<u>Comments to the EBA Consultation Paper</u>

Draft Guidelines

On management of non-performing and forborne exposures

EBA/CP/2018/01- 08 March 2018

<u>Question 4</u>:

- **Does section 4.3.2 capture all relevant options available for credit institutions to implement their NPE strategy?**

<u>Answer:</u>

- **Restructuring Funds; an alternative strategy to active management of non-performing loans (NPE). A half-way approach between "hold/forbearance" and "portfolio reductions" strategies**

<u>**Summary: 1. Introduction; 2. The specific assets perimeter; 3. Differences and similarities with other "traditional" strategies; 4.The rationale of the "Restructuring Fund" model; 5. Specific legal/regulatory features of the "Restructuring Fund" 6. Suggested incentives and policy actions (legal/regulatory/supervisory) aimed at creating a friendlier environment to foster and boost the role of the Restructuring Fund of the NPE's market; 7. Conclusions.**</u>

1. <u>Introduction.</u>

This comment to the EBA Consultation is aimed at proposing and illustrating an innovative **tool/strategy** to address the general, wider and multifaceted NPE issue **from a bank perspective**; **an half-way strategy between a traditional "hold/forbearance" approach and a traditional "portfolio reduction" approach, producing a changing in the type of exposure (see section 4.3.2 of the Consultation Paper)**. Such a new, complementary, tool is aimed at overcoming market inefficiencies that other "traditional" approaches/tools currently present and, at the same time, helping to reduce effectively the legacy assets at bearable levels. At the same time this is a **"debtor-level"** approach that pursues the concentration of all the exposures of the banking system *vis-à-vis* the same debtor, as a precondition for a successful restructuring process of corporate borrowers in distress. Such a tool can be identified in a so called "Restructuring Fund" (Carrière, 2016), a specific and peculiar kind of AIF (the "Fund").

2. The specific asset perimeter.

A preliminary, fundamental assumption is that the wide variety of different situations encompassed within the broad, general definition of NPEs, deserve rather different analytical approach and solutions. As a matter of fact, the envisaged solution is confined to a specific and peculiar kind of assets, a sub-set of the wider NPE asset class; in particular, the envisaged scheme proves to be efficiently applicable to those particular kinds of NPE – the UTP (unlikely to pay) – that present the following features: **1)** exposures *vis-à-vis* corporate entities (typically small- and medium-sized enterprises, "SMEs"), a more heterogeneous kind of recoverable loans that, normally, are not efficiently managed with other tools (Beck, 2017); **2)** exposures *vis-à-vis* borrowers in financial distress which commenced, or are ready to commence, a restructuring process through the recourse to the out-of-court or settlement procedures laid down by lawmakers in recent years; **3)** exposures that appears to be viable for forbearance measures and, therefore, show concrete perspectives of a positive restructuring of the borrower, including through debt-to-equity swap transactions; **4)** exposures that show an attitude to be considered, aggregated and managed with a "cluster" approach.

3. Differences and similarities with other "traditional" strategies.

The proposed tool/strategy is half-away between a traditional "hold/forbearance" approach and a traditional "portfolio reduction" approach.

A. The illustrated approach shows many similarities with the experience of Asset management companies (AMCs) as utilized in the recent past, mainly on a national-wide scale (as analysed by scholars Barba Navaretti, Calzolari, Pozzolo, 2017; Guonan, Enria, Haben, Quagliariello, 2017; Ben S.C. Fung, 2006; Hyoung-Tae, 2003; Visco, 2016 and institutions WB, 2016; ECB, 2017; ECB, 2017; EBA, 2017; FSI, 2017; IMF, 2015; BoI, 2017; EBA, 2017; ECB, 2012; ESMA, 2016; EC, 2018) although there are many relevant differences in the two models. The same differences exist with regard to any traditional securitisation approach:

