay current liabilities by using current assets. It is, however, highly dependent upon the quality of the receivables and inventory. If either or both are of poor quality, the ratio will be misleading. A general rule of thumb is that the ratio should be at least 2:1 for a healthy company. It must be recognized that the distressed borrower's ratios will be considerably lower. Throughout the course of his analysis, the WO should be forming an opinion on what it would take for the borrower to achieve a more normal ratio within a reasonable time frame.

(b) **Quick ratio** which includes only liquid assets (cash, readily marketable securities and accounts receivable) in the numerator is a measure of the firm's ability to meet its obligations without relying on inventory. A minimum ratio of 1:1 would be acceptable.

2.2 **Solvency** or **leverage** ratios measure the company's reliance on debt rather than equity to finance its operations as well as its ability to meet all its obligations and liabilities.

Box 2: Using Debt/EBITDA ratio in assessment of borrower's viability

Following the initial viability assessment during the segmentation exercise (see Chapter 3), a more thorough analysis, including refreshed financial indicators and collateral estimates, should be done to better understand the viability of the borrower and provide the most appropriate workout strategy. The graph below illustrates how the viability of non-performing borrowers can be assessed by the WU using the updated information about Debt/EBITDA ratio and quality of collateral.

Exposures D, E category or/and 90 dpd ≥ 10.000 EUR

Viable borrower LTV ≤ 80 Debt/EBITDA ≤ industry average +20% with cap at 5	Viable borrower LTV ≥ 80 Debt/EBITDA ≤ industry average +20% with cap at 5
Marginally viable borrower LTV ≤ 80 Debt/EBITDA ≥ industry average +40% with cap at 8	Marginally viable borrower LTV ≥ 80 Debt/EBITDA ≥ industry average +40% with cap at 8

The WO would use the information about latest available (currently end 2015) average debt/EBITDA ratio for the industry, with 20 and 40 percent adjustment margin to allow for fluctuations in economic cycle and the company's specific circumstances (see table below for historic debt/EBIDTA ratios in Slovenian economy). The model proposes to introduce ratio caps of 5 and 8, for viable and marginally viable borrowers, respectively. The ratio caps could be further modified considering the industry specifics. Under this model, borrowers with debt/EBITDA ratio in excess of 8 would be considered unviable, and referred for legal solution.

Financial debt/EBITDA ratios in Slovenia's key economic sectors

		2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
C	Manufacturing	2,51	3,39	3,92	3,68	3,4	3,45	3,26	2,49	2,16
F	Construction (rhs)	5,08	5,9	9,41	29,79	25,67	17,27	12,23	118,07	6,1
G	Wholesale and retail	3,96	4,39	5,27	5,44	5,79	6,21	5,67	4,43	3,81
H	Transport and storage	8,16	9,84	15,58	9,05	7,55	6,66	6,27	5,57	5,45
I	Hotels	6,24	8,5	9,4	12,01	12,27	12,68	11,88	16,34	7,82
L	Real estate (rhs)	10,17	12,12	15,97	14,18	18,19	31,06	53,59	76,14	16,22

Source: Chamber of Commerce & Industry of Slovenia, based on data from Ajpes

(a) **Debt to EBITDA** (total liabilities/EBITDA) is a measure of the firm's borrowing capacity. The lower the ratio the better, with a ratio below 3 generally expected from a viable borrower in manufacturing or trade sector.[35] Borrowers with ratios between 3 and 8 would fall into a marginally viable category. A ratio ≥ 8:1 indicates that the firm is highly over-indebted and

[35] Investment funds buying NPLs for workout usually target to achieve debt/EBITDA ratio at 3 and, based on this assumption, calculate a price they are willing to pay for NPL acquisition.

probably will not survive unless debt forgiveness is applied. Box 2 presents more details how debt to EBITDA ratio can be used as one of the key criteria for determining the borrower's viability.

(b) **Times interest earned** or the **coverage** ratio (net profit before tax + interest expense/interest expense) is a measure of the firm's ability to generate sufficient earnings to pay interest. It also can be used to measure the degree by which earnings can decline without affecting the firm's ability to pay interest. A ratio of 2:1 is considered the minimum acceptable level of coverage.

(c) **Debt coverage (**net profit +depreciation and amortization/current maturities of long term debt**)** is a measure of the firm's ability to generate sufficient earnings to meet its debt servicing obligations. A ratio of 2:1 is desirable.

2.3 **Profitability** ratios measure the company's growth and ability to generate profits or produce sufficient cash flow to survive.

(a) **Rate of sales growth/decline** (change in sales/previous year's sales) measures the percentage change in sales year over year.

(b) **Gross profit margin** (gross profit/net sales) indicates how well the company can generate a profit at the gross profit level. It addresses three areas: inventory control, pricing and production efficiency.

(c) **Net profit margin** (net income/net sales) measures how much of the company's net sales are kept as income. This ratio should remain stable or increase over time.

2.4 **Efficiency** ratios measure management's ability to effectively employ the company's resources and assets.

a) **Receivable turnover (**average net receivables/net sales x 360) measures the firm's ability to generate cash from its receivables. Shorter collection periods are preferable. Longer collection periods should be investigated as poor receivables quality can greatly increase this ratio and significantly impact cash flow

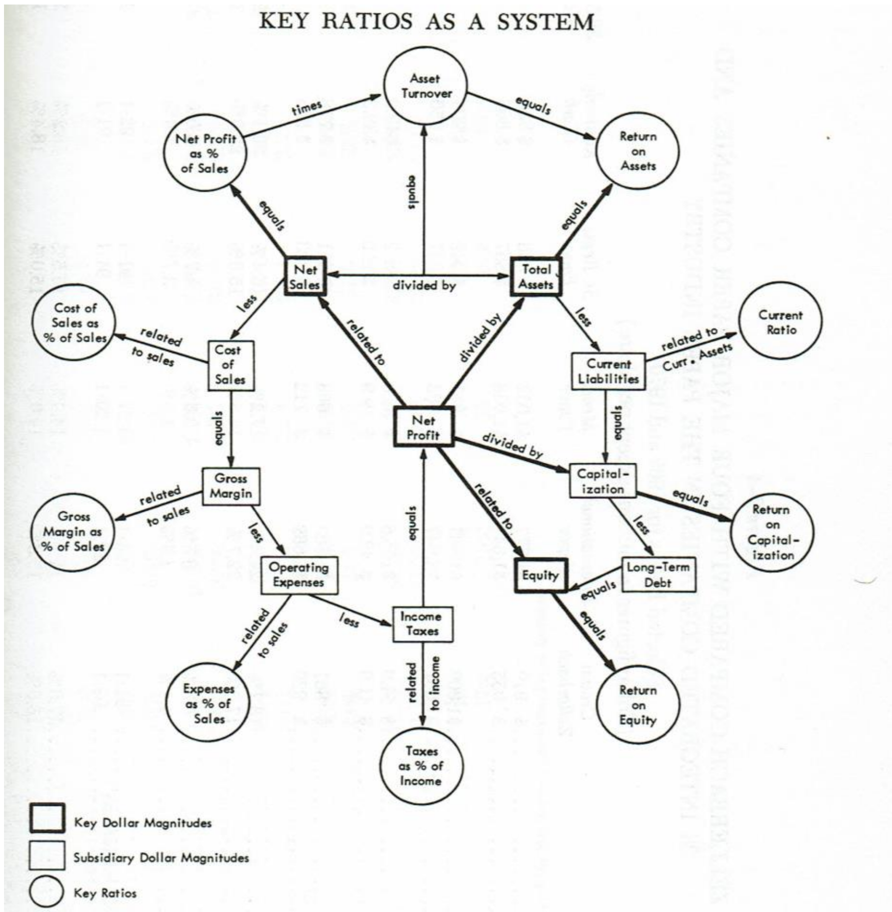
b) **Inventory turnover** (average inventory/cost of goods sold x 360) measures the firm's ability to manage its inventories. Lower values of this ratios are generally considered to be good. Increasing or high ratios could reflect slowing sales, bulk purchases to take advantage of favorable discounts or in advance of price increases. Inventory turnover varies significantly between different industries. Businesses which sell perishable goods such as markets or restaurants will have very low ratios as compared to those companies selling non-perishable goods

c) **Payable turnover** (average payables/cost of goods sold x 360) measures the firm's ability to use suppliers' funds to finance its operations. High days outstanding may indicate cash flow problems.

d) **Return on equity** (net income/average stockholders' equity) measures profitability of business. Higher values are generally favorable indicating management's ability to generate income on new investments. However, reductions in share capital financed by debt will artificially boost the ratio.

It is important to keep in mind that financial analysis is more than simple "number-crunching". It is a process which helps explain how management's decisions affected the company's performance, and assess whether, and under what circumstances, the company can generate sufficient cash flow to repay its debt. The analysis should focus on both the numerator and the denominator of ratios, as significant changes could occur in both, but the ratio would remain the same. Without this detailed analysis, the WO could miss important underlying trends. Understanding how the ratios are interrelated (See Figure 9) for an old but still relevant model) and how even a small change in one ratio may impact others can provide important clues as to the company's real problems as well as what corrective actions need to be taken to restore the company's financial health.

Figure 9: Key ratios as a system[36]



All the above listed financial indicators should be analyzed in the context of Slovenian situation and taking into account the specifics of various economic sectors (e.g., manufacturing, construction, hotels). It should be noted that indicators vary across sectors, sometimes substantially. However, the WO should exercise prudence in his analysis and utilize reasonable caps and floors for certain ratios. For reference, the WO may want to use recent historical data on evolution of specific ratios in various sectors of economic activity in Slovenia (see the data on select industry specific ratios in Appendix 1).

2.5 Balance sheet analysis

In addition to computing and analyzing the key ratios, the WO should carefully review the balance sheet to develop a basic understanding of the composition of the borrower's assets and liabilities. Primary emphasis should be placed on developing a complete understanding of all obligations outstanding to the bank and other creditors, including the purpose of the credits, their repayment terms and current status, to determine the total debt burden of the company and the amount of debt that needs to be restructured.

[36] Helfert, Erich A., *Techniques of Financial Analysis*, Third Edition, Richard D. Irwin. Homewood, Illinois, 1972, pg.71.

The composition of liabilities, particularly "other liabilities" and accrued expense items should be addressed. Wages payable and taxes are two particularly problematic accounts. Both represent priority claims against the borrower's assets and must be settled if a successful restructuring or bankruptcy is to take place.

The analyst should also conduct a careful examination of "other assets" and the "property, plant and equipment" accounts to determine if there are any unencumbered or excess assets which might be sold or pledged as collateral.

2.6 Cash flow analysis - defining financial viability

When financial statements are prepared on an accrual basis, cash flow analysis ties together the income statement and the balance sheet to provide a more complete picture of how cash (both sources and uses) flows through the company. Cash is the ultimate source of loan repayment. The less cash is generated by operations, the less likely the borrower will be able to repay the loan, making it more likely that the bank will need to rely on its collateral (asset liquidation or bankruptcy) for repayment. Thus, the primary emphasis when conducting the financial analysis of the borrower should be on its cash generation capabilities.

It is important to note that net profit or EBITDA does not equate to cash flow. This is particularly true for fast growing companies caught in the vicious cycle where growth costs cash, and more growth costs more cash. The proper analysis of cash flow involves the use of both the balance sheet and the income statement for two consecutive fiscal years to identify the sources and uses of cash within the company (see Table 9 for a simplified methodology to calculate cash flow). Changes in working capital and fixed asset expenditures are quantified and cash needs are highlighted, providing a clear view of the many competing uses of cash within the company.

