

# Guidelines on Management of Problem Loans

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# 1. Introduction

## 1.1 Purpose of document

The purpose of this document is to support the Saudi banking sector in their ongoing efforts to accelerate the resolution of non-performing loans (NPLs) associated with large corporates, micro, small and medium-sized enterprise sector. This document seeks to reflect the local and international best practices on dealing with problem loans, these guidelines also seek to take into account the specifics of Kingdom of Saudi Arabia's (KSA) economic and banking sector structure and the extensive experience accumulated by KSA banks in dealing with their corporate borrowers, as well as KSA's existing legal, regulatory and institutional framework for resolution and does not identify the possible obstacles to efficient and timely problem loan management that might still exist in this broader framework, or to propose potential improvements which would be outside the banks' sphere of control.

Bank loans can become "problem loan" because of problems with the borrower's financial health, or inadequate processes within banks to restructure viable borrowers, or both. In ascertaining how to deal with a problem loan, it is important to distinguish between a borrower's "ability to pay" and "willingness to pay," Making this distinction is not always easy and requires effort. These guidelines should guide banks staff in dealing with problem loans including non-performing loans (NPLs) extended to corporate and Micro, Small and Medium Enterprises (MSMEs). It deals with both ad-hoc and systemic financial distress and delves into how borrower problems may have arisen in the first place. It provides guidance to banks staff responsible for handling individual problem loans and to senior managers responsible for organizing portfolio-wide asset resolution.

## 1.2 Scope of Implementation

These guidelines are applicable as better practices for all banks licensed under Banking Control Law, including Foreign Bank Branches. These guidelines should be read in conjunction with Mandatory Rules on the Management of Problem Loans and Rules on Credit Risk Classification and Provisioning issued by Saudi Arabian Monetary Authority (SAMA).

Whenever the requirements specified under these guidelines differ from existing laws, regulations and circulars issued by SAMA or other government organizations, the later shall take precedence over these guidelines.

## 2. Problem Loan Prevention & Identification

### 2.1 Early warning signals as a tool for preventing NPLs

One of the keys to maintaining acceptable levels of Non-Performing Loans lies in the ability to identify potential payment difficulties of a borrower as early as possible. SAMA views instituting an effective framework within regulated entities as a mandatory requirement. The sooner the problem is identified, the easier it will be to remedy it. Early warning signals (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 loan.

The purpose of the EWS is therefore twofold:

- i. To produce an early signal of potential payment difficulties of the borrower; and
- ii. To allow the opportunity to develop a corrective action plan at a very early stage.
- iii. When the borrower exhibits early warning signs, the bank should proactively identify the driver and assess whether the borrower's case should continue to be handled by the business / commercial unit or if the Workout Unit (whether involved in a shadow capacity at first or have full control of the case) should be involved.

Banks should ensure that proper training is provided to the business units on how to manage accounts with early signs of stress.

### 2.2 Scope of EWS process

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

#	Area	Description
1	Signal Identification	<ul style="list-style-type: none"><li>• Responsibility for establishing parameters for signals and monitoring resides in a separate unit or function within risk management, middle or back office.</li><li>• Upon identification of a signal, notification is sent to the respective relationship manager and his team leader that action is required to close the EWS breach.</li></ul>

2	Action	<ul style="list-style-type: none"> <li>• Relationship Manager contacts the borrower and identifies the source and magnitude of a potential payment difficulty.</li> <li>• After analysis and in consultation with risk management, a corrective action plan is put in place.</li> <li>• A loan is added to the watch list prepared on the basis of EWS for the purposes of further monitoring.</li> </ul>
3	Monitoring	<ul style="list-style-type: none"> <li>• Risk management approval required to remove the loan from watch list prepared on the basis of EWS.</li> <li>• A loan can remain on watch list for a time period specified by the bank. After that period, loan must be either returned to originating unit or transferred to Workout Unit.</li> <li>• While on the watch list, a loan should be classified with a lower risk rating compared to the one prior to moving to the watch list.</li> </ul>

## 2.3 Stages of EWS process

### 1. Identification:

Early warning signs are indicators that point to potential payment difficulties. These indicators could be alienated into five broad categories:

- i. Economic environment,
- ii. Financial indicators,
- iii. 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 has been explained below from sections "i to v".