- The main difference is that **no substantial transfer** of the impaired assets is made to external entities, as it occurs in other approaches, such as securitisations or even "traditional" AMCs. This is a scheme "captive" to the banking system, whereby several banks "contribute" their assets to a common entity, the Fund, and obtain its units in exchange. That overcomes any current "lemon market" and "fire sale" issues (Onado, 2017; Fell, Grodzicki, Martin, O'Brien, 2017), that represent the main constraints/concern to traditional disposal/securitization transactions. The envisaged scheme, skips any issue related to the need of "bridging" intertemporal pricing gaps and to asymmetric information (Onado, 2017; Constancio, 2017). Since the banks are contributing the receivables to the common vehicle that will carry out the restructuring process and the recovery, no gaps exist between bid and ask prices, nor between market value and real value of the assets, this resulting for the banks in an immediate loss and need of recapitalization. In the envisaged scheme, the positive outcome of the restructuring process, the upside, is kept inside the banking ring and redistributed to the participating bank, thereby avoiding any undue transfer of value outside such ring.

- The envisaged scheme more efficiently addresses the issue of moral hazard, it being construed in a way that necessarily and structurally "keep skin in the game", (Barba Navaretti, Calzolari, Pozzolo, 2017) with a retention of the "risk" (although transformed and diversified) as well as of the "upside" related to the contributed assets (Fell, Grodzicki, Martin, O'Brien, 2017).
- Another main difference with the "traditional" AMC model and traditional securitisation approach is that – in the light of the peculiarities of the conferred assets – the focus is not only (or mainly) on banking balance sheet and capital requirements needs, but also on efficiency of the restructuring processes for the corporate borrowers involved. This is a "debtor-level" approach that pursues the concentration of all the exposures of the banking system *vis-à-vis* the same debtor, as a precondition for any successful restructuring process of corporate borrowers in distress.
- The asset valuation process is far less a crucial issue in the envisaged structure than in "traditional" AMCs and securitisation structures (Avgouleas and Goodhart, 2017; Bruno, Lusignani, Onado, 2017). The correct determination of the "market value" or "real economic value" does not entail a substantial economic issue for the contributing banks, since no external transfer of value takes place; the correct determination of value for the "contributed" assets is just and primarily an issue of equal treatment among the banks participating in the Fund.
- In the event this tool would be applied on a system-wide scale and approach, it should not entail any of the delicate EU legal constraints on state aid, as raised by State/Government-backed and supported initiative. It can well be structured as a purely private initiative, although certain incentives/policy actions at general level could assist the tool in order to foster and boost its systemic role (see section 6. hereinafter).
- No other issues that may be analysed with regard to "traditional" AMCs, do appear relevant in the envisaged structure; in particular, issues such as capital structure or

funding structure (Fell, Grodzicki, Martin, O’Brien, 2017) do not present any particular problem, this being a purely private structure.

B. The envisaged scheme shares with the traditional AMC or Outsourcing schemes:

- the virtue of disengaging managerial resources that would otherwise be absorbed by the internal management of NPEs, letting them free to pursue and concentrate on the main targets of reducing overcapacity and overhauling business model (Enria, 2016);
- the centralization of specific recovery expertise and capabilities with the consequence of breaking the links between banks and borrowers, that may result in problems for banks having weak governance structure and lending protocols (Klingebiel, 2000);
- a friendly scheme for the entrepreneurial system that may benefit from restructuring and reorganization, avoiding destruction of economic value (Fell, Grodzicki, Martin, O’Brien, 2017);
- the need of a well-designed governance and a strong mandate to independent and expert Fund manager (Fell, Grodzicki, Martin, O’Brien, 2017) aimed only at the maximization of the recovery rate;
- the need for incentives to induce banks to contribute (centralize) their exposures *vis-à-vis* the same borrower. This may occur by using the fiscal leverage or introducing legal/contractual mechanisms such as a “creditor drag along”.

