Authors:[1]

Ardian Salihu (Manager, I&R, I.D. Inspiring Development GmbH)

Michael Kowalski (Managing Partner, I.D. Inspiring Development GmbH)

Summary

The emergence of the pandemic last year propelled loan restructuring[2] to the forefront of MSME lending activities on a global scale. Institutions reacted quickly and applied wholesale restructuring to deal with the impact of Covid on the repayment capacity of large part of MSME portfolio. For most institutions, it was the first time that restructuring was widely utilized as a tool for managing problematic loans.

By now, all institutions in MSME banking should have put in place comprehensive loan restructuring frameworks to manage this portfolio efficiently and transparently. However, the approach in many institutions still appears to be rudimentary, lacking structure and consistency, and providing little clarity on the underlying asset quality. Hesitations of institutions to fully embrace restructuring as a valid portfolio management tool, combined with limited guidance from regulators and low pressure from investors for an updated and finetuned restructuring approach and respective reporting appear to be the most limiting factors. However, discussions on closing the books this year are likely to be more difficult than in 2020, where management judgement was typically accepted for the assessment of the restructured loan portfolio quality.

Moving forward, institutions should enhance their restructuring framework. It should be based on clear definitions and a suitable classification system of restructured loans according to their risk profile. This will lead to adjusted organizational structures, well-designed processes, and adequate control measures in place. Moreover, an enhanced provisioning methodology, encompassing restructured portfolio, will increase efficiency of the institution and substantially improves transparency and as such the communication basis with regulators, investors, and auditors alike.

Background

Until recently loan restructuring was rarely used in MSME banking as a sound and effective portfolio management instrument in the normal course of business. For many institutions, restructuring was either completely taboo, applied only selectively to larger exposures, or used as the last resort for recovery – often offered only to clients clearly heading towards default, after they had passed the "point of no return". As such, restructuring was used too little and too late, and therefore often did not yield meaningful results. In many institutions this further contributed to an overall negative view of restructuring, as it was seen as ineffective and a proxy for a highly problematic portfolio. This is reflected in many institutions facing severe internal challenges in transparently identifying, managing, and reporting restructured loans.

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[1] The views expressed in this paper represent the personal opinions of the authors and should not be read as the institutional views of I.D. Inspiring Development GmbH. For questions or comments, please contact the authors:
Ardian Salihu: salihu@inspiring-development.com
Michael Kowalski: kowalski@inspiring-development.com

[2] Restructuring: concessions made by the lender through modification of a loan agreement to accommodate the actual or anticipated financial difficulties of a lending client to meet the current contractual repayments on time and/or in full. In this paper it is generally used in connection with the loans granted by MSME banks to enterprises or individuals, rather than the loans granted by developed country investors to said banks.

Another key factor to institutions underutilizing loan restructuring was the resulting signaling effect. Many debt and equity investors worried about evergreening of portfolios and therefore considered restructured loans as non-performing loans. They typically set tight covenants for this high-risk portfolio.

Finally, regulators often contributed to this situation. There is no universally accepted definition for restructurings as well as a shortage of proper regulatory frameworks and guidelines for treating and reporting loan restructurings. Instead, in many cases these loans are simply categorized as substandard loans. This has at times required institutions to build excessive additional reserves for restructured loans, thus affecting profitability and ultimately raising concerns among investors.

Covid Era and its Implications on Loan Portfolio Management

The emergence of Covid in 2020 and its impact on financial institutions was a defining moment in portfolio management and loan restructuring. The severe economic impact of lockdown measures, client immobility, and swift regulatory and governmental relief measures quickly led to wholesale restructurings of portfolios to avoid large-scale defaults. However, by now, many institutions, investors and regulators still appear to be ill prepared for structurally dealing with the aftermath of initial Covid response measures.