It is the responsibility of the unit/section assigned for managing EWS process to interpret the signals received from a borrower and determine whether that borrower should be included in the watch list (prepared on the basis of EWS) for further corrective action.

In most cases, such a decision will involve the identification of groups of signals that validate one another. Taken alone, individual indicators can be too ambiguous/inconclusive to predict financial distress, but when a holistic approach is adopted the unit/ section responsible for managing EWS, may decide that the combination of certain signs anticipates serious financial distress.

Determining what combination of signs, that will trigger the scenario to classify the borrower as watch list, requires adequate knowledge of the industry and will involve some subjective judgment as well. 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 might be based also on personal contacts between the bank and the borrower, especially in the context of medium-size enterprises.

For example, a trigger for the transfer to the watch list could be a signal received from only one substantial indicator, such as Debt/ Earnings before interest, taxes, depreciation and amortization (EBITDA) to be above 5 (the aforementioned example has been included for clarity purposes only and; should not be viewed as SAMA's interpretation of the given financial ratio). However, the transfer may also be triggered by the combination of less significant indicators, e.g., an increase in the 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 analysis of the historical data and backtesting results. For the purpose of simple EWS approach (using one or multiple indicators with specific thresholds), the bank should define trigger points for creating signals based on good practice and analysis of historical 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 the individual level or at a portfolio level. For example, if real estate prices fall by more than 5 percent on an annual basis, for the group of loans that have real estate as collateral a review should be performed to determine if the collateral value is adequate in the light of price adjustment or not. Collateral evaluation should be done in accordance with SAMA Guidelines. In cases the collateral is no longer sufficient, a bank should take corrective action to improve collateral coverage.

An additional factor that should be considered in managing EWS is the concept of materiality. For this reason, a bank may define a level of average loan size in the NPL portfolio, determine that all loans 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 specified cases.

**i. Economic environment:**

Indicators of the overall economic environment are very important for the 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 (as per international practices, real gross domestic product (GDP) growth is the main driver of nonperforming loan ratios) 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 loan servicing difficulties early on. Data sources for these indicators should be a combination of the bank’s internal economic forecasts and (particularly, in case of smaller banks) forecasts of respected forecasting banks in the country or abroad. Indicators of economic environment are especially relevant for predicting the future payment ability of individual entrepreneurs and family business owners. 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.

**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 loans. Major changes in economic sentiment indicators and consequently growth forecasts should serve as a key flag for certain loan groups (retail, real estate, agriculture, hospitality sector, etc.). In most cases, oil prices, government spending, and inflation along with GDP growth has a good correlation with the prices of real estate. In a 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	For MSME, an increased unemployment rate indicates a potential adjustment in the 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).

**Note:** The above has been outlined for illustrative purposes only,

**ii. Financial indicators:**

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 signals are generated in a timely manner, the bank may require more frequent interim financial reporting (e.g., quarterly for material loans and semi-annual for all others).

Data sources for financial indicators may be either company financial statements received directly from the borrower. For example, an increase in debt/EBITDA ratio could be due to (i) an increasing loan level, or (ii) a decrease of EBITDA. In the first case, 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. Financial indicators should be monitored continuously based on quarterly financial statements for material loans and on a semi-annual basis for others.



**Table 2: List of Potential Financial Indicators**

Indicator	Description
Debt/EBITDA	The prudent ratio should be used for most companies 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 above a defined threshold.
Cash flow	Large decline during reporting period, or negative EBITDA.
Turnover (applicable for MSME)	A 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 loan to customers	Lengthening of days in receivables outstanding. Sales can be increased at the expense of deteriorating quality of customers.

**Note:** The above has been outlined for illustrative purposes only.

For the MSME portfolio, wherein the quality of financial statements is weak it may be feasible to develop financial ratios based on cash flow statements, Banks are therefore advised to require the respective borrower to disclose details of all its bank accounts maintained, so as to enable capturing the state of liquidity. However, the privacy of the

borrowers has to be ensured and written consent needs to be taken in order to access their personal information.