4. <u>The rationale of the “Restructuring Fund” model</u>

According to the operative model of a so-called “Restructuring Fund” (Carrière, 2016; Guiotto, 2017; Sartori, 2018) a plurality of banks will “contribute” the NPEs held *vis-à-vis* a number of common corporate borrowers to an AIF, against issuance of the funds’ units that will be held, and may be kept, in the banks’ portfolios *in lieu* of the original contributed NPEs; to this effect the envisaged strategy consist of and produce a change in the kind of the original banks’ exposure (see. Section 4.3.2.c) of the Consultation Paper). As a result, the AIF Manager (AIFM) shall proceed to “actively” manage the contributed NPEs “as a pool”, with the consequence that the credit risk originally attributable to each bank will be pooled and, therefore, diversified. The NPEs will not be managed in view of their mere recovery/collection, but rather “actively” in order to proceed to the “restructuring” of the corporate borrower in distress, by means of the procedures commonly available to resolve company distress included, if necessary, debt-to-equity swap transaction. The trend of value and flows deriving from the Funds’ units will then be linked to the pro-active management of the credits and the successful outcome of the business restructuring procedure. The restructuring actions are carried out by the Manager of the AIF, with a specific professional expertise in corporate restructuring and acting independently by the banks in compliance with AIFM

Directive. Differently from securitisation, this structure aims at extracting and retaining the embedded value deriving from the upside return of restructuring process inside the banking ring (so long the contributors/selling banks retain the Units in their portfolio).

The AIF scheme proves also to be more efficient than "in-house" restructuring processes directly managed by the banks' internal departments; on the one hand, this is due to a more evident in-depth specialization, expertise and efficiency of the actions required; on the other hand, this structure allows to achieve a favourable and fundamental effect of concentrating those credit positions that were originally atomized over a very large number of banks, holding different interests, (for amounts involved, quality and nature), and sometimes in contrast among them. The main and most apparent consequence of such an atomization is indeed that the restructuring proceedings risk to run in a very time-consuming and complicated "loop" of (banks-borrower and interbank) negotiations, which often causes these proceedings to become inefficient and ineffective, thus jeopardising any opportunity to leave the crisis behind. Hence, besides reducing the banks' operating costs connected with the internal management of complex restructuring processes, the structure at issue triggers and enhances the chances for successful conclusion of the corporate borrowers' restructuring processes, increasing the recovery rate. Meanwhile, as the corporate borrowers' restructuring processes come across debt-to-equity swap (*i.e.* transactions entailing the conversion of the NPEs into *equity*/quasi-*equity* instruments), this operative structure allows for a more flexible and efficient management of this stage, while upholding the principle of banks/industry separation.

Similarly functional to an efficient restructuring process of the distressed corporate borrowers, appears to be the pairing of such process of active management of the NPE with the availability of the so called "new finance" (usually in the form of "D.I.P. financing"); ideally the AIF may be structured in two sub-funds. Alongside the "credits sub-fund", a separate and autonomous "new finance sub-fund" may be considered. A complementary, accessory and functional sub-fund, aimed at supporting the restructuring process of the portfolio corporate borrowers through the supply of "new finance",[1] normally (legally and/or contractually) ranking senior to other creditors according to the restructuring legal framework and market standard practice.

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[1] Under Italian Law, the ability of an AIF to provide "direct lending" has been firstly introduced and regulated by art.22.5 of Law Decree 91/2014, followed by the implementing provision contained in Law Decree 18/2016, amending the TUF (Consolidated Financial Act) by introducing the new "Capo II-*quinquies*".

5. Specific legal/regulatory features of the "Restructuring Fund"[2]

The Fund appears to be structured according to the described rationale. In particular, it is a bank-driven, private AIF, according to the definition contained in Article 4(1)(a) of Directive 2011/61/EU (AIFMD), and compliant with the Directive itself.