Table 9: Template for Calculating Cash Flow

Cash Flow Analysis for Non-Real Estate and Non-Financial Companies	20XX	20XX	20XX
Net Income + Depreciation + Non-cash Charges (Deferred Taxes)	Each of these items is taken directly from the income statement of the year for which cash flow is being calculated		
(Inc) Dec Accounts Receivable (Inc) Dec Notes Receivable (Inc) Dec Inventory (Inc) Dec Other Current Assets Inc (Dec) Accounts Payable Inc (Dec) Accruals Inc (Dec) Income Tax Accruals Inc (Dec) Miscellaneous Current Liabilities	To calculate change in each balance sheet item, compare amount shown on previous year's balance sheet to amount shown for current year. Increases in assets and decreases in liabilities represent uses of cash. Decreases in assets and increases in liabilities are sources of cash.		
(Dec) Scheduled Debt Service	Enter amount of current maturities of long term debt shown on previous year's financial statements.		
Net Operating Flows			
(Inc) Dec Miscellaneous Non-current Assets	Calculated as above		

(Inc) Dec Fixed Assets	Net fixed assets from prior year's balance sheet minus current year's depreciation from income statement equals indicative fixed assets. If amount is greater than net fixed assets shown on current year's balance sheet, the difference between the two amounts represents the purchase of equipment and is shown as a use of cash. If the amount is smaller, the difference between the accounts represents the sale of assets, hence it is a source of cash.
Total Investing Flows	
(Dec) Dividends Paid	Amount shown on current year's income statement
Inc (Dec) in Common, Preferred and Treasury Stock	Compare amount shown on previous year's balance sheet to amount shown for current year. Increases in equity accounts are sources of cash, decreases are uses.
Inc (Dec) Notes Payable – Bank Inc (Dec) Notes Payable – Other Banks Inc (Dec) Short-Term Working Capital Debt	Compare amount shown on previous year's balance sheet to amount shown for current year. Increases in liabilities represent sources of cash. Decreases are uses of cash.
Inc (Dec) Long-Term Debt	Compare amount (long term debt plus current maturities) shown on previous year's balance sheet to amount shown for current year. An increase represents a source of cash, decreases are uses.
Inc (Dec) Subordinated Debt	Compare amount shown on previous year's balance sheet to amount shown for current year. An increase represents a source of cash, decreases are uses.
Total Financing Flows	
Change in Cash and Marketable Securities	
Annual Sales	
Notes: () Decline in cash **Inc Increase** **Dec Decrease**	

2.7 Business Plan

A comprehensive financial analysis of the non-performing borrower includes an assessment of the company's business plan containing a detailed description of how the owners and management are going to correct existing problems. While no one can forecast the future with certainty, a candid discussion between the borrower and the bank on new business plan and financial projections is an essential part of the viability assessment exercise. It provides both the bank and the borrower an opportunity to explore how the company will operate under different scenarios and allows management to have contingency (or corrective action) plans in place should actual results deviate significantly from the projections.

The assessment of the business plan and projections should follow the same process as that for analyzing the financial statements. But in this case, the focus of the WO will be on validating the assumptions (Are they realistically conservative and in line with past performance?[37]) and performing a sensitivity analysis to see how results will vary under changed assumptions. Again, the emphasis should be placed on tracing the flow of cash through the business to determine the company's ability to pay. This work can also provide insights regarding operational changes that may be needed to increase cash flow so that debt repayment can be accelerated or the firm can self-finance increased working capital needs.

[37] Following recessions (or GDP contraction periods), the analyst should carefully incorporate trends from this period and focus instead more on conservative future prospects.

2.8 Cash budget

In a workout, the ability to generate and preserve cash is the key to the company's survival. All borrowers should be required to prepare a cash budget for the next year. The cash budget is similar to the cash flow analysis discussed above in that it identifies the sources and uses of cash. The cash budget differs, however, in two important respects: (i) it is forward looking; and (ii) it breaks down the annual sources and uses by month to reveal the pattern of cash usage within the company. It also clearly identifies additional financing needs as well as the timing and amount of cash available for debt service

The cash budget is a powerful tool which helps the borrower to limit expenditures and preserve cash to meet upcoming obligations such as taxes. It can also compensate for the poor quality of formal financial statements in the case of micro and small enterprises. Table 10 presents a sample format for larger, more sophisticated borrowers. For smaller borrowers, a simple listing of monthly cash receipts and cash disbursements will suffice. Actual results need to be monitored monthly and corrective actions taken immediately to ensure that the company remains on plan.

Table 10: Sample Cash Budget[38]

[Company Name]

12-Month Cash Flow

Period Beginning	1/1/14	2/1/14	3/1/14	4/1/14	5/1/14	6/1/14	7/1/14	8/1/14	9/1/14	10/1/14	11/1/14	12/1/14
Period Ending	1/31/14	2/28/14	3/31/14	4/30/14	5/31/14	6/30/14	7/31/14	8/31/14	9/30/14	10/31/14	11/30/14	12/31/14
Cash at Beginning of Period	15,700	17,325	17,325	17,325	17,325	17,325	17,325	17,325	17,325	17,325	17,325	17,325
Cash at End of Period	17,325	17,325	17,325	17,325	17,325	17,325	17,325	17,325	17,325	17,325	17,325	17,325
Operations	**Jan'14**	**Feb'14**	**Mar'14**	**Apr'14**	**May'14**	**Jun'14**	**Jul'14**	**Aug'14**	**Sep'14**	**Oct'14**	**Nov'14**	**Dec'14**
Cash receipts from												
Customers	57,767											
Other operations												
Cash paid for												
Inventory purchases	(22,000)											
General operating and admin expenses	(3,333)											
Wage expenses	(10,250)											
Interest	(1,125)											
Income taxes	(2,733)											
Net Cash Flow from Operations	12,325	0	0	0	0	0	0	0	0	0	0	0
Investing Activities												
Cash receipts from												
Sale of property and equipment	2,800											
Collection of principal on loans												
Sale of investment securities												
Cash paid for												
Purchase of property and equipment	(6,250)											
Making loans to other entities												
Purchase of investment securities												
Net Cash Flow from Investing Activities	(3,450)	0	0	0	0	0	0	0	0	0	0	0
Financing Activities												
Cash receipts from												
Issuance of stock												
Borrowing												
Cash paid for												
Repurchase of stock (treasury stock)												
Repayment of loans	(2,833)											
Dividends	(4,417)											
Net Cash Flow from Financing Activitie	(7,250)	0	0	0	0	0	0	0	0	0	0	0
Net Cash Flow	1,625	0	0	0	0	0	0	0	0	0	0	0

[38] First month's results have been entered as an example of how the form should be completed.

3. Business viability assessment

Unlike the financial assessment which is highly quantitative, the business assessment is more qualitative in nature. Its purpose is to assess the firm's ability to survive over the longer term. It focuses not on the firm's financial performance, (contained in the financial statements and business plan) but rather on the quality of its management, the nature of the company's products and physical plant and the external environment in which the firm operates (including competition).

Management has long been acknowledged as the primary cause of business failures. The most common reasons include: (i) lack of necessary general management skills required to run a larger organization; (ii) inability or unwillingness to delegate responsibilities to others; (iii) lack of experienced and capable managers in key positions; (iv) lack of basic intelligence or skills to run the company; and (v) inadequate management systems and controls. Because a restructuring cannot be successful without competent and fully committed management, the bank needs to carefully consider if identified weaknesses can be corrected. If not, the restructuring process should stop and the borrower referred to the legal team for collection.

Product assessment focuses on the nature of the product and its longevity potential. Among the questions it attempts to answer are:

- Is the product a consumer or durable good or is it a service? Is the product mix diversified or reliant on a single product?
- Is the product perishable or durable?
- Is demand elastic or inelastic? Is it fad or style related?
- Is the product subject to technical obsolescence? Are their significant barriers to entry?

The primary focus of the assessment of the physical plant is not on its valuation but rather on its capacity and efficiency. It attempts to answer the question: "Are substantial upgrades or new facilities needed to meet demand for the product today and in the foreseeable future?" If the answer is yes, the costs must be quantified and included in the base projections.

External factors include the assessment of the general macro environment as well as overall industry and market conditions. It focuses on assessing the potential impact on the borrower of changes in the economic as well as regulatory climate; analyzing the strength of the borrower's position within the industry (market share) and its competitors; and gaining a better understanding of the borrower's market and how changes within the market might impact the company's performance.

3.1 Use of outside expertise to prepare business viability assessment

Restructuring Guidelines for Micro, Small and Medium-sized Companies

III.a. Small companies

In the case of small companies and subject to cooperation of the owner or the management, which is trustworthy and provides reliable financial and other information, the use of external consultants is not efficient in terms of time and costs. In the opposite case, the bank may engage external consultants or demand the audit of the company's financial statements.

b. Medium-sized companies

It is recommended that medium-sized companies (as defined in the ZGD-1) are analysed in more detail, namely, it is reasonable to use a similar approach as in the case of large companies, which means a guided and aligned coordination between the banks and the inclusion of an external consultant to prepare an independent overview of operations, particularly in the following cases, provided that at least one of the following conditions is met:at least 3 banks are involved in the process;

- there is doubt about the reliability of financial and other information;
- there is doubt about the fairness and competence of the management;
- a specific activity is involved of which the bank does not have sufficient internal know-how;
- there is great probability that the company will need additional financial assets.

For large (above EUR 2 million) commercial or real estate exposures, the business viability portion of the analysis should ideally be performed or validated by an independent third-party such as a consultant or the restructuring unit of an accounting firm. Unless the exposure is unduly large, MSME borrowers seldom warrant the use of outside expertise. Section III.b of the Guidelines, however, recognizes an exception in the case of a medium sized borrower meeting one or more of the specified criteria.

All banks should have clear procedures regarding the level of approval authority required and the process to be followed when contracting for an independent review. Whenever possible, workout officers should request proposals from several firms. In addition, these procedures should require that the deliverables, together with their due dates, and the pricing structure, including penalty fees, be clearly laid out. The contract should also include interim progress reports to ensure that the timelines will be met and that no revisions to the contract are required due to circumstances outside of the control of the bank and/or consultant. The work product should be carefully reviewed by the WO to ensure it meets the terms of the contract and is of the expected standard of quality. All requests for payment should also be reviewed and approved by the WO.

To expedite and further standardize the contracting process, banks may choose to establish a list of pre-approved vendors. These firms, chosen for their demonstrated expertise, may or may not have negotiated an agreed upon fee structure with the bank. The use of standardized contract is also recommended.

4. Documenting the results of the financial and business viability analysis

Restructuring Guidelines for Micro, Small and Medium-sized Companies

III.a The result of efficient diagnostics must be a comprehensive picture of the company's past and future operations and its stakeholders. Standardised (fast) approach should contain the following elements of the audit:

- a focused meeting with the debtor, the goal of which is a clear identification of the reasons for the problems and the assessment of the ability to introduce radical changes into the operations;
- exposure of the banks and all other creditors (related persons, in particular);
- the analysis of the balance sheet structure - the structure of maturity of receivables and operating liabilities, identification of assets suitable for sale and assessment of the value of this property;
- the analysis of the trends of the key indicators of individual categories of financial statements: EBITDA margin, net financial /EBITDA, total debt/equity, interest coverage, debt service coverage ratio – DSCR, net sales revenue/operating receivables, accounts payable/total debt, quick liquidity ratio, cash flow from operations, costs of services etc.
- 3- to 5-year projection of cash flows based on conservative assumptions - the plan of operations must not be a wish list but rather a critical view of the possibilities of the company's development in its branch of industry;
- analysis of the necessary resources for the financing of working capital and investments (capex);
- review of all indemnities (in the case of personal guarantees also an overview and an assessment of the guarantor's property);
- overview of the quality and assessment of the value of collaterals and the calculations of different scenarios (implementation of restructuring or the exit strategy).

Section III.a of the Guidelines requires that the findings of the financial and business viability analysis be documented in writing in sufficient detail to provide a comprehensive picture of the borrower's present financial condition and its ability to generate sustainable cash flows in the future. Each bank will have its own standard format for documenting the analysis but should insure that it incorporates, at a minimum, the information proscribed in Section III.a of the Guidelines. The results of financial analysis should be updated annually in conjunction with the receipt of the company's financial statements. The business assessment should be updated at least every three years or whenever major changes occur in either borrower's management or the external operating environment.