**iii. 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 behavioral indicators:**

Indicator	Description
Loan to value (LTV)	LTV > 100 % indicates that the value of the collateral is less than the loan amount outstanding. Reasons for this could be that collateral has become obsolescent or economic conditions have caused a rapid decrease in value. To be prudent, the ratio should be below 80 %, to provide adequate cushion to cover the substantial cost associated with collateral enforcement.
Downgrade in internal credit risk category	An annual review of borrower’s credit profile reveals shortcomings.
Breaches of contractual commitments	Breach of covenants (financial or non-financial) in the loan agreement with bank or other financial institutions.
Real estate indexes	The bank should monitor real estate indexes in adequate-granularity. Depending on the 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 loans that have similar collateral. At this stage, the bank should review if LTV with the new collateral value is adequate.
Credit card loans	Delay in settling credit card loans or increasing reliance on provided credit line (particularly for partnerships and individual entrepreneurs).

**Note:** The above has been outlined for illustrative purposes only.

**iv. Third-party indicators:**

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 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	
Default / any negative information	SIMAH Report / Negative press coverage, reputational problems, doubtful ownership, and involvement in financial scandals.	SIMAH Report / Media
Insolvency proceedings for major supplier or customer	May have a negative impact on the borrower	Information from courts and other judicial institutions.
External rating assigned and trends	Any rating downgrade would have been an indicator deteriorating in the borrower profile	Rating Agencies

**Note:** The above has been outlined for illustrative purposes only.

**v. Operational indicators:**

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

Indicator	Description	
Frequent changes in senior management	Often rotation of senior management, particularly Chief Executive Officer (CEO), Chief Financial Officer (CFO), Chief Risk Officer (CRO), could indicate internal problems in the company.	Annual report and discussion with the company.

Qualified audit reports	At times, auditors raise concerns about the quality of financial statements by providing modified opinions such as qualification, adverse and even some times disclaimer.	Annual report
Change of the ownership	Changes in ownership or major shareholders (stakeholders or shareholders).	Public registries and media.
Major organizational change	Restructuring of organizational structure (e.g., subsidiaries, branches, new entities, etc.).	Public registries and media.
Management and shareholder contentiousness	Issues arising from the management and from the shareholders which would result in serious disputes.	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 backtested in order to find out the indicators with the highest signaling power. For this purpose, indicators should be tested at different stages of an economic cycle.

**Note:** The above has been outlined for illustrative purposes only.

## 2. Corrective Action:

Once an early warning signal is identified, based on the criteria explained above, the unit responsible for managing EWS, needs to flag the potentially problematic loan to the relationship officer / respective portfolio manager in charge of the borrower's relationship.

The cause and severity of the EWS is assessed and based on the assessment the borrowers can be categorized as 'watch list'. Following are the two potential scenarios:

- Loans remain performing while on the watch list and will be brought back to regular loans after some time, and

- The credit quality of the loan continues to deteriorate and it is transferred to the bank's Workout Unit (Remedial / Restructuring etc.).

Once the borrower is classified as watch list, the bank should decide, document and implement appropriate corrective actions (within the specified timeframe) in order to mitigate further worsening of loan's credit quality.

**Corrective action might include:**

- i. Securing additional collateral or guarantee (if considered necessary).
- ii. Performing more regular site visits.
- iii. More frequent updates to the credit committee.
- iv. Assessment of financial projections and forecast loan service capacity.

**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 pre-empt 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 borrower remains on the watch list, bank's primary contact with the borrower remains the business officer/portfolio manager, although the head of business as well as risk management, are expected to take a more active involvement in the decision and action process for larger, more complex loans. While on the watch list, the borrower should be classified in a lower rating than "ordinary" borrowers.

All loans in the bank's portfolio should be subject to the EWS described above. This applies to performing loans that never defaulted, but to restructured loans as well.

**A. Timeline**

For EWS to be effective, clear deadlines for actions should be in place, and consistently enforced (see an indicative timeline in Table below). The level and timing of the monitoring process should reflect the risk level of the loan. Large loans should be monitored closely and by the Risk department and respective Credit committees or any higher management committees.

Banks should also establish the criteria to monitor large corporate loans and at the same time importance to be provided to smaller loans, and the same

should be followed by designated staff within the bank, with the results reported to the management.