- As already seen, the Fund may be structured as an "umbrella fund" consisting of two separate investment Sub-funds, namely: (**i**) the "**Credits Sub-fund**" and (**ii**) the "**New Finance Sub-fund**"; each of them may be considered, from a legal and regulatory standpoint, as a separate, autonomous fund. No commingling should occur between two or more sub-funds of a specific umbrella fund, nor can it be pursued by the Manager.
- The Fund will be sponsored, set up and managed by a private and independent management company ("**AIFM**"). AIFM will actively and independently manage each of the investment positions of the Fund (whether relating to the Credits Sub-fund or to the New Finance Sub-fund) without the possibility for the Banks to influence, control or otherwise affect the financial evaluation, and operating strategies and policies of the management company.
- The Fund will be reserved to professional investors (as defined under article 6, par. 2-*quinquies* and 2-*sexies* of the Italian Legislative Decree No. 58 of 1998) and to non-professional investors in the case set forth by article 14, par. 2 of the Economic and Finance Ministerial Decree No. 30 of 2015. In particular, the Credits Sub-fund will be only subscribed by Banks and, to a minor extent, by individuals (managers).
- At the closing of the Fund, the Banks will transfer/contribute "without recourse" Credits (and all connected security interests and guarantees), to the Credits Sub-fund, for a value calculated following a due diligence carried out independently by AIFM on each Target Company and based on the expected recoveries and expected enterprise value of the Target Company following the restructuring process (and, therefore, even considering the divestment of the equity of the Target Company according to usual M&A processes). Said transfer shall take place against issuance by the Sub-fund to the relevant contributing Banks, of a number of units (the "**Units**") corresponding to the value of the transferred Credits/Permitted Securities.
- The Credits Sub-fund and the New Finance Sub-fund have their own management policies. In particular, the former's management policies will be aimed at pursuing a dynamic and proactive management of the turnaround processes of a limited number of pre-determined and identified distressed Italian companies (the "**Target Companies**"); this shall occur in view of their restructuring and the maximization of the recovery rate of the Credits, subject to conditions regulated in the Fund Regulation, including through debt-to-equity (or quasi-equity) swaps transactions and/or acquisition

2 With specific, particular, regard to Italian legal/regulatory/supervisory framework.

or subscription of equity (or quasi-equity) in the Target Companies ("**Permitted Securities**").

- The value and the distribution of the proceeds related to the Units issued by the Credits Sub-fund to the Banks, is indirectly related to and, from a substantial point of view, reflected and "backed" by the underlying pool of assets of the Fund (originally the Credits/Permitted Securities), as actively managed and transformed (if necessary even through debt-to-equity swap transactions sorting in divestments conducted according to standard M&A process).
- In order to support, foster and enhance the restructuring process of the Target Companies – aimed at improving the recovery prospects of the Credits – the New Finance Sub-fund may provide Debtor-in-Possession (D.I.P.) Finance to the Target Companies using the financial resources provided by the investors subscribing the units related to such Sub-fund (the "**Investors**").[3]
- The investment policy of the Fund provides that the return for the Unit-holders of the Credit Sub-fund will derive from:
  - firstly, the stand-alone management of the credits, without the advance of New Finance. The concentration of the credit *vis-à-vis* the Target Companies, which increases the commercial influences towards them, the appointment of a new management in the Target management, the possibility of a debt-to-equity swap transaction, are all factors that may improve the recovery rate of the credits;
  - secondly, when and if necessary, the strengthening of the financial position of the Target Companies through the injection of New Finance, whose seniority will be regulated according to the Italian restructuring legal framework and/or contractual subordination provisions according to standard market practice.
- The Banks, as Unit-holders, will have full and equal-ranking recourse on the Sub-Fund assets, without any internal tranching of risk.[4]
- The Fund's trading in derivatives will be permitted only to the extent that it allows to hedge against the exposure of the Sub-fund.
- The Fund does not allow a leverage higher than required under Article 51(3) of Directive 2009/65/EC.

[3] According to the ability for AIF to provide "direct lending" following to art.22.5 of Law Decree 91/2014 and Law Decree 18/2016.
[4] To this extent the Credit Sub-fund and the Fund itself do not seem in any way considered as a securitisation under article 4 paragraph 61 e 67, as further clarified in whereas n. 50 of the same CRR regulation.