5. Summary of key good practices

- Conduct detailed financial and business viability assessments of all borrowers proportionate both to the size of exposure and type of borrower
- Develop thorough understanding of how ratios are interrelated and can be used to project effects of corrective actions.
- Place primary emphasis on analyzing cash flow.
- Require cash budgets from all borrowers and monitor on a monthly basis to ensure borrower is performing to plan.

Chapter VI. Developing the Workout Strategy

1. Purpose of workout

Under a best-case workout scenario the bank and the viable (or marginally viable) borrower will agree on the restructuring/forbearance strategy aiming to return defaulted borrower to a fully performing status in the shortest feasible time frame. This requires matching the borrower's sustainable repayment capacity with the correct forbearance option(s). There is, unfortunately, no one standard ("one size fits all") approach. Instead, the WO must pick and choose from a variety of options to tailor a forbearance plan that meets the needs of specific borrower.

For the bank to consider approving a restructuring/forbearance plan, the borrower must meet two essential pre-conditions: (i) his projected cash flows must be sufficient to repay all or a substantial portion of its past due obligations within a reasonable time frame; and (ii) he must display cooperative behavior.

Not all borrowers will be able to repay their obligations in full. However, this does not mean they should automatically be subject to legal action. Instead, the bank should proceed with restructuring whenever it can reasonably document that the revised terms (which may include conditional debt forgiveness) will result in a greater recovery value for the bank than a legal procedure (bankruptcy or foreclosure) or a sale of loan to third party.

2. Workout options

At the initial segmentation stage the loan-to-value and debt-to-EBITDA ratios were used to help identify potentially viable borrowers (see Chapter 3). This group of borrowers has then been subject to in-depth financial analysis and business viability assessment (see Chapter 5), which has narrowed the number of candidates for potential restructuring/forbearance even further. At this stage the WO should have a fully informed view as to the nature and causes of the borrower's difficulties. Based on this understanding, the WO should work with the borrower on developing a realistic repayment plan designed around the borrower's projected sustainable cash flows and/or the liquidation of assets within acceptable timeframes. Understanding and knowing when to use each of the options discussed below provides a WO with the flexibility necessary to tailor appropriate restructuring/forbearance proposals.

Restructuring/forbearance proposals should focus mostly on financial restructuring and include provisions for additional security and/or guarantees, as well as revised or new covenants prohibiting dividends or other equity withdrawals, limiting salaries of management, strengthening financial reporting, and introducing key performance indicators based on the company's projections to allow the bank to monitor the company's interim performance. In addition, the bank should consider operational restructuring conditions (such as sale of company in whole or in part, discontinuation of non-core activities or business lines, reducing size of facilities, etc.) when warranted.[39]

The broad guidance on the use of various restructuring/forbearance solutions contained in Section IV of the MSME Guidelines (summarized in Table 11 below) has recently been supplemented by the more granular approach of the recently issued ECB's Draft Guidance on NPLs.

[39] Operational restructuring requires fundamental changes in the operations of a company and thus can only be driven by the owner/management. Most restructurings, therefore, are limited to "financial restructuring", i.e,, modification of the terms of company's financial obligations.

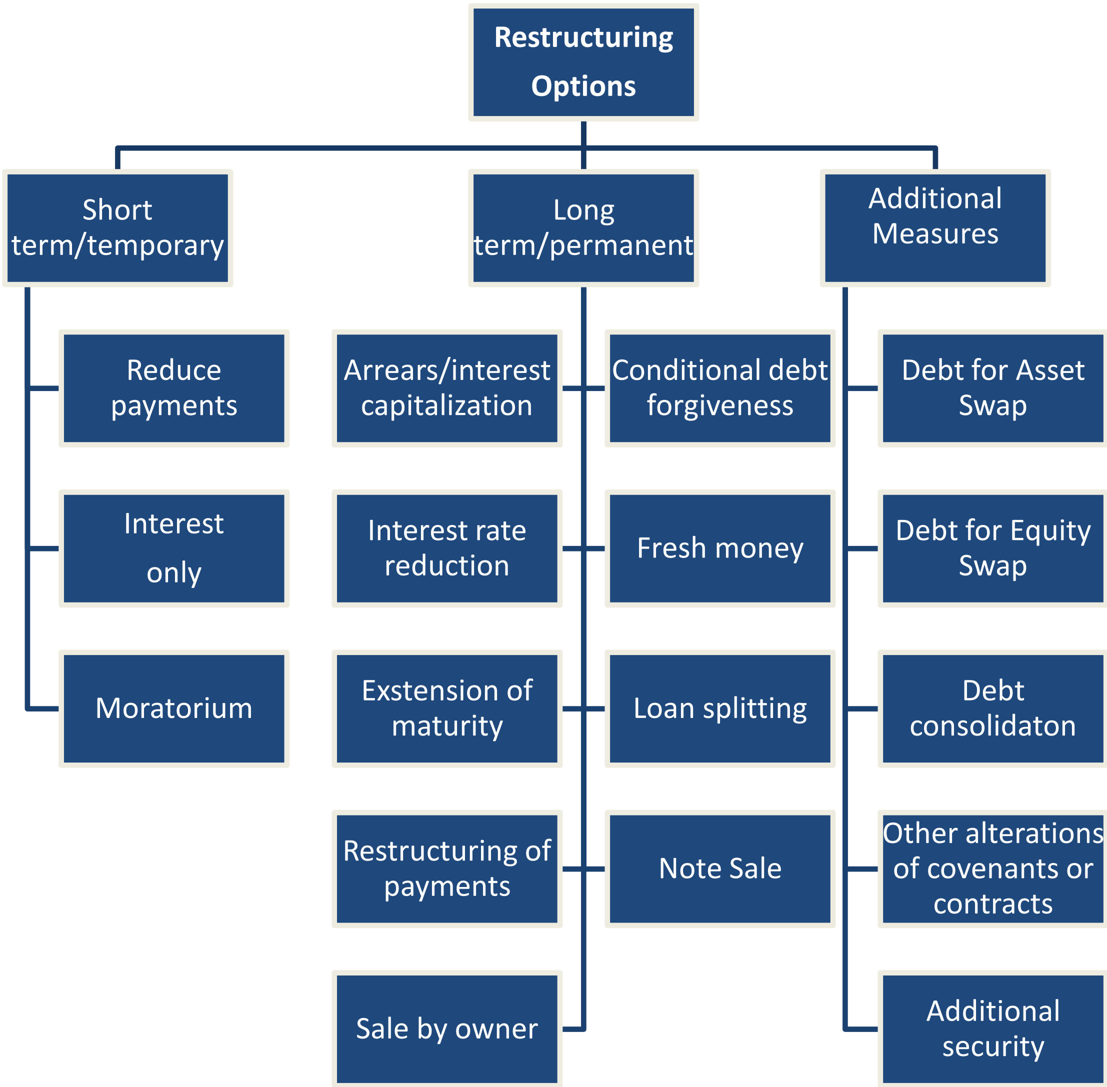
Table 11: Summary of Workout Options

Borrower Type	Workout Measure	Description
Viable	Normal reprogramming IV.a	Future cash flows sufficient for repayment of debt until sustainable level of cash flow reached within 5 years. Consider personal guarantees, conversion of loans from owner(s) to equity or other subordinated form, capital increase, additional collateral, sale of excess assets, achievement of certain levels of financial indicators.
Marginal	Extended repayment period IV.b.1	Extended period of reprogramming needed to reach sustainable level of cash flow, i.e., more than 5 years, with final payment in equal installments or balloon or bullet payment. Final maturity not to exceed 10 years.
	Loan Splitting IVb.2&3	Debt is split into two parts: the first, representing the amount that can be repaid from sustainable cash flow) is repaid in equal installments (principal and interest) with a maturity to 5 years; the remaining portion is considered to be excess debt (which can be subordinated) which may be split into several parts/tranches. Note(s) may be non-interest bearing or PIK (payment in kind) with interest payable either at maturity or from the proceeds of specific asset sales. Maturity not to exceed 10 years. SPV, founded in a legally permissible manner, may be used to house the excess debt and excess assets.
	Conditional Debt Forgiveness IV.b.4&5	To be used to encourage owners to make an additional financial contribution to the company and to ensure that their interests are harmonized with those of the bank, particularly in those cases when the net present value of the company (taking into consideration the all collateral and potential cash flow) is lower than the total exposure. Bank may choose to: • Partial write-off in the framework of the owner's cash equity contribution, particularly in all cases where the owner(s) have not guaranteed the debt; • Partial write-off in the framework of a cash capital increase from a third-party investor where they have not assumed the role of guarantor; • Partial write-off in the case of a particularly successful business restructuring that materially deviates from the operating plan that served as the basis for the restructuring; • Partial write-off in those cases when the above-average engagement of the owner(s) (i.e. successful sale of excess assets) guarantees a higher level of repayment to the bank(s). Loans can also be written off if the collateral has no economic value, and such action ensures the continuation of the company's operations and it is evident that the owner has already his entire property in the business and has lost it, if the debtor possesses significant "know-how", and the bank has confidence in the management or if the cause for the problems came from objective external factors.

	Debt to Equity Swaps IV.b.6	Appropriate for medium sized companies where the company can be sold, has nice products/services, material know how; or significant market share, etc.
	Debt to Asset Swaps IV.b.7	Can be an effective tool particularly in the case of stranded real estate projects provided that the real estate is in good condition and can be economically viable managed in the future. The transaction must not be legally disputable, considering the provisions of the insolvency and liability legislation. May also be used for other real estate cases, equity stakes, and securities with determinable market value.
	Short term restructuring IV.b.7	Restructuring agreements with a one year maturity may be appropriate in those cases such as small SMEs where the bank feels closer monitoring or increased pressure to perform is necessary.
	Individual Loan Sale III.3(footnote 1)	Sale of the exposure is reasonable under the following conditions: the bank does not have sufficient capacity to effectively manage the borrower; the buyer has a positive reference; and the buyer is a major specialist in the area of resolving non-performing loans.
Non-Viable Borrowers	Collateral Liquidation by owner IV.d	SME owners have strong attachments to their property. They may fail to carry out the sale within the agreed upon time frame or have unrealistic expectations regarding the value of the property. It is recommended that the bank set short deadlines; obtain a notarized power of attorney allowing it to activate the sale procedures; and have sufficient human resources within the real estate market to expedite the sales process.
	Execution or Insolvency IV.c	To be used when the borrower is not viable or non-cooperative, and the no feasible restructuring solution can be put in place.

Figure 10 presents the various options broken into three broad categories: (i) **short term** measures most appropriately used in early stage arrears to stabilize the situation and give the borrower and the bank time to develop a longer-term strategy; (ii) **longer term/ permanent** solutions which will result in the reduction of the exposure; and (iii) **additional measures** which do not directly lead to repayment but strengthen the bank's collection efforts.

Figure 10: Restructuring/forbearance options



2.1 Short term restructuring measures

Short term measures do not lead, in and of themselves, to the repayment of a borrower's obligations. Instead they are designed to provide: (i) temporary relief in response to a clearly identified short term disruption in a company's cash flow (e.g., event out of the company's control, like a sudden fall in demand due to external circumstances); or (ii) time for the creditor(s) to assess the situation and determine an appropriate course of action. They are most appropriate to use when there is a reasonable expectation that the company's sustainable cash flow will be strong enough to allow the resumption of its existing payment schedule at the end of the forbearance period. As these options envision that the borrower will be able to bring defaulted amounts of interest and/or principal current at the end of the forbearance period, they should not exceed a tenor of 24 months (12 months in the case of real estate or construction projects) and must be used in combination with longer term solutions such as an extension of maturity, revision in terms and additional security.

Specific short term measures to consider include:

- **Reduced payments** – the company's cash flow is sufficient to service interest and make partial principal repayments.

- **Interest only** – the company's cash flow can only service its interest payments, and no principal repayments are made during a determined period of time.

- **Moratorium** – an agreement allowing the borrower to suspend payments of principal and/or interest for a clearly defined period, usually not to exceed 90 days. This technique is most commonly used at the beginning stages of a workout process (especially with multi-bank borrowers) to allow the bank and other creditors time to assess the viability of the business and develop a plan for moving forward. Another appropriate use is in response to natural disaster which has temporarily interrupted the company's cash flow.