Indicator	Responsibility	Workout (once the trigger identified)	Description
Any triggers identified / or any Signal received	Relationship Manager (RM) / Portfolio Manager (PM).	Max 1 working day.	RM / PM starts analyzing the borrower details to investigate further.
Follow up with the borrower and report with analysis	Relationship Officer / Portfolio Manager.	Max 3 working days for a material loan and 5 working days for others.	RM / PM contacts borrower determines reasons, and provide analysis.
Decision on further actions	Relationship Manager & Head of Business; EWS manager.	Max 6 working days for material loan and 10 working days for others.	Decision for a loan 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	Relationship Manager & Head of Business, EWS manager and Credit Committee.	Every fortnightly for material loans and 1 month for others, the list is reviewed and amended, if needed.	Risk manager/EWS manager (in consultation with Head of Business) monitors the performance of the borrower and agreed mitigation measures. If needed, based on the recommendation of Credit Committee or any other delegated committee takes

			decision to transfer to Workout Unit.
Final decision	Head of Business /Risk manager, EWS manager.	Banks as per their internal policy can specify the maximum time a borrower can remain on watch list.	Borrower can be on watch list only on a temporary basis. Banks should assess as how much time should be specified for which the borrower remains in watch list, once the specified time is completed a final decision should be taken, i.e., loan either removed from watch list (if problems are resolved), or transferred to Workout Unit.

**B. Establishing criteria for transfer to Workout Unit:**

Banks shall establish and document a policy with clear and objective time-bound criteria for the mandatory transfer of loans from Loan Originating Units to the Workout Unit along with the specification of relevant approvals required for such transfers. The policy should include details on areas where proper collaboration is required between the Workout Unit and Loan Originating Units especially in scenarios where the borrowers are showing signs of stress but still being managed by the Loan Originating Units.

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 Workout Unit (WU) for more intensive oversight and resolution. Allowing past-due loans to remain within the originating unit for a long time perpetuates the problem, leads to increased NPL levels within the bank, and ultimately results in a lower collection/recovery rate.

**C. Following are generally the key indicators for transferring to Workout Unit (not all-inclusive):**

- i. Days past due (DPD) based on internal thresholds and considering the nature of the borrower should be included as a mandatory trigger (For further guidance on this refer to SAMA rules on Credit Risk Classification and Provisioning).
- ii. Debt to EBITDA  $\geq$  Internally set threshold dependent on the nature and industry of the borrower (not applicable to an MSME, in cases wherein reliable financial information is not available),
- iii. Net loss during any consecutive twelve-month period  $\geq$  Internally set threshold dependent on the nature and industry of the borrower,
- iv. A loan classification of “Watch list ” if syndication is involved and/or reputational/legal issues are at stake;
- v. Length of time on watch list (e.g., more than twelve months), or at least two unsuccessful prior restructurings;
- vi. An indication of an imminent major default or materially adverse event, including government intervention or nationalization, notice of termination of operating license or concession, significant external rating downgrade of borrower or guarantor, sudden plant closure, etc.;
- vii. Litigation, arbitration, mediation, or other dispute resolution mechanism involving or affecting the banks; or
- viii. Evidence or strong suspicion of corruption or illegal activity involving the borrower or the borrower’s other stakeholders.

**Note:** *Banks are encouraged to develop customized indicators for the MSME sector.*

The decision to transfer a loan to the Workout Unit should be based on a refined judgment that the loan 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) loan-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 the Board of Directors or any other bank’s board designated committee.



**Note:** *Banks should define clear and objective criteria in its internal documentation, for handing over a borrower to the workout and legal support unit, as well as the criteria for returning the borrower 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.*

The work out unit should seek to restructure the loan and maximize banks recovery for borrowers considered as viable. Borrower's viability needs to be evaluated in light of comparing the losses that may transpire in case of restructuring versus foreclosure.

However, on the other hand, foreclosure proceedings may be initiated, if the bank after due process concludes that the case is ineligible for restructuring consideration either because of financial or qualitative issues.

## 2.4 EWS structure and institutional arrangements

### **Structure of EWS within the Bank**

To ensure the independence of the process, and achieve a holistic approach to credit risk monitoring, and prevent conflicts of interest, the unit responsible for managing EWS should operate outside of the loan originating unit. Best practice indicates that the responsibilities to manage the EWS process should be assigned within the credit risk management department and 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 Board of Directors of the bank. They should be subject to annual review and reapproved by the Senior Management Committee to incorporate:

- i. Required changes identified during previous operational periods;
- ii. Regulatory amendments; and
- iii. Additionally, independent quality assurance (e.g., review of the process by an external expert or the Internal Audit function) should be considered.