6. Suggested incentives and policy actions (legal/regulatory/supervisory) aimed at creating a friendlier environment to foster and boost the role of the "Restructuring Funds" on the NPE's market[5]

In the current European and Italian Legal/Regulatory system, "Restructuring Funds" have not been expressly addressed by primary and/or secondary sources of law, yet. According to the above analysis and under a comparative perspective it may be claimed that, nowadays, "Restructuring Funds" should deserve the lawmakers' and regulators' attention in order to create for them a friendlier legal and regulatory environment, able to boost their role in the NPE's market. In fact, at domestic level, recommendations have been made over the years to provide for a specific regulatory framework for such innovative models so as to facilitate their adoption in the Italian market (Vitucci, 2015). In this respect, it is worth recalling the recent and authoritative words of the Governor of the Bank of Italy (Visco, 2016), who held that: *[...]non-performing loans (almost one third of the total) to firms in temporary difficulty but with sound chances of making a turnaround, especially given the strengthening of the economic recovery, could be managed better. Proper coordination of the banks involved is essential, as is the intervention of corporate restructuring specialists.* […].

- "Restructuring Fund" – Fine tuning of regulatory aspects

At its earlier stage, a "Restructuring Fund" will – predominantly but not exclusively – invest in «receivables», for this reason it may be considered similar to "receivables investment funds"; and, at a cursory glance, the rules under Title V, Chapter 3, Section V, paragraphs 5 and 6.3, and Section VI, paragraph 1, of the Collective Asset-Management Regulation dated 19 January 2015 (the "**CAM Regulation**") may be assumed to apply. This may entail the application of certain prudential rules and constraints that do not fit with the specific rationale and operation of this peculiar kind of Funds. Therefore, it would be appropriate to explicitly exclude "Restructuring Funds" (as far as their typical components of "claim sub-fund" and "new-finance sub-fund") from certain specific types of funds that are acknowledged and ruled by secondary sources of law, in the light of the fact that their assets are invested in "claims" (on a typical, systematic and/or exclusive basis), with subsequent non-applicability of the prudential rules set out therein.

- Creditor Drag-Along mechanism

An additional goal to pursue at legislative level is to accelerate and smooth recovery procedures; this is feasible through a concentration of all credit positions currently atomized among multiple banks (often showing not aligned interests) over one sole professional counterparty of the corporate borrower. In this respect, a sort of "creditor drag-along" mechanism ought to be introduced, as a step forward in the path drawn by the recent introduction of compulsory accession to restructuring agreements or a moratorium under article 182-*septies* of the Italian bankruptcy act (introduced by article 9 of law decree n.83 of 27 June 2015, as amended and converted into law

[5] With specific, particular, regard to Italian legal/regulatory/supervisory framework.

no. 13 of 26 August 2015). Such mechanism should consist in an inducement/obligation of the banks engaged in restructurings under out-of-court procedures, to transfer their claims to a Restructuring Fund designated by the majority of the banks.

A similar solution had already been adopted in the past (in the 70s of the last century, in upheaval periods not less harsh than nowadays), when banks were entitled/bound to transfer their non-performing loans into certain corporate vehicles (bearing the ambiguous denomination of "società consortili" according to law no. 787 of 5 December 1978) appointed to professionally and collectively manage the recovery of the company in financial distress, subject to prior conversion of such receivables into its equity or bonds. Therefore, this may be seen as a step back to the future, in the light of the current and more efficient tools available (at that time, investment funds had still to come for our financial system) and in the context of the new schemes for the solution of corporate financial distress.

- Extend the application of article 58 of the Consolidated Banking Act (Transfer of legal relationships) and certain related provisions of the Italian Securitization Law to "Restructuring Funds"

The legal provision contained in article 58 of the Consolidated Banking Act (Transfer of legal relationships) and certain other related provisions of law no. 130 of 30 April 1999 (Italian Securitization Law) – namely articles 4 and 6, paragraph 2, as incorporated by reference in article 7, paragraph 2-*bis* – should be expressly extended to any and all cases where a "transfer of receivables" in favour of a "Restructuring Fund" is contemplated. In essence, the above provisions concern the deed of transfer of receivables (legal form, effectiveness and enforceability) and the steadiness of the expected cash flow of the collections arising from the assigned receivables (and provide coverage against clawback or invalidity risks).