2.2 Long term/permanent restructuring

Longer term/permanent options are designed to permanently reduce the borrower's debt. Most borrowers will require a combination of options to ensure repayment. In all cases, the bank must be able to demonstrate (based on reasonable documented financial information) that the borrower's projected cash flow will be sufficient to meet the restructured payment terms.

Specific options to consider include:

- **Interest and Arrears capitalization**[40] – adds past due payments and/or accrued interest arrears to the outstanding principal balance for repayment under a sustainable revised repayment program. WOs should always attempt to have the borrower bring past due payments and interest current at the time a loan is rescheduled. Capitalization, intended to be used selectively, is likely to be more widespread when borrowers have been in default for an extended period. <u>This measure should be applied only once,</u> and in an amount that does not exceed a pre-defined size relative to the overall principal as defined in the bank's forbearance policy. The bank should also formally confirm that the customer understands and accepts the capitalization conditions.

- **Interest rate reduction** – involves the permanent (or temporary) reduction of the interest rate (fixed or variable) to a fair and sustainable rate. This option could be considered when the evolution of interest rates has resulted in the borrower receiving finance at an exorbitant cost, compared with prevailing market conditions. However, banks should ensure that lower interest rate is sufficient to cover the relevant credit risk.

[40] Interest and arrears capitalization was listed as a short-term measure in the ECB Draft Guidance Note. As this solution is a variation of the reducing payments and maturity extension options with respect to the past due interest and arrears, it has been included in this section.

- **Extension of maturity -** extension of the maturity of the loan (i.e., of the last contractual loan installment date) allows a reduction in installment amounts by spreading the repayments over a longer period.

- **Rescheduled Payments -** the existing contractual payment schedule is adjusted to a new sustainable repayment program based on a realistic assessment of the borrower's cash flows, both current and forecasted. This is usually used in combination with an extension of maturity. In addition to normal rescheduling, additional repayment options include:

  a) **Partial repayment -** a payment is made against the credit facility (e.g., from a sale of assets) that is lower than the outstanding balance. This option is used to substantially reduce the exposure at risk and to enable a sustainable repayment program for the remaining outstanding amount. This option is generally preferable, from the creditor's standpoint, to the balloon, bullet or step-up options described below.

  b) **Balloon or bullet payments** – are used in the case of more marginal borrowers whose sustainable cash flow is insufficient to fully repay the loan within the rescheduled tenor. A balloon payment is a final installment substantially larger than the regularly scheduled installments. As a rule, it should not exceed 30 percent of the original principal amount of the loan. Bullet loans carry no regular installment payments. They are payable in full at the maturity date and frequently contain provisions allowing the capitalization of interest (payment in kind interest) throughout the life of the loan.

     These options should only be used/considered in exceptional circumstances, and when the bank can duly document future cash flow availability to meet the payment. Bullet loans are frequently used in conjunction with loan splitting. In this case, the unsustainable portion of the debt represented by the bullet loan should be fully provisioned and written off in accordance with bank policy.

  c) **Step-up payments -** should be used when the bank can ensure and demonstrate that there is a good reason to expect that the borrower's future cash flow will be sufficient to meet increases (step-up) in payments.

- **Sale by owner/assisted sale** – this option is used when the borrower agrees to voluntarily dispose of the secured assets to partially or fully repay the debt. It is usually combined with the partial repayment option or conditional debt forgiveness. The borrower must be monitored closely to ensure that the sale is conducted in a timely manner and the agreement should contain a covenant allowing the borrower to conduct the sale if the borrower fails to do so within the specified timeframe.

- **Conditional debt forgiveness -** involves the bank forfeiting the right to legally recover part or the whole of the amount of an outstanding debt upon the borrower's performance of certain conditions. This measure may be used when the bank agrees to a "reduced payment in full and final settlement", whereby the bank agrees to forgive all the remaining debt if the borrower repays the reduced amount of the principal balance within an agreed timeframe.

  This option should be used to encourage owners to make an additional financial contribution to the company and to ensure that their interests are aligned with the bank's. It is particularly appropriate in those cases where the net present value of the borrower's projected repayment capacity (taking into consideration all the collateral and potential cash flow) is lower than the total exposure. In these cases the bank may consider:

- Partial write-off in return for a cash equity contribution from an owner(s), particularly in those cases where the owner(s) have not guaranteed the debt.
- Partial write-off in the framework of a cash capital increase from a third-party investor where they have not assumed the role of guarantor.
- Partial write-off in the case of a particularly successful business restructuring that materially deviates from the operating plan that served as the basis for the restructuring.
- Partial write-off in those cases when the above-average engagement of the owner(s) (i.e. successful sale of excess assets) guarantees a higher level of repayment to the bank(s).
- Loan can also be written off if: (i) the collateral has no economic value, and such action ensures the continuation of the company's operations; (ii) it is evident that the owner has invested his entire property in the business and has lost it; (iii) the debtor possesses significant "know-how", and the bank has confidence in the management; or, (iv) the problems were caused by objective external factors.

Banks should apply debt forgiveness options carefully since the possibility of forgiveness can give rise to moral hazard, weaken the payment discipline, and encourage "strategic defaults". Therefore, institutions should define specific forgiveness policies and procedures to ensure strong controls are in place.

- **Fresh money -** providing new financing arrangements to support the recovery of a distressed borrower is usually not a standalone viable forbearance solution, but should be combined with other forbearance measures addressing existing arrears. It should only be applied in exceptional cases and requires a thorough assessment of the borrower's ability to repay. For exposures over EUR 2 million independent sector experts should be used to validate the viability of proposed business plans and cash flow projections. Whenever possible, additional collateral should be required and the repayment of these funds should be accorded priority treatment in bankruptcy.

  One of the most difficult decisions facing a WO is whether to advance additional funds to the borrower. The general rule of thumb is that "first loss, least loss" and many banks have strict policies prohibiting lending new monies. There are, however, three specific situations where it may be warranted. They are: (i) the need for fresh money to be used for working capital to restart the business; (ii) advances required to protect the bank's collateral position; or, (iii) small advances to prevent large contingent exposures (guarantees) from being called.[41]

- **Loan splitting –** is used to address collateral and cash flow shortfalls. In this option, the debt is split into two parts: (i) the portion representing the amount that can be repaid from sustainable cash flow is repaid in equal installments of principal and interest (with a maturity not to exceed 5 years); and (ii) the remaining portion represents "excess debt" (which can be subordinated). This portion may be further split into several parts/tranches (which may be non-interest bearing or PIK notes) and is frequently used in combination with payments from the sale of specific assets or bullet payments at maturity.

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[41] In this case, the bank has determined that it will be unable to recover most if not all funds required to honor the guarantee. It therefore represents the bank's maximum loss. The bank, therefore, would try minimize losses by making small advances to prevent the guarantee from being called.

- **Note sale** –individual note sales, generally conducted at the WO level, are most commonly used when a new investor wishes to restructure the company's overall debt burden on commercially acceptable market terms. This option is usually combined with conditional debt forgiveness and requires that the purchase price be equal to or greater than the current Net Present Value (NPV) of the restructured loan.

2.3 Additional measures

Additional measures are not considered to be viable stand-alone restructuring/forbearance options as they do not result in an immediate reduction in the loan. However, when combined with one or more of the previously identified options, they can provide incentives for repayment or strengthen the bank's overall position.

- **Debt-to-asset swap –** transfers a loan, or portion of a loan, into "other assets owned" where the ultimate collection of the original loan requires the sale of the asset. This technique is generally used in conjunction with conditional debt forgiveness or partial loan repayment and maturity extension options. The management and sale of real estate properties also requires specialized expertise to ensure that the bank maximizes its returns from these assets.

- **Debt-to-equity swap** – transfers the loan, or portion of the loan, into an investment. Generally used to strengthen the capital structure of large highly indebted corporate borrowers, it is seldom appropriate for MSME borrowers due to limited access to equity markets and difficulties in determining the fair value of illiquid securities. Like the debt-to-asset swap above, this option may also require the bank to allocate additional resources for managing the new investment.

- **Debt Consolidation** – more common for retail exposures, entails the combination of multiple exposures into a single loan or a limited number of loans. This solution should be combined with other forbearance measures addressing existing arrears. This option is particularly beneficial in situations where combining collateral and secured cash flows provides greater overall security coverage for the entire debt than individually. For example, by minimizing cash leaks or by facilitating re-allocation of cash flow surplus between exposures.

- **Other alterations of contract/covenants –** when entering a restructuring/forbearance agreement, it is generally necessary to revise or modify existing contracts/covenants to meet the borrower's current financial circumstances. Examples might include revising ratios such as minimum working capital or providing additional time for a borrower to sell excess assets.

- **Additional security -** additional liens on unencumbered assets (e.g., pledge on a cash deposit, assignment of receivables, or a new/additional mortgage on immoveable property) are generally obtained as additional security from a borrower to compensate for the higher risk exposure or cure existing defaults in loan-to-value ratio covenants.

3. Evaluating alternative strategies based on NPV analysis

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III. - Before the final assessment of the manner of handling each debtor the basic scenario of the going concern must be compared with the alternative scenarios, such as the sale of exposure, execution, liquidation of collaterals or bankruptcy**.**

IV. - If new information is obtained after deciding on the resolving approach, the bank must re-examine and refresh it. For example, if it turns out that the company had been misleading it with certain information, the approach and the measures must be more aggressive. On the other hand if the debtor puts forward or presents a repayment proposal during the (announced) measures, which would considerably improve the bank's position, the bank may mitigate the measures subject to fulfilment of certain conditions or eliminate them completely. This means that there is a certain flexibility of restructuring measures for the company.

Lenders generally have a choice of choosing to restructure/ a loan, sell the exposure (note sale), or liquidate the underlying collateral either by sale by owner or legal procedures (e.g. enforcement or insolvency). Section III of the Guidelines requires banks to compare the value of the proposed restructuring option against the other alternatives. In practice, unless the bank is in active discussions with a prospective purchaser of the exposure or the borrower has agreed to voluntarily liquidate the collateral these alternatives would not be considered. The analysis will be confined to comparing the value of the proposed restructuring against enforcement and bankruptcy. Choosing the optimal option, i.e., the solution that returns the highest value to the bank, is not always clear-cut. **Using a simple Net Present Value (NPV) analysis is recommended in order to provide a more quantitative justification for the decision.**

The general formula to calculate net present value is:

$$\mathrm{NPV}(i, N) = \sum_{t=0}^{N} \frac{R_t}{(1+i)^t}$$

Where i = interest rate per period
N = total number of periods
R_t= net cash flow per period t
t = period in which cash flow occurs

Net present value (NPV) is the sum of the present values (PV) of a stream of payments over a period of time. It is based on the concept of time value of money - money received in the future is less valuable than money received today. To determine NPV, the net cash flow (cash payments of principal, interest, and fees less the bank's out-of-pocket costs for legal fees, consultants, etc.) received annually is calculated. Each of these amounts or future values (FV) is then discounted to the present by using an appropriate market based discount rate. The sum of the PVs equals the NPV. Because of its simplicity, NPV is a useful tool to evaluate which of the possible workout options results in the maximum recovery to the bank.

Table 12 illustrates the use of the NPV methodology to compare between four broad workout options. In this highly simplified case, the factory of a good customer has been severely damaged in a devastating flood. The customer requests that its currently outstanding EUR 1.000.000 loan be restructured as follows: 1 year interest only with the balance to be repaid in 4 annual installments. The rate on the loan will be 5 percent. Simultaneously, an independent third party investor offers to purchase the loan for EUR 825.000.