**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 the loan;
- ii. Is it part of a group or related party;
- iii. Material or non-material loan;
- iv. Date added to the list;
- v. Reviews taken (including timestamps) and outcomes,
- vi. Mitigation measures; and
- vii. Reasons for inclusion in the watch list.

The watch list (or at least material loans on it) should be presented monthly to a designated management committee (Executive Committee or Risk Committee) only or in parallel with the 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 Board should also receive monthly:

- a) A detailed list of material loans for information; and
- b) Aggregate figures for the loans 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. (For details on samples of EWS refer to Appendix 1).

### 3. Non-performing Loans (NPLs) Strategy

The bank's goal in the resolution process should be to reduce non-performing assets as early as possible, in order to:

- i. Free up coinage and capital for new lending;
- ii. Reduce the bank's losses, and return assets to earning status, if possible;
- iii. Generate good habits and a payment culture among borrowers; and
- iv. Help maintain a commercial relationship with the borrower by conducting a responsible resolution process. To ensure that the 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. The bank must also put in place and maintain adequate institutional arrangements for implementing the strategy.

#### 3.1 Developing the NPL strategy

The NPL reduction strategy should layout 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 (minimum 3 years). 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.

The strategy development process is divided into the following two components:

1. Assessment; and
2. Design.

##### **1. Assessment**

In order to prepare the NPL strategy, Banks should conduct a comprehensive assessment of their internal operating environment, external climate for resolution, and the impact of various resolution strategies on the bank's capital structure.

##### **i. Internal Self-Assessment**

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 are to be taken into consideration to correct the situation. Specific details are noted below:

**a) Internal Operating Assessment:**

A thorough and realistic self-assessment should be required and performed to determine the severity of the situation and the paces that need to be taken internally to address it, there are a number of key internal aspects that influence the bank's need and ability to optimize its management of, and thus reduce, NPLs and foreclosed assets (where relevant).

**b) Scale and drivers of the NPL issue:**

- Size and evolution of its NPL portfolios on an appropriate level of granularity, which requires appropriate portfolio segmentation;
- The drivers of NPL in-flows and outflows, by portfolio where relevant;
- Other potential correlations and causations.

**c) Outcomes of NPL actions taken in the past:**

- Types and nature of actions implemented, including restructuring measures;
- The success of the implementation of those activities and related drivers, including the effectiveness of restructuring treatments.

**d) Operational capacities:**

Processes, tools, data quality, IT/automation, staff/expertise, decision-making, internal policies, and any other relevant area for the implementation of the strategy) for the different process steps involved, including but not limited to:

- early warning and detection/recognition of NPLs;
- restructuring;
- provisioning;
- collateral valuations;
- recovery/legal process/foreclosure;
- management of foreclosed assets (if relevant);
- reporting and monitoring of NPLs and the effectiveness of NPL workout solutions.

For each of the process steps involved, including those listed above, banks should perform a thorough self-assessment to determine strengths, significant gaps and any areas of improvement required for them to reach their NPL reduction targets. The resulting internal report should be prepared and the same to be maintained for the record purpose.

Banks should monitor and reassess or update relevant aspects of the self-assessment at least annually and regularly seek independent expert views on these aspects, if necessary.

## **ii. Portfolio Segmentation**

### **Purpose and principles of portfolio segmentation**

Segmentation is the process of dividing a large heterogeneous group of Non-performing loans into smaller more homogeneous parts. It is the essential first step in developing a cost-effective and efficient approach to NPL resolution. Grouping borrowers with similar characteristics allow 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 Unit, including allocation of staffing and specialized expertise for a more in-depth analysis of borrower's viability and design of final workout plan.

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

In order to deal with the stock of NPLs, the bank should follow the principles of proportionality and materiality. Proportionality means that adequate resources should be spent on specific segments of NPLs during the 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 loans compared to smaller loans during the resolution process. These principles should guide the allocation of financial, time and human (in terms of numbers and seniority) resources in WU.

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 the originating unit to the WU.

### **Two-Stage segmentation process**

It is recommended that the basic segmentation of the bank's NPL portfolio is done in the following two stages. The main objective is to select a smaller pool of loans relating to potentially viable borrowers, which warrant the additional (substantial in case of material loans) follow-up effort from WU, including in-

depth viability analysis and re-evaluation of collateral, in order to design an appropriate workout plan.