- **Investors (debt and equity)** were kept on standstill for an extended period while waiting for the full impacts of Covid to materialize and for clarity in the financial implications to emerge. In many instances, actions on current investments and on new ones are still on hold, even becoming questionable in light of the uncertainties surrounding the risk profile of the investees' loan portfolio.
- Some **regulators** went from being very cautious on restructuring to the other extreme by heavily promoting it, often without prescribing adequate control mechanisms. While this is understandable in the initial context of Covid measures, a lack of regulatory guidance has significant implications on how institutions deal with and follow-up on restructured cases. A fine-tuning of the definition of restructured cases and clarity on recognizing successful restructurings as part of the standard portfolio is still largely missing.
- Some **auditors** are still trying to develop standardized criteria for an adequate approach to portfolio valuation and assessment. In 2020, there was widespread acceptance of a "blind spot" in FI loan portfolios due to significant management discretion in determining loan loss provisions where statistically valid data was absent. There was an overall understanding that the impact of Covid on defaults had yet to be quantified. Accordingly, there was little pressure on institutions for having convincing, traceable, and reliable definitions, or assessment criteria for the credit risk of restructured loans. This situation cannot be expected to hold for the audits of 2021 results.
- Most concerning, many **institutions** are still struggling to comprehensively manage their restructured loan portfolio. There is limited control and oversight of the restructured portfolio and an inability to truly define and assess the quality of the underlying portfolio. The typical risk indicators that used to be a good proxy of portfolio quality (i.e., PAR 30, PAR 90, NPL, etc.) have reduced relevance and need to be enhanced.

In our view, institutions should be able to apply restructuring as a meaningful tool for loan clients in difficult situations, without excessive provisioning repercussions and undue deterioration of portfolio risk indicators. Initially, this will primarily be for the institution's internal benefit of managing the restructured loan portfolio effectively and efficiently. In addition, though, it will provide a solid basis for more effectively and transparently communicating with other key parties (investors, regulators, and auditors) on their restructured loan portfolio.

Framework for Restructuring

Institutions should develop a framework with well-defined processes, parameters, and responsibilities to manage the challenges of addressing restructured loans. The framework must enable the classification of restructured loans into performing and non-performing categories and adequately respond to clients' needs with treatment and, recognition of losses where recovery potential is limited. While the framework must comply with regulatory requirements, it should not be only regulatory driven but rather be comprehensive and specific for that institution. It should be designed and customized to match the institutional status and the client segments it serves and needs to be compatible with its lending framework and methodology. As such, we consider the following aspects as vital:

Definition of Restructuring

- Establishing a precise **definition** for restructured loans.
- The definition needs to be based on the recognition that the institutions is willing to make concessions on existing loan contracts, accepting that the payment capacity of the client has deteriorated.

Classification System

- Restructured loans need to be channelled into a **portfolio classification system.**
- This ensures that different groups of risk profiles of restructured loans are adequately reflected – not all restructured loans are the same.
- There must be criteria for restructured loans to be regarded as recovered so that they again become a part of the institution's standard loan portfolio (proper follow-up notwithstanding).
- The internally used definition and the classification system must be reconciled with applicable regulatory requirements, reporting and accounting standards.

Policies and Procedures

- Setting up **policies and procedures**, including related internal control environment and control points.

Roles and Responsibilities

- Define **roles and responsibilities** across the organization, on all hierarchies, including special authorizations for decision-making.
- A separation of front office and back-office activities must be observed – managing restructured loans is, with few exceptions, inherently a back office function.
- A special "credit control" function for independent monitoring of restructured portfolios is recommended.

Personnel

- **Personnel** must be sufficiently trained to conduct such operations, from underwriting to execution and monitoring.
- Allowing a rotational flow of specialized staff from and to front office operations ensures flexibility to adjust staff capacity over time to match institutional needs.

IT Systems

- Adjusting **IT systems** to enable adequate flagging, tracing, reporting, monitoring, etc., automatization of processes to ensure efficiency.