For purposes of the NPV analysis, the bank's standard risk adjusted discount rate for is 7 percent. The collateral was valued within the past month by the bank's internal appraisal staff at EUR 833.333 and a 10 percent discount has been applied to adjust the price to its estimated auction sale value in year 2 under the bankruptcy scenario. The value of the property has been reduced an additional 10 percent under the enforcement scenario to recognize the additional length of time to conclude this proceeding. Expenses for the enforcement proceeding (based on Slovenian experience, see Appendix 2) are estimated to be EUR 2.500, and the expected duration is 3 years. The cost of the insolvency procedure, also based on the Slovenian experience (see Appendix 2), has been estimated to be approximately EUR 42.422, and the process is expected to last two years. Under these circumstances, the analysis indicates that the bank should sell the loan to a third party. [42]

Table 12: Sample NPV analysis of workout options

Option		NPV	Y1	Y2	Y3	Y4	Y5
Restructure		**812.155**					
	Principle		0	250.000	250.000	250.000	250.000
	Interest		50.000	50.000	37.500	25.000	12.500
	Cash Flow		50.000	300.000	287.500	275.000	262.500
Loan Sale		**825.000**					
	Cash Proceeds						
Enforcement		**548.811**					
	Sale at auction				675.000		
	Cost of Proceeding		(800)	(950)	(750)		
			(800)	(950)	674,250		
Insolvency		**619.556**					
	Sale at auction			750.000			
	Cost of Proceeding		(3.554)	(38.868)			
			(3.554)	711.132			

The above results are highly sensitive to the choice of the discount rate. The results are inversely correlated to the discount rate, i.e., the higher discount rates result in lower values and lower rates lead to higher values which may seriously underestimate the true costs of the workout process. Determining the rate is an art not a science and it should reflect both the riskiness of the borrower and a proxy for the cost of the workout. In

[42] In this case, the bank has opted to calculate the NPV of legal proceedings on a "worst case basis". WOs have been instructed to assume that the opening value of the estate equals the estimated sales value, that the property sells for the estimated value, and that all proceeds distributed are from the sale of the bank's collateral. As there are no other sources of funds, the bank will be required to pay the administrator's remuneration from the sales proceeds. The remaining nine creditors are unsecured and will receive no distribution from the estate.

the above example, for instance, the assumption has been made that the bank will use its internal legal staff for any enforcements or insolvency proceedings. No deductions are made, therefore to reflect these costs. If, however, they had chosen to use outside counsel, that cost would have been reflected in the analysis as cash outflows, reducing the ultimate recovery value. Very importantly, the bank should keep in mind that restructuring/forbearance strategy is associated with substantial expenses the workout unit needs to incur to prepare, negotiate, and monitor the restructuring agreement. Banks can choose to adjust discount rates upward to more fully reflect these costs, or consider using standard cost per year in the analysis so as to reflect the true costs of various workout solutions.

4. Summary of key good practices

- Ensure borrow meets preconditions for restructuring – sufficient sustainable cash flows to repay the debt and cooperative behavior. Borrowers who fail one or both preconditions should be promptly referred for legal procedure.
- Focus on matching the borrower's sustainable repayment capacity with the correct restructuring/forbearance option(s).
- Understand the different types of restructuring/forbearance options and mix and match to address the borrower's specific problems.
- Evaluate different workout options using NPV analysis of expected recoveries.
- Ensure that discount rate is truly reflective of both the riskiness of the borrower as well as the full internal and external cost of managing and resolving the NPL.

Chapter VII. Negotiating and Documenting the Restructuring

1. Developing the negotiating strategy

1.1 SWOT analysis

Throughout the analytical process, the WO should be identifying and evaluating the relative strengths and weaknesses in the borrower's and other key stakeholder's positions. Consideration should be given to how these strengths and weaknesses may be used to achieve a credible restructuring.

A simple SWOT analysis may help the WO to formulate and organize his thoughts (Figure 11). Strengths and weaknesses in the bank's position are identified in the top two quadrants. These represent factors which are within the control of the bank. External factors which may influence the outcome are then identified in the bottom quadrants. Once the WO has gained an understanding of these factors he can begin the build them into his negotiating strategy.

Figure 11: Assessing negotiating position through SWOT analysis

The WO should never enter a negotiation without a well-developed strategy in place. Overall as well as specific goals should be defined; key needs of the borrower identified; proper solutions developed; and clear negotiating parameters established. These should include not only the bank's absolute bottom line but also a list of items that can be given up during the negotiations to incentivize the borrower, including among others fees, penalties, and interest accrued but unpaid. If the WO has done his/her homework there should be no "surprises" during the negotiations. The bank should remain firmly in control of the negotiations, greatly enhancing the chances of a successful outcome.

Although the borrower should be made aware of deadlines to complete negotiations (i.e., that the specific restructuring plan being offered will expire if not accepted within 30 days), the WO must not allow this to be used to pressure the bank into accepting a sub-optimal restructuring. In truth, the borrower has a greater incentive to close the deal quickly as the more protracted the process the greater likelihood that he will end up in insolvency proceedings.

While the negotiations are apt to get heated at times, both parties must ultimately recognize that it is in both their best interests to cooperate to find a mutually acceptable solution. Negotiations need not be a "winner takes all" experience which ends with the banker standing triumphantly over the bloodied borrower. A skilled negotiator will leave the borrower with a sense that he "won", thus gaining his future cooperation.

1.2 Use of outside expertise

As long as the business is viable, it is in the interest of both the borrower and the lender to reach a sustainable restructuring solution. The level of financial knowledge and sophistication can vary from client to client and therefore a financial advisor might be needed for less sophisticated borrowers. Potential areas for advice are the following: (i) full understanding of the bank's restructuring proposal (financial and legal), and (ii) ability to draft a business plan as a cornerstone for restructuring discussion with the bank.

It would be natural behavior from the borrower's side to distrust the bank's restructuring proposal, particularly if the person or the company is not financially sophisticated. Thus, two prospective avenues for consultations should be open for the borrower: (i) detailed information with restructuring examples in the bank's brochures or website, or (ii) external advice from a lawyer or a financial specialist. One solution to be considered is to organize a client educational unit within the bank that would provide general financial counsel services to clients, including NPL resolution. However, for psychological reasons, the borrowers most probably would have more trust in third-party advice. Therefore, consideration should be given to establishing a more independent counseling/mediation service under the auspices of Banking Association, or Chamber of Commerce.

1.3 Involvement of guarantor

Depending on the terms of a guarantee, a guarantor is either fully or partially liable for the debt of a third party (the borrower). The guarantor, therefore, should be kept fully informed about the status of the loan and the resolution process so that he is fully prepared to meet his obligations if the bank chooses to call the guarantee. New guarantees or a re-statement of the previous ones should be obtained whenever changes are made to the loan. This is to ensure that the guarantor cannot use as a defense against payment that changes were made, to which he would not have agreed, without his knowledge or consent.

1.4 Dealing with multi-bank borrowers

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II.d. - The role of the coordinator should be assumed by the bank with the largest exposure, but the other banks must also be willing to accept it, should the bank with the largest exposure refuse such activities for objective reasons. When appointing the coordinator and setting its powers, the banks shall strive for the following:

- As a rule, a coordinator should be appointed within 1 month.
- The coordinator should be appointed for a certain period (no more than 6 months) with the possibility of renewal (3 months).
- During this mandate term, the coordinator may not withdraw without a grounded reason. If the banks do not renew the coordinator's mandate term 1 month prior to expiry, the restructuring process is completed.
- The coordinator shall be responsible for the assessment of the need to sign a Standstill Agreement (SSA), the assessment of the need to extend the coordinator's mandate, the assessment of the need for external consultant (financial or legal) and the drafting of the proposed solution for debtor restructuring.
- In the beginning of the process, the coordinator must clearly define the goals, take care of strict compliance of the deadlines, transparent communication and information of all stakeholders and cooperation by agreement
- The coordinator takes care of the minutes of creditor meetings which sum up the decisions and the orientations of the process. In case individual creditors or the debtor constantly change their positions without reason, thereby jeopardizing the process, the coordinator transparently informs all creditors and the debtor and is entitled to withdraw as coordinator.
- If an agent is necessary after the completion of the restructuring, this role is usually assumed by the coordinator unless agreed otherwise by the creditors. The coordinator takes over all further communication with the debtor, with the purpose of limiting mutual administrative activities.

It is generally agreed that a negotiated out-of-court debt restructuring is preferable to court proceedings. It tends to be both faster and less costly. But getting multiple lenders with different collateral and priorities to co-operate and agree has proven difficult. To facilitate the process, Corporate Restructuring Guidelines have been issued in Slovenia for both large and MSME borrowers. Based on the so-called London Approach, the guidelines serve as a roadmap or guide to organizing and managing the restructuring process. Section II.d. of the MSME Restructuring Guidelines details the process to be followed. WOs must familiarize themselves with the role of the coordinator and be prepared to assume the responsibilities, if necessary, when a borrower has loans from more than one bank.

Banks should strive to actively participate and cooperate in these negotiations. While banks may have genuine differences of opinion about the proper course of action to be taken with a borrower, they should state their views openly and be prepared to compromise, when warranted.

1.5 Who bears the costs of the workout?

Formalizing a workout implies incurring in multiple costs that may significantly compromise the financial position of the parties involved in the workout. In many occasions, negotiating who bears the costs of the restructuring process becomes a very controversial point. There is no written rule on who should bear these costs, which may vary on a case by case basis.

The practice in Slovenia, aligned with the international restructuring practice, is that the borrower bears the costs of those external consultants engaged in the restructuring negotiations. This implies that the borrower does not only assume his own costs, but also the costs and fees of auditors, lawyers and financial advisors that were engaged at creditors' request to complete the restructuring. While this is standard practice, there are certain limits to this general rule that try to prevent that the amount of these external costs become excessive:

- The borrower is only supposed to assume those costs incurred by the whole body of creditors. This implies that creditors who wish to use their own advisers shall cover their own costs.
- When engaging the external consultants and throughout the court of the workout, creditors must strive to help the borrower control and manage such costs, and should not incur into any costs that may not be considered reasonable.

2. Documenting the restructuring agreement

2.1 Determining required documentation

Every restructuring transaction is different in its own way, and these differences are reflected in the type and number of documents required to formalize the workout. Factors like the number of creditors, the size of the debt restructured and the type of collateral used in the original lending transaction determine the complexity and number of documents required to formalize a workout. In some cases, workouts can be formalized with a single letter. In others, many documents with multiple signatures will be required. Regardless of the number of creditors and complexity of debt structure, the restructuring documentation will determine the conditions and effectiveness of the restructuring, and it is essential that all documents are signed by all parties involved. Until all documents have been formalized, it is still possible that the restructuring negotiations fail and that bankruptcy proceedings are initiated.

The documentation formalizing the workout should always be prepared by a lawyer, who could be mapped to the WU, or the legal team, or to a 'collection' department[43]. While the lawyer should be primary responsible for elaborating this documentation, he is not supposed to draft it on his own, and a close collaboration with the Workout officer in charge of negotiating the workout is required.

In the case of MSME workouts, the restructuring documentation is typically simplified in comparison with the restructuring of larger corporate borrowers. This is just a reflection of the fact that the negotiating process is simpler, and most negotiating milestones are either abridged or do not take place at all. For example, considering that the number of creditors in MSME workouts is typically limited to only a few lending institutions (if not reduced to just one), it is typically not necessary to:

- Hold meetings of creditors to gather consensus around which workout strategy to follow; or
- Appoint a coordinator creditor to lead the negotiations with the borrower.

Thus, in most cases it will not be necessary to formalize in writing an agreement on the appointment of a coordinator, or to prepare written minutes reflecting the decisions taken at the creditors' meeting.[44] Although these documents may be necessary in some exceptional cases, it will not be the norm that they

[43] See discussion above in Chapter 2 on the different options for locating the legal function within an organization.
[44] These two documents were provided as an annex to the Slovenian Principles of the Financial Restructuring of Corporate Debt, applicable to larger corporates.

are prepared. By contrast, the workout will always require the formalization of a restructuring agreement, which may be complemented by additional security documents (if creditors demand taking additional security over new assets of over already pledged assets) and/or a standstill agreement.