### **Stage one – Segmentation by nature of business, past-due buckets, loan balance, and status of legal procedure**

The bank's portfolio, segmentation can be conducted by taking multiple borrowers' characteristics into consideration. Segmentations should have a useful purpose, meaning that different segments should generally trigger different treatments by the NPL WUs or dedicated teams within those units. Following is the list of potential segmentation criteria that can be utilized by banks:

- i. Nature of the business: Micro, Small and medium-sized enterprises (MSMEs), including sole traders/ partnerships and Corporates: (by asset class or sector).
- ii. Legal status: for existing loans already in legal proceedings or legal action has already been taken.
- iii. Arrears bucket/days past due (the higher the level of arrears the narrower the range of possible solutions)
  - a) Early arrears (>1 dpd and ≤90 dpd)
  - b) Late arrears of (>90 dpd)
  - c) Loan Recovery Cases > 90 dpd or 180dpd)
- iv. Loan balance: Banks may decide the threshold for segmentation based on the size of the outstanding loan and cases with multiple loans;

### **Stage two – initial viability assessment**

Following the initial segmentation, NPLs which are currently not in legal procedure should be further screened according to two criteria: (i) financial ratios (or Cash flows based ratios in case of MSME); and (ii) loan-to-value (LTV) ratio. These ratios are generally available to the bank from the borrower's latest financial statements (or bank statements) in the loan file, and should ideally not require any additional information from the borrower.

LTV ratio provides a good indication of the level of collateral against the outstanding loan. It is seen as a readily available indicator that captures quantitative aspect of collateralization of the loan, which should be an integral part of initial viability assessment. However, banks should consider stressed value of collateral (i.e. forced sale value in case of liquidation) for computation of these ratios. The quality of the collateral should also be considered for further assessment during later stages of restructuring process.

Banks are expected to set up internal LTV ratios depending on the size segment (Corporate / MSME) and the nature of the industry in which it operates and annual refine/ assess parameters, with an aim to be able to compare the cost of restructuring vs the cost of foreclosure/ legal proceeding. Segmentation according to LTV at this early stage is helpful for starting to consider various workout strategies described in Chapter 6.

Banks may consider below indicative broad benchmarks for the viability parameters as a part of initial assessment, these are intended to be indicative rather than prescriptive (i.e. determining viable, marginally-viable and non-viable borrowers):

- Debt/EBITDA ratio is used as a proxy for initial viability assessment of the borrower and reflects how leveraged the company is. The company is considered highly leveraged post breaching a certain threshold and the risk of loan repayment in full and in time could be excessive.
- The loan service coverage ratio should be comparable to the sector average within the restructuring period in which the unit should become viable.
- Trends of the company based on historical data and future projections should be comparable with the industry. Thus, the behavior of past and future EBIDTA should be studied and compared with industry average.
- For project finance and other multi-year loans, Loan life coverage ratio (LLCR), as defined below should be 1.4, which would give a cushion of 40% to the amount of loan to be serviced. For the details on the computation of LLCR , refer to Appendix 2.

$$LLCR = \frac{\text{Present value of total available cash flow (ACF) during the loan life period (including interest and principal) + Cash Reserves}}{\text{Outstanding amount of loan}}$$

The selection of thresholds for these indicators used in the initial viability assessment should be based on general market indicators.

SAMA is cognizant that acceptable thresholds with regards to key financial and collateral coverage ratio would vary depending on the nature of the industry, its economic outlook over the life of the loan, and size of the loans, hence does not lay down prescriptive limits. However, Banks are expected to assess document the above, as part of its NPL portfolio segmentation exercise. No particular ratio should be considered in Isolation, whilst segmenting the borrower and banks are advised to develop (either expert-based or statistical) rationale.

The following has been illustrated to provide indicative guidelines as to how a segmentation could be undertaken:

**Figure 1: Stage two of segmentation based on LTV and EBITDA (the below ratios are indicative only)**

Borrower Segmentation	Loan-to-Value (LTV) Ratio	Earnings before Interest, Tax, Depreciation and Amortization (EBITDA) Ratio
Viable borrower	$\leq 80$ or $\geq 80$	Debt/EBITDA $\leq 5$
Marginally viable borrower	$\leq 80$ or $\geq 80$	Debt/EBITDA $\leq 8 \geq 5$
Non-viable borrower	$\leq 80$ or $\geq 80$	Debt/EBITDA $\geq 8$

Banks should identify loans that may be non-viable as a result of primary viability assessment at this stage of the segmentation. Segregating these loans at this stage would enable banks to save time and financial resources. Identified non-viable loans should be promptly referred to legal unit under Workout Unit or considered for foreclosures.