- Interests held by Banks in private equity vehicles and Bank-Industry Separation

The regulatory provisions applicable to interests held by banks in private equity vehicles are set out in the Third Part, Chapter 1, of the Banking Supervisory Guidelines – Circular no. 285 of 17 December 2013 of the Bank of Italy. According to such legal framework, the Fund at issue could, at first glance, be considered to fall in the scope of «private equity vehicles», with the consequence that the relevant prudential rules applicable to banks in connection with «indirect equity investments» under Section VI, Chapter 1, Third Part, of the Banking Supervisory Guidelines would then apply. On the contrary, considering that the equity stakes that the Fund (and thus, "indirectly", by the contributing/quota-holders banks) may acquire in the Target companies, fit with the specific derogation applicable to «interests in companies under temporary financial distress», set out in the Third Part, Chapter 1, Section IV, paragraph 2 of the Banking Supervisory Guidelines, this makes such rules more appropriate, and substantially consistent, with the governance policy of such a type of vehicle.

This would permit to avoid that the banks' investment in the Fund's units be appraised in the light of compliance with the supervisory thresholds applicable to «private equity vehicles» (concentration threshold and aggregate threshold), thus limiting or preventing some banks from contributing their receivables into the Fund.

- Regulatory treatment of risk weighing of the positions undertaken by the Banks towards the "Restructuring Fund"

The regulatory treatment of risk weighing of the positions undertaken by the Banks towards the Fund ought to be clarified in view of the provisions of EU Regulation no. 575/2013 (the so-called "CRR Regulation").

In particular, it is worth pointing out that the provisions on securitisations do not appears to be applicable to the case at issue, since:

(i) The Fund approach is not comparable to that of securitisation , neither from a structural nor a functional standpoint;

(ii) As regards the "Restructuring Fund", the portfolio of receivables relating to the receivables sub-fund does not provide for any "tranching" of the relevant exposures, which is an unavoidable requirement for a transaction to qualify as a securitisation transaction pursuant to the CRR Regulation.

The provisions under articles 128 or 132 of the CRR Regulation should consequently more appropriately apply to investments held by Banks in the "Restructuring Fund's" units.

- Accounting treatment

The structure of the above described transaction will normally allow the Banks to obtain a de-recognition effect according to IAS principles; in particular, Banks will be entitled to de-recognize the portfolio of receivables contributed to the Fund *vis-à-vis* the Fund's units received.

7. Conclusions

In the light of the above analysis it can be pointed out as the most innovative effects of such an alternative management strategy are:

- **From the banking system perspective**, the retaining within the banking ring of the upside that may result from the procedures of active restructuring of the concerned receivables - instead of transferring them "at discount" values, missing a transparent and efficient market, at present, capable of determining their fair value - often by their swap into equity, so as to concurrently originate benefits for the banks in terms of: **(i)** derecognition, in their financial statements; **(ii)** improvements in the use of resources, and cutbacks in the management costs, as these would be outsourced to dedicated and competent fund managers; **(iii)** governance, as the banks would be safeguarded against any relationships/reputation or litigation issues arising from the debtor's relationship management; **(iv)** regulatory compliance, as it would allow for a sounder implementation of the bank-industry separation where the receivables are converted into the debtor's equity; **(v)** keeping a structural retention, suitable to avoid any moral hazard risks inherent to the originate-to-distribute model.

- **From the entrepreneurial system perspective**, the main positive outcome of this model consist in achieving a concentration of all credit positions in one sole professional counterparty of the debtor – where multiple banking creditors have an exposure towards the same debtor – which would be otherwise atomized in a number of inconsistent, and sometimes, divergent interests, along with more swift and efficient restructuring/recovery procedures. Compared with alternative models, such a crucial factor permits to extract an enormous value from those restructuring processes that are fated to be otherwise trapped in wearing, ineffectual and everlasting "inter-bank summits". Therefore, this model benefits the entrepreneurial sector, which nowadays is suffering from endemic corporate distress, as much evidently as the banking system, in terms of rationalization, enhancement and acceleration of corporate restructurings.

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