2.2 Standstill Agreement

In those cases where several creditors are involved, formalizing a standstill agreement is typically the first step involved in the workout process. The standstill is an agreement between the borrower and relevant creditors, typically lending institutions, confirming that they will not enforce their rights against the borrower for any default during a limited period of time. The main purpose of the standstill is to give the borrower sufficient 'breathing space' to collect information and prepare a survival strategy, while in parallel creditors work on formulating a joint approach. Standstill agreements may also include other obligations to be observed during the standstill period, for example, that creditors grant additional financing to the borrower to cover working capital, or postpone any capital or interest payments due.

In the context of an SME workout, it may be necessary to sign a Standstill agreement, even if the number of creditors is limited. The main advantage of formalizing such document is that it will provide sufficient certainty to both parties that a workout is being negotiated, ensuring that the borrower can focus his efforts in the operational changes needed to succeed. For those cases where it is required to formalize a Standstill agreement, Appendix 3 includes a template adopted to the MSME context. However, in certain cases it may not be necessary to formalize a Standstill agreement and creditor(s) and borrower will proceed on the mutual understanding that a standstill exists. This will typically occur when there is just a single creditor that holds a close and long-standing commercial relationship with the borrower, who is being cooperative in the workout negotiations.

The contents of the standstill agreement will largely depend on the transaction at hand, but typically will imply that creditors will assume some (or all) of the following obligations, among others:

- Not to start enforcement actions against the borrower or his assets;
- Not to declare the loan agreement breached, or accelerate the loan;
- Not to take additional collateral or improve his position with respect to other creditors;
- Not to charge additional fees or penalty interests;
- Not to set-off any amounts against the borrower for pending obligations.

In return, the borrower will agree not to take any action that would harm the creditors, such as the sale or transfer of assets to a third party or make payments to any creditors except in the ordinary course of business, and will allow the creditors full access to all necessary books and records.

2.3 Restructuring Agreement

The restructuring agreement is the main document that regulates all the details of the workout. In the case of SMEs, where the workout documentation will often be simplified, the restructuring agreement will many times be the only document formalized, and it is very important that all details are captured accurately, not just in connection with the payment obligations of the borrower but also with his behavior during the lifetime of the restructuring agreement. When drafting a restructuring agreement, it should be born in mind that the main purposes of this document are (i) to explain how the borrower is going to restructure both his debt and his operations, if applicable, and (ii) to specify how and when creditors are to be repaid.

There is no standard format for how a restructuring agreement should look like. The details of the agreement will largely depend on the needs of the business and the willingness of creditors to make concessions to avoid a bankruptcy of the borrower. For example, in the case of a workout consisting of a simple rescheduling of maturities, a signed letter may be enough to document the workout. However, in case the maturity dates as well as the principal and applicable interests of the loan agreement are modified, drafting a new agreement will probably be necessary. In this case, it is highly advisable that the legal department of the lending institutions is brought onboard from the outset, since they should determine whether (i) the workout will be documented into a new agreement that will replace the existing contractual documentation existing between the borrower and creditors, or (ii) the original loan agreement will remain in place but as amended by the terms and conditions included in an additional agreement. This second approach has the advantage that it will not be necessary to amend the already existing security package, which will keep its priority without the need of seeking new registrations.

In terms of the substantive content of the restructuring agreement, the document may include any of the debt restructuring techniques discussed in Chapter 6. These options can be combined or arranged in such a way that alternative options can be offered to several types of creditors, depending on the class to which they are allocated. Restructuring plans are consensual in nature and assume all parties to the agreement consent to the terms agreed in the document. However, a key concept for restructuring agreements to succeed is to treat all parties fairly and avoid discrimination of similarly situated creditors in terms of their collateral, priority and outstanding obligations. All creditors holding the same position vis-à-vis the borrower should obtain a similar treatment.

2.4 Key covenants

Covenants are undertakings (or promises) given by a borrower as part of a loan agreement. Their purpose is to provide the lender with an early warning sign of potential problems. They also provide another avenue of communication between the borrower and the lender.

Covenants can be affirmative, negative or positive in nature. They usually cover such areas as financial performance (e.g., will maintain total debt to EBITDA not greater than 3:1, or pay all taxes as they become due); information sharing (e.g., will provide audited annual financial statements); or ownership/ management arrangements (e.g., will employ financial management with demonstrated experience, or will not pay dividends without the consent of the bank).

Violation of any covenant gives the lender the right to call the loan, charge fees, or collect interest at a higher rate. In practice, it has proven difficult to call a loan that is paying as agreed based on a covenant default. In this case, after developing a thorough understanding of the cause of the problem and its severity, the borrower is likely to issue either a temporary or permanent waiver in return for the borrower undertaking an agreed upon corrective action program.

All restructuring agreements should contain covenants. At a minimum, they should include provisions to submit financial statements; pay taxes as they become due; prohibit sale of company, in whole or in part, without prior approval of bank. Covenants for larger, more complex borrowers need to be specifically tailored to meet their individual situations. In addition to the items mentioned above, they are likely to include profitability, efficiency, liquidity, and solvency ratios; requirements to dispose of assets or raise equity within specific timeframes; or prohibit investments or restrict business activities to those currently engaged in.

3. Communicating with the borrower during the workout process

The bank should have detailed internal guidelines and rules regarding bank's staff communication with the borrower. These should include timetables for responding to customer requests or complaints. The guidelines should clearly identify who within the bank is responsible or authorized to issue various types of communication such as commitment letters, demand letters, etc. With respect to borrowers that have been transferred to the WU, the following basic principles[45] should be observed:

- The WO must act honestly, fairly, and professionally at all times.
- The WO has the right to end a meeting if the borrower becomes abusive or displays threatening behavior.
- The WO should avoid putting excessive pressure on the borrower and/or guarantor. All contacts with the borrower should take place at reasonable times (weekdays between 9am and 8pm) and at a mutually convenient location.
- Communication with the borrowers (and guarantors)) should be documented (audio, letters, protocol, notes to credit file) and retained for an appropriate time. Notes to the credit file should be factual and not contain derogatory or inflammatory comments with respect to the debtor.
- All communications of a legal nature such as commitment letters, demand letters, or other communications with respect to legal proceedings must be signed by those individuals authorized to do so by policy.
- All written communications from the borrower should be acknowledged within (5) business days.
- The WO should make clear from the beginning that all restructuring proposals require the approval of either one or more committees or senior managers. The borrower should be given an approximate timetable for approval and promptly notified of any delays.
- All approved restructuring proposals should be communicated to the borrower and guarantor(s) in writing, clearly spelling out all the terms and conditions, including covenants if required together with all reasonable[46] costs arising from the transaction.
- Borrowers should be notified in writing if their restructuring proposal is declined, including the reasons for rejection.

4. Resolution of disputes

When the lender and the borrower fail to reach an agreement or the borrower considers the bank's proposed restructuring (forbearance) plan or negotiation process does not follow the principles described in the paragraphs above, the borrower should have the right to elevate his case to the level above the WO. General established practice is for the borrower to write directly to a senior manager of the bank, generally the CEO. The letter is then referred to the respective unit for investigation of the facts and preparation of a response.

Given the nature of the resolution process which is likely to generate a number of such inquiries, banks may wish to consider formalizing this process. An example of a more formal process can be summarized as follows:

- An Appeals Committee consisting of at least three senior officers is formed.
- The members of the Committee should be knowledgeable about the credit granting process but be independent from the credit origination, workout, and risk management functions. Legal and internal auditing staff make good candidates for membership.
- A member should disclose potential conflicts of interest and recuse themselves from further discussions with respect to any relevant case being discussed by the Committee.

[45] https://www.eba.europa.eu/documents/10180/604521/EBA+Opinion+on+Good+Practices+for+Borrowers+in+Payment+Difficulties.pdf

[46] Not greater than necessary to compensate the creditor for the costs incurred to restructuring the borrower's obligations

- The borrowers should have prompt and easy access to filing an appeal. Good practice in this regard includes: standardized appeal forms together with a list of information or required documents needed in the review of the appeal, and deadlines for the submission and reviews of appeals.
- Submission of appeals should be acknowledged in writing.
- The decision of the Appeals Committee should be announced within one (1) month from date of submission and should be in writing and include the reasons for the committee's decision.
- The borrower would have a right to appeal on a specific issue only once.

It should be understood that restructuring/forbearance of debt obligations is a concession by the bank, and not a right of the borrower. This means that the creditor does not have any legal obligation to agree on a restructuring with the borrower, and remains free to take any actions foreseen in the loan agreement against the borrower, including bankruptcy, foreclosure of collateral, and sale of loan to a third party. Therefore, borrowers must understand that they do not have an automatic right to restructure their loan. Appeals should be limited to cases where the borrower believes that all pertinent facts were not considered or has new relevant information to present.

5. Summary of key good practices

- Assess the strengths and weaknesses in both the bank's and the borrower's positions and then develop a negotiating strategy to obtain objectives.
- Determine if bank required to assume role of coordinator in multi-bank exposure.
- Encourage less sophisticated borrowers to seek advice of counsel or financial advisor to ensure they fully understand the terms and conditions of restructuring proposal.
- Involve guarantor(s) in restructuring negotiations and require either a new guarantee (preferable) or an acknowledgement in writing that guarantor understands and agrees to the terms of the restructuring.
- Document transaction making use, to the extent possible, of standardized documents particularly for smaller exposures.
- Develop covenants appropriate to the level of complexity and size of the transaction.
- Follow a code of conduct in dealing with the borrower, and have in place a clear mechanism for resolution of disputes.

Chapter VIII. Monitoring the Restructuring Plan

Restructuring Guidelines for Micro, Small and Medium-sized Companies

IV. e. - The approval of the restructuring agreement is only a part of the process of resolving, since the bank must continue to monitor the debtor to ensure timely reprogramming of payments and meeting of commitments. If reasons exist on the part of the debtor to deviate from the agreement that are reasonable and objectively justifiable, the bank may approve a waiver of commitment. In the event of material unjustified deviations, the bank must impose additional requirements, penalty interest, termination of agreement, blocking of the transaction account, execution, etc.

The control over the fulfilment of all commitments and timely payments must be ensured by the bank by setting up appropriate IT and organisational support. If there is no confidence in the management, the bank should strive to involve an external consultant or authorised person to periodically monitor the company's operations on behalf of the bank.

For SMEs, a short quarterly review is the most cost-efficient manner, namely in the form of meetings with the key staff and inspecting the documentation, analysing the financial statements in order to obtain an overview of a realistic business and financial situation of the debtor.

1. Monitoring arrangements for restructured NPLs

Restructured borrowers should be subject to intensive monitoring to ensure their continued ability to meet their obligations. The WU should use the bank's EWS system (see Chapter 1) to alert WOs of any potential problems. All borrowers should be subject to periodic review, the timing of which and depth of analysis required should be proportional to the size of the exposure together with the level of risk inherent in the credit. Those exposures which are material in nature and pose the greatest risk to the institution should be reviewed monthly on an abbreviated basis focused on recent developments. More in-depth reviews would be done on a quarterly and annual basis in conjunction with receipt of interim and annual financial statements. Smaller exposures might be monitored semi-annually for the first year with annual reviews thereafter. Finally, the smallest exposures could be subject to an annual review of their financial statements.

Senior management should also be monitoring closely the KPIs of specific portfolio segments to ensure that the goals imbedded in the strategic plan are on track. Deviations from plan should be identified and appropriate time-bound, corrective action plans put in place and monitored.

1.1 Changing the risk rating of the loan

All banks should have clear written policies and procedures in place which outline the specific criteria together with required cure periods which must be satisfied to upgrade (or downgrade) the risk rating on a loan. While the goal of the restructuring is to improve the exposure's risk rating, the borrower must demonstrate its ability to meet the terms of the restructuring as well as show an improvement in its risk profile for a specified period of time before an upgrade is appropriate. Allowing an upgrade within a short period, say 6 to 9 months, is likely to lead to a higher level of "cosmetic" restructurings, providing temporary rather than permanent solutions for a company's problems. The BoS requires a one year waiting period after restructuring before a loan becomes eligible for consideration of an upgrade.