The remaining pool of loans, recognized as viable and marginally viable after the initial assessment, should be assigned to the Workout Unit for an in-depth viability assessment based on additional information to be collected from the borrower and collateral re-evaluation. The differentiation on the grounds of collateral value reflected in the LTV ratio at this early stage allows the Workout Unit to receive a workout file with more granular information. Following this analysis, a customized workout plan is selected based on comparison of Net Present Value (NPVs - is the difference between the present value of cash inflows and the present value of cash outflows over a period of time) of expected recoveries under various alternative options.

**Potential additional segmentation criteria:**

In addition to basic segmentation using loan size, financial or collateral-based loan ratios, banks may choose to further segment the NPL portfolio using additional borrower characteristics. These include:

- i. 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);
- ii. Number of days past due. Higher payment interruption period could indicate a higher predisposition to legal actions;



- iii. Loan purpose (e.g., working capital, purchase of the real estate, or tangible assets);
  - iv. Type of collateral (e.g., commercial or residential real estate, land plot, financial assets);
  - v. Location of collateral;
  - vi. Country of residence/incorporation ((a) residents, (b) non-residents); and
  - vii. Interest coverage ratio (low ratio indicates problem with free cash flows).
- If however, further segmentation into small groups is unlikely to lead to better results and may result in lost focus, banks are advised to document the rationale for SAMA's comfort.

### **iii. External conditions and operational environment**

Understanding the current and possible future external operating conditions/environment is fundamental to the establishment of an NPL strategy and associated NPL reduction targets, related developments should be closely followed by banks, which should update their NPL strategies as needed.

The following list of external factors should be taken into account by banks when setting their strategy, however, it should not be seen as exhaustive as other factors not listed below might play an important role in specific circumstances.

#### **a) Macroeconomic conditions:**

Macroeconomic conditions will play a key role in setting the NPL strategy. This also includes the dynamics of the real estate market and its specific relevant sub-segments. For banks with specific sector concentrations in their NPL portfolios (e.g. Building & Construction, Manufacturing, Wholesale and Retail Trade), a thorough and constant analysis of the sector dynamics should be performed, to inform the NPL strategy.

#### **b) Market expectations:**

Assessing the expectations of external stakeholders (including but not limited to rating agencies, market analysts, researchers, and borrowers) with regard to acceptable NPL levels and coverage will help to determine how far and how fast banks should reduce their portfolios. These stakeholders will often use national or international benchmarks and peer analysis.

#### **c) NPL investor demand:**

Trends and dynamics of the domestic and international NPL market for

portfolio sales will help banks make informed strategic decisions regarding projections on the likelihood and possible pricing of portfolio sales. However, investors ultimately price on a case-by-case basis and one of the determinants of pricing is the quality of documentation and loan data that banks can provide on their NPL portfolios.

**d) NPL servicing:**

Another factor that might influence the NPL strategy is the maturity of the NPL servicing industry. Specialized services can significantly reduce NPL maintenance and workout costs. However, such servicing agreements need to be well steered and well managed by the bank.

**iv. Capital implications of the NPL strategy**

Capital levels and their projected trends are important inputs to determining the scope of NPL reduction actions available to banks. Banks should be able to dynamically model the capital implications of the different elements to their NPL strategy, ideally, under different economic scenarios, those implications should also be considered in conjunction with the risk appetite framework (RAF) as well as the internal capital adequacy assessment process (ICAAP).

Where capital buffers are slim and profitability low, banks should include suitable actions in their capital planning which will enable a sustainable clean-up of NPLs from the balance sheet.