Portfolio Classification System

The conceptual design of a portfolio classification system is key for the framework and must fit the specifics of the institution. It has to bridge the internal needs of the institution (operationally and for portfolio management purposes) with external reporting requirements (regulatory framework and financial reporting).

An example of a high-level conceptual guide for such a system is provided below. It outlines the key instruments we consider important for institutions to have in their toolset for restructuring, as well as a sample of general restructuring criteria and internal roles and responsibilities for execution and monitoring. It also shows how an internal risk classification can be linked to IFRS 9 criteria for provisioning purposes.

Type of Restructuring	Criteria for Restructuring	Responsibility	Monitoring	Impact and Risk Classification	IFRS 9 Stage
Technical Restructuring	▪ Technical issues with payment plan (inadequate repayment dates, wrong tenor at initial disbursement, lowering of interest rate to adjust to market) ▪ Payment capacity of the client not affected	Business Team	Standard monitoring	▪ No changes in asset value ▪ Low risk	Stage 1
Standard Restructuring	▪ Minor or temporary payment capacity constraints ▪ Not in default 30 days or more ▪ First restructuring	Business Team	Special monitoring of the restructured portfolio	▪ Minor changes in asset value, focus on full recovery of the principal and interest ▪ Low risk	Stage 1
Watch Restructuring	▪ Significant payment capacity constraints ▪ In default (PAR > 30 days) or repeat restructuring	Arrears Management / Recovery team	Special monitoring of the restructured portfolio	▪ Material changes in asset value, focus on recovery of principal ▪ Medium risk	Stage 2
Deep Restructuring	▪ Permanent and significant payment constraints ▪ Business unable to serve its debt under current form ▪ Other sources of income considered for restructuring ▪ PAR > 30, repeat restructurings, prolonged periods of no principal payments (PAR >90 days)	Recovery Team	Intensified monitoring	▪ Significant changes in asset value, focus on partial recovery of principal ▪ High risk	Stage 3

Communication with Key Stakeholders

Institutions implementing a comprehensive framework for restructurings as outlined above will need to rely on the acceptance of external parties for maximum effectiveness. This is especially crucial for:

- **Regulators**: Institutions should engage with their regulators on the key concepts and benefits of their restructuring approach, ideally contributing to the enhancement of the regulatory framework. Regulators ideally favor transparency on the structure of restructured loan portfolios, with sensible and reasonably granular provisioning requirements in line with differentiated risk profiles to avoid penalizing restructuring.
- **Investors:** Lenders and equity investors should engage in deeper discussions with their clients on restructured loans, demanding from institutions to present a sensible, transparent, and coherent conceptual framework. As such, investors and lenders should be open to recognizing different types of restructuring and adjust their performance indicators and covenants in their evaluation and monitoring process. In the end, greater transparency, a common understanding, and consistent indicators for assessing credit risk and performance of the restructured loan portfolio will benefit the investor and the institution alike.

Conclusions

Covid continues to affect the nature of business and related business practices in many sectors. The pandemic has permanently changed the understanding and perception of loan restructuring and initial Covid measures has propelled its use to the forefront of loan portfolio management activities. It is here to stay and is no longer to be avoided at all costs.

Yet for many MSME-oriented institutions, designing and implementing sensible and efficient portfolio management (incl. loan restructuring), and related credit risk management concepts remains challenging. All too often core aspects show deficiencies and must be improved, such as the definition of restructuring, fine-tuned classifications, the adequacy of the methodology in place, organizational aspects, responsibilities, processes, and overall portfolio management activities.

A well-structured and consistent restructured loan portfolio classification system will form the core of a convincing framework. It enhances structuring the operational handling of restructured loans, improves portfolio management, and allows for fine-tuned risk profiles, provisioning, internal and external reporting, and bolsters compliance with regulatory requirements.

The closing of the 2021 financial year is likely to bring intensive discussions with auditors, investors and regulators on the restructured loan portfolio, its risk profile and the adequacy of loan loss provisions. Institutions must be prepared to present a comprehensive, consistent, and ultimately trust-building framework.