It is important to realize that upgrade is not automatic after the one year period, but rather should be based on the borrower's current and expected future performance. The borrower's should demonstrate that financial difficulties no longer exist. The following criteria should be met in order to dispel concerns regarding financial difficulties: (i) the borrower has made all required payments in a timely manner for at least one year; (ii) the exposure is not considered as impaired or defaulted; (iii) there is no past-due amount on the exposure; (iv) the borrower has demonstrated its ability to comply with all other post-forbearance conditions contained in the master restructuring agreement; and (v) the borrower does not have any other exposures with amounts more than 90 dpd at the date when the exposure is reclassified.

A particular attention should be paid to bullet and balloon loans (with reduced front payments). Even after one year of flawless performance, the repayment in full of a balloon loan that relies on a sale of real estate at the end of repayment period can be questionable if real estate market experiences adverse performance.

1.2 Transferring the borrower back to the originating unit

Restructuring Guidelines for Micro, Small and Medium-sized Companies

II.a.2. - The following criteria should be applied when transferring a client back to the commercial unit:
- the client regularly meets all its obligations from the restructuring agreement;
- at least one year has passed from the beginning of validity of the restructuring and the debtor has repaid at least 10 percent of the restructured principal in that period;
- the debtor's indebtedness, measured with the net financial liabilities/EBITDA indicator;
- the transfer had been approved on the basis of the analysis of the debtor's financial position by the competent committee of the bank.

Once a borrower has demonstrated its ability to meet the all the terms of its restructured obligations for a period of at least one year, repaid at least 10 percent of its restructured debt, and no longer displays any of the signals which would cause automatic transfer to the WU, the loan should be transferred back to the originating unit for servicing and follow up. Borrowers need to be seen to be viable by their customers and suppliers. A bank's willingness to work with a company to resolve its problems together with the resumption of a normalized banking relationship provides the public with a level of comfort that allows them to do business with the company.

2. When restructuring fails

It is to be expected that a certain number of restructurings will fail, mostly for the reasons outside the bank's direct control. If the restructured borrower does not perform his obligations, the WO needs to quickly assess if the problem is temporary in nature and easily corrected (e.g., a temporary slowdown in sales to a major customer who is moving to a new location) or more permanent in nature (e.g., the company's major product has been rendered obsolete by EU regulations). If the company is still viable in the long term and the problem can be easily corrected, the borrower could be allowed to restructure the terms of repayment one more time. In general, however, multiple restructurings can be an indication that the borrower is no longer viable and that there are problems in the approval process. If the problem is of a more permanent nature (e.g., as evidenced by second payment default), the borrower should be deemed non-viable and promptly referred for legal proceedings.

The bank should closely monitor failed restructurings to determine the reasons behind them and assess the appropriateness of its strategies.

3. Summary of key good practices

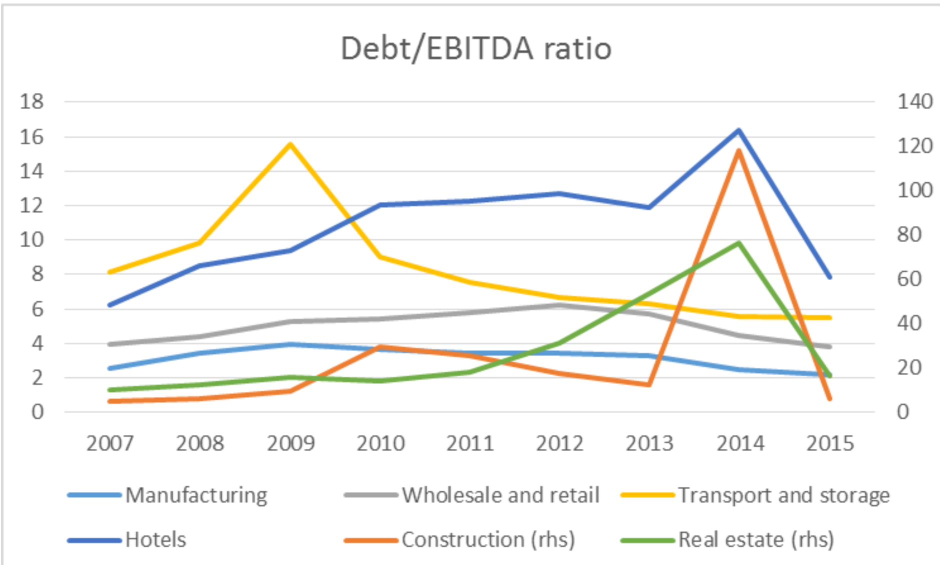
- The performance of restructured loans should be monitored closely to ensure that the borrower is meeting the terms and conditions of the restructuring.
- The level and depth of monitoring should be based on the materiality principle, i.e. those exposures posing a greater risk to the institution should be subject to the greatest oversight.
- Regularly analyze the causes of failed restructurings and revise restructuring options accordingly.
- If a restructuring fails due to a temporary problem that it is easily corrected, the restructuring agreement should be revised. However, if the problem is more permanent in nature and the company has become non-viable, the legal proceedings should be commenced immediately.

Appendixes

Appendix 1. Financial ratios for economic sectors in Slovenia[47][48]

Financial debt/EBITDA

		2007	2008	2009	2010	2011	2012	2013	2014	2015
C	Manufacturing	2,51	3,39	3,92	3,68	3,4	3,45	3,26	2,49	2,16
F	Construction (rhs)	5,08	5,9	9,41	29,79	25,67	17,27	12,23	118,07	6,1
G	Wholesale and retail	3,96	4,39	5,27	5,44	5,79	6,21	5,67	4,43	3,81
H	Transport and storage	8,16	9,84	15,58	9,05	7,55	6,66	6,27	5,57	5,45
I	Hotels	6,24	8,5	9,4	12,01	12,27	12,68	11,88	16,34	7,82
L	Real estate (rhs)	10,17	12,12	15,97	14,18	18,19	31,06	53,59	76,14	16,22

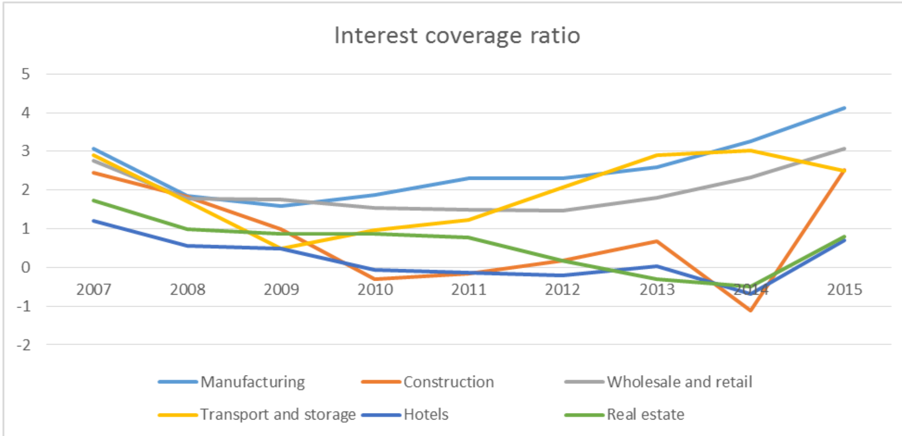


Interest coverage ratio

		2007	2008	2009	2010	2011	2012	2013	2014	2015
C	Manufacturing	3,06	1,86	1,59	1,87	2,3	2,31	2,58	3,25	4,13
F	Construction	2,44	1,83	1	-0,31	-0,15	0,17	0,67	-1,11	2,53
G	Wholesale and retail	2,76	1,79	1,75	1,54	1,5	1,46	1,8	2,33	3,06
H	Transport and storage	2,9	1,71	0,49	0,96	1,23	2,06	2,91	3,02	2,49
I	Hotels	1,2	0,57	0,49	-0,07	-0,13	-0,2	0,03	-0,68	0,7
L	Real estate	1,74	0,98	0,88	0,87	0,78	0,18	-0,3	-0,49	0,8

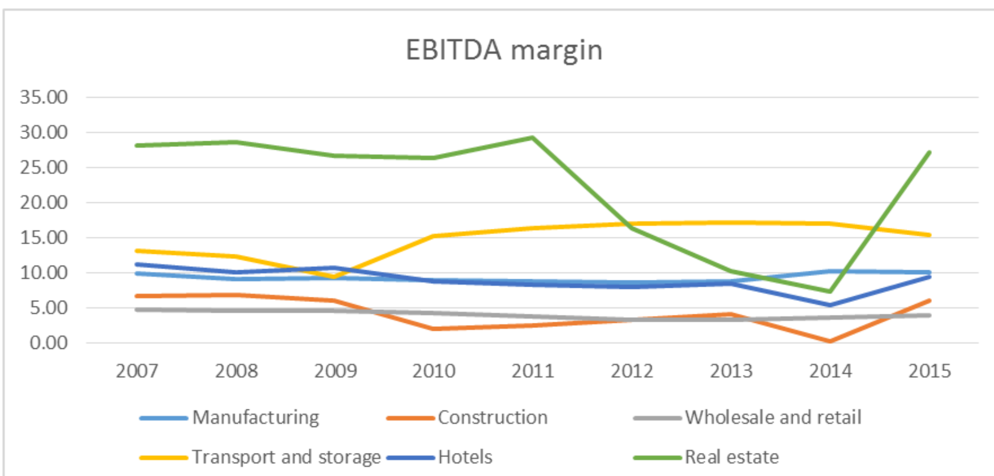
[47] The data were provided by Chamber of Commerce & Industry of Slovenia (database Kapos), based on non-consolidated, non-audited financial statements provided by Ajpes (Agency of the Republic of Slovenia for Public Legal Records and Related Services). The data are from all companies, including MSMEs and large companies, in the respective sector.

[48] The database exhibits the so called survivorship bias because non-viable companies exit the database the year bankruptcy is declared.



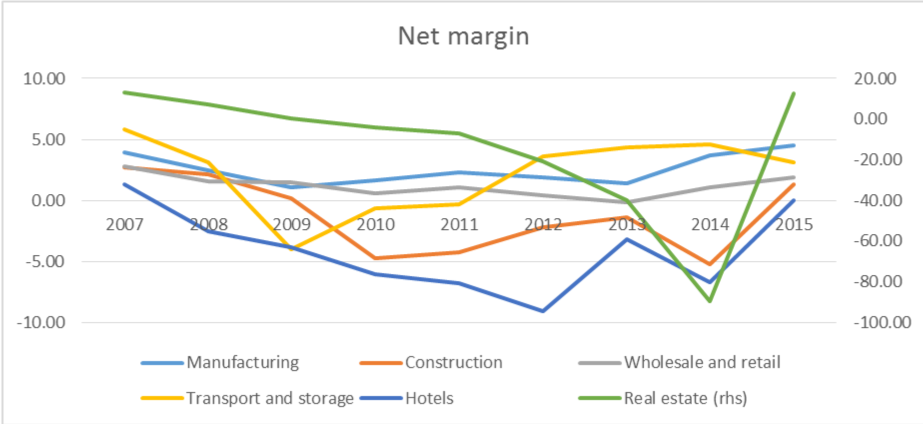
EBITDA margin

		2007	2008	2009	2010	2011	2012	2013	2014	2015
C	Manufacturing	9,97	9,23	9,34	8,92	8,76	8,71	8,88	10,33	10,20
F	Construction	6,77	6,85	6,03	2,10	2,57	3,37	4,13	0,37	6,17
G	Wholesale and retail	4,87	4,71	4,66	4,28	3,90	3,42	3,43	3,74	4,04
H	Transport and storage	13,10	12,30	9,44	15,25	16,42	16,97	17,14	16,97	15,41
I	Hotels	11,20	10,16	10,78	8,77	8,43	8,05	8,48	5,52	9,44
L	Real estate	28,21	28,59	26,74	26,39	29,27	16,37	10,29	7,41	27,13



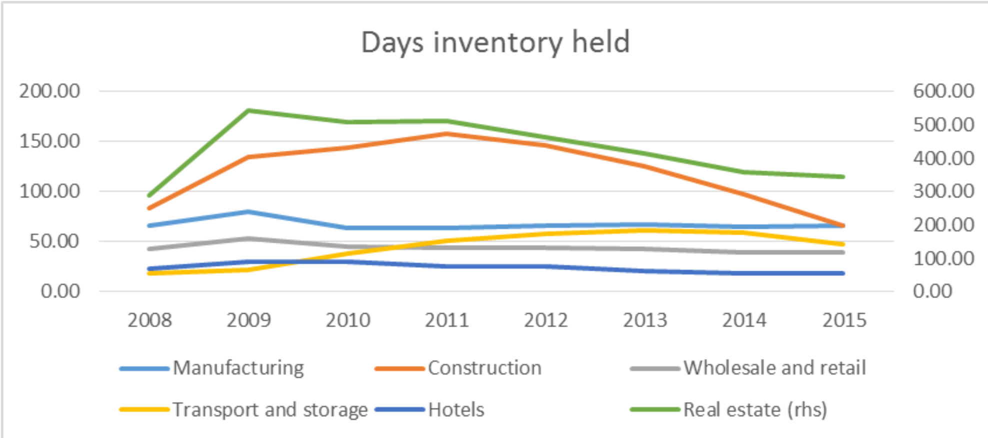
Net profit margin

		2007	2008	2009	2010	2011	2012	2013	2014	2015
C	Manufacturing	3,97	2,45	1,08	1,68	2,34	1,90	1,39	3,68	4,55
F	Construction	2,71	2,16	0,20	-4,77	-4,26	-2,19	-1,39	-5,19	1,30
G	Wholesale and retail	2,76	1,53	1,52	0,62	1,09	0,40	-0,12	1,11	1,90
H	Transport and storage	5,81	3,09	-3,96	-0,61	-0,35	3,58	4,33	4,63	3,15
I	Hotels	1,33	-2,54	-3,80	-6,02	-6,77	-9,07	-3,19	-6,74	0,00
L	Real estate (rhs)	13,24	6,97	0,50	-4,10	-7,04	-20,54	-40,14	-89,32	12,42



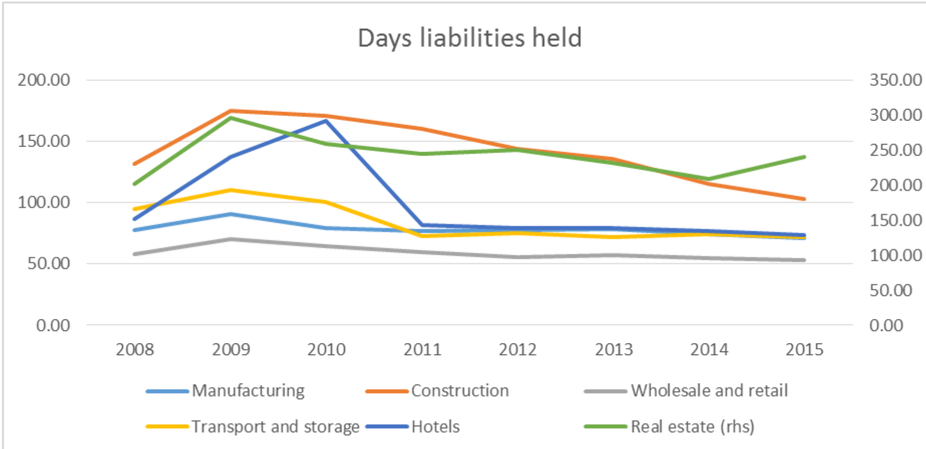
Days inventory held

		2008	2009	2010	2011	2012	2013	2014	2015
C	Manufacturing	65,90	79,60	64,20	63,70	66,60	67,20	65,40	65,80
F	Construction	83,40	134,30	144,30	158,50	146,80	125,60	97,00	65,90
G	Wholesale and retail	43,40	53,50	44,90	43,80	44,00	42,80	39,50	40,00
H	Transport and storage	18,40	21,80	38,60	51,10	58,60	61,80	59,40	48,00
I	Hotels	23,30	30,60	29,90	25,70	25,30	21,20	18,10	18,10
L	Real estate (rhs)	288,70	543,50	509,40	512,40	464,90	416,20	357,50	343,90



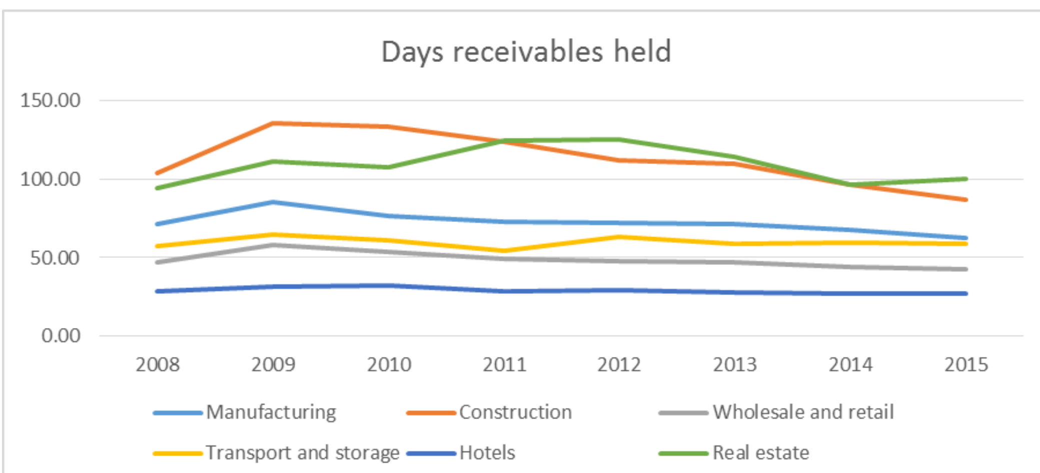
Days liabilities held

		2008	2009	2010	2011	2012	2013	2014	2015
C	Manufacturing	77,40	90,90	79,20	76,60	77,50	78,40	74,70	71,00
F	Construction	131,60	174,90	170,70	160,30	143,60	135,80	115,10	103,30
G	Wholesale and retail	57,60	69,90	64,90	59,30	55,90	57,00	54,40	52,70
H	Transport and storage	94,90	110,50	100,60	72,70	74,80	72,00	74,10	72,00
I	Hotels	86,20	137,10	166,40	82,00	79,10	79,00	76,60	73,60
L	Real estate (rhs)	201,30	296,00	258,80	243,90	249,90	231,30	209,10	240,00



Days receivables held

		2008	2009	2010	2011	2012	2013	2014	2015
C	Manufacturing	71,70	85,40	76,20	72,60	71,90	71,50	67,50	62,60
F	Construction	103,80	135,40	133,60	123,40	111,70	109,60	96,10	86,50
G	Wholesale and retail	47,30	58,20	53,90	49,40	47,50	46,70	44,00	42,90
H	Transport and storage	57,30	64,60	60,70	54,50	63,00	58,50	59,30	58,60
I	Hotels	28,80	31,60	32,60	28,80	29,30	27,60	27,40	27,30
L	Real estate	93,90	111,40	107,40	124,70	124,90	114,20	96,50	100,10



Appendix 2. Estimated cost and time of legal solutions in Slovenia

This Appendix explains the rules applicable to determine the costs incurred in collecting on a non-performing loan in Slovenia through two broad legal solutions, i.e., bankruptcy and enforcement. Additionally, this text also indicates the time that such legal proceedings are expected to take, on average. The rules and estimates included in this Appendix are based on the information collected from Slovenian banks and legal practitioners. In addition to the costs described below there might be other costs that may apply in the context of a legal solution, like for example the experts' fees or third party advisors that the parties may hire. However, these costs have not been included in this Appendix to ensure comparability of the legal solutions proposed.

Bankruptcy costs are broken down as follows:

- *Court fees*: a flat fee to initiate bankruptcy proceedings applies to all cases (EUR 246). In addition, the petitioning party must also pay applicable taxes, which vary depending on the value of the assets of the insolvency estate. To prevent insolvent borrowers from filing and not paying the tax, there is an advance payment of EUR 3.434,50 for all filings (both debtor and creditor initiated).

- *Attorneys' fees* would obviously depend on the agreement reached between the petitioning party and his advisors, and will vary significantly depending on the nature of the case and the type of attorneys hired.

- *Publication fees* amount to EUR 120 to cover for the publication in the official gazette the opening of the bankruptcy case.

- *Administrator*: Total remuneration is based on 3 components: (i) value of the estate, (ii) number of creditors, and (iii) proceeds distributed to creditors. Each of these amounts must be calculated according to the formulas presented in the Box below.

Bankruptcy time. It seems to take at least one year to complete a bankruptcy case in Slovenia, but generally not more than 2 years.

Enforcement costs would amount to approximately EUR 2.500 regardless of the size of the exposure or the value of the collateral, as follows:

- *Application fee*: EUR 40 to 55

- *Appraisal of the property*: EUR 350-750, assuming the court will have to appoint an independent expert to conduct a valuation, which is typically the case.

- *Appraisal of the business share*: EUR 1.500.

- *Request for postponement* of enforcement: EUR 30, assuming there will be at least one.

- *Attorney's fees*: See comment above on bankruptcy costs.

- *Seizure of property*: EUR 70-500, to pay the courts' officers that ensure repossession.

Enforcement time, assuming the collateral is real estate property, depends on how many appeals the borrower is willing to attempt, the diligence of the court as well as its backlog. Considering all these factors, 2.5 years seems a realistic estimate.

This box breaks down the different components involved in the calculation of the administrator's remuneration in a bankruptcy procedure in Slovenia.

1. **Elaboration of the opening report**

Administrator's remuneration for the elaboration of the opening report is calculated according to the following table:

Heading	The basis for the calculation of the EUR (value of assets in the balance sheet - 2nd paragraph)		Compensation in EUR
I.	to 47.350		3 percent
II.	above 47.350	to 100.000	1.420,50 + 1 percent over 47,350
III.	above100.000	to 500.000	1.947 + 0,5 percent above 100,000
IV.	above 500.000	2.000.000	3.947 + 0,2 percent above 500,000
V.	above 2.000.000	to 4.400.000	6.947 + 0,1 percent above the 2,000,000
VI.	above 4.400.000		9.347 + 0,08 percent above 4,400,000, **but not exceeding 20,000 EUR**

2. Testing claims

Administrator's remuneration for the testing the claims is calculated according to the following table:

Heading	The number of claims lodged in due time		The amount of the refund in EUR
I.	to 10		1.420,50 EUR
II.	above 10	to 50	1.420,50 EUR + 94,70 EUR for each claim above 10
III.	above 50	to 100	5.208,50 + 47,35 for each claim above 50
IV.	above100	to 200	7.576 + 23,68 for each claim above 100
V.	above 200		9.944 + 5 for each claim over 200, **but not exceeding 20.000 EUR**

3. Realization of the bankruptcy estate and distribution of proceeds to creditors.

Heading	The basis for the calculation of the euro (amount of the liquidated assets subject to distribution		Compensation in euro
I.	to 37.500		10 percent
II.	over 37.500	to 375.000	3.750 + 4 percent over 37.500
III.	over 375.000	to 750.000	17.250 + 3 percent over 375.000
IV.	over 750.000	to 2.250.000	28.500 + 1 percent over 750.000
V.	over 2.250.000	to 3.550.000	43.500 + 0,5 percent over the 2.250.000

Appendix 3. Sample Forms and Templates [49]

Preparing For the Workout - Checklist for MSME Borrowers
Standstill Agreement template
Restructuring Process Timetable

[49] Attached as a separate file

Appendix 4. Case Studies of MSME NPL Workout[50]

Case Study #1: Printer Ink, Ltd. - Loan Restructuring
Case Study #2: Atlas Battery Company, Ltd. - Multi-Bank Loan Restructuring
Case Study #3: GRQ Ltd. –Bankruptcy of unviable company

[50] Attached as a separate file.