**2. Design**

The design phase should identify options to be used to resolve NPLs, establish specific targets for NPL reduction, together with performance indicators detailing how the NPL reduction strategy will be implemented over short, medium and long term periods. Following are key components of the design phase:

**i. Strategy implementation options**

Banks should review the range of NPL strategy implementation options available and their respective financial impact. Examples of implementation options, not being mutually exclusive, are:

- **Hold/restructuring strategy:** A hold strategy (A hold strategy is not to terminate the relationship with the troubled borrower) option is strongly linked to the operating model, restructuring and borrower assessment expertise, operational NPL management capabilities, outsourcing of servicing and write-off policies.

- **Active portfolio reductions:** These can be achieved through either sales and/or writing off provisioned NPL loans that are deemed unrecoverable. This option is to be linked to provision adequacy, collateral valuations, quality loan data, and NPL investor demand.
- **Change of loan type:** This includes foreclosure, loan to equity swapping, loan to asset swapping, or collateral substitution.
- **Legal options:** This includes insolvency proceedings and foreclosure proceedings
- **Out-of-court solutions:** Out-of-court debt restructuring involves changing the composition and/or structure of assets and liabilities of borrowers in financial difficulty, without resorting to a full judicial intervention, and with the objective of promoting efficiency, restoring growth, and minimizing the costs associated with the borrower's financial difficulties (for details on out of court solutions please refer to section 6.2.2.)

Banks should ensure that their NPL strategy includes not just a single strategic option but rather combinations of strategies/options to best achieve their objectives over the short, medium and long term and explore which options are advantageous for different portfolios or segments and under different conditions.

Banks should also identify medium and long-term strategic options for NPL reductions which might not be achievable immediately, e.g. a lack of immediate NPL investor demand might change in the medium to long term. Operational plans might need to foresee such changes, e.g. the need for enhancing the quality of NPL loan data in order to be ready for future investor transactions.

Where banks assess that the above-listed implementation options do not provide an efficient NPL reduction in the medium to long-term horizon for certain portfolios, segments or individual loans, this should be clearly reflected in an appropriate and timely provisioning approach. The bank should write off loans that are deemed to be uncollectable in a timely manner.

## ii. Targets

Before commencing the short to medium-term target-setting process, banks should establish a clear view of what reasonable long-term NPL levels are, both on an overall basis but also on a portfolio-level basis. In spite of uncertainty around the time frame required to achieve these long-term goals, however, they are an important input to setting adequate short and medium-term targets.

Banks should include, at a minimum, clearly defined quantitative targets in their NPL strategy (where relevant including foreclosed assets), which should be approved by the senior management committee. The combination of these targets should lead to a concrete reduction, gross and net (of provisions), of NPLs, at least in the medium term. While expectations about changes in macroeconomic conditions can play a role in determining target levels (if based on solid external forecasts), they should not be the sole driver for the established NPL reduction targets.

In determining, the targets banks should establish at least the following dimensions:

- by time horizons, i.e. short-term (indicative 1 year), medium-term (indicative 3 years) and possibly long-term;
- by main portfolios (e.g. retail mortgage, retail consumer, retail small businesses and professionals, MSME corporate, large corporate, commercial real estate);
- by implementation option chosen to drive the projected reduction, e.g. cash recoveries from hold strategy, collateral repossessions, recoveries from legal proceedings, revenues from the sale of NPLs or write-offs.

The NPL targets should at least include a projected absolute or percentage NPL reduction, both gross and net of provisions, not only on an overall basis but also for the main NPL portfolios.

Where foreclosed assets are material, a dedicated foreclosed assets strategy should be defined or, at least, foreclosed assets reduction targets should be included in the NPL strategy. It is acknowledged that a reduction in NPLs might involve an increase in foreclosed assets for the short term, pending the sale of these assets. However, this timeframe should be clearly limited as the aim of foreclosures is a timely sale of the assets concerned.

Targets shall be initially defined for all main portfolios on a quarterly basis for the first year. Each of these high-level targets is to be accompanied by a standard set of more granular monitoring items, e.g. non-performing loan ratio and coverage ratio, etc.

**Below shows high-level quantitative targets as per better international practices.**

Sustainable solutions-oriented operational target:

- Loans with long term modifications / NPL plus performing forbore loans with Long term Modifications.

Action-oriented operational targets:

- Active NPL MSMEs for which a viability analysis has been conducted in the

last 12 months / Active NPL MSMEs.

- MSME and Corporate NPL common borrowers for which a common restructuring solution has been implemented.
- Corporate NPLs for which the bank(s) have engaged a specialist for the implementation of a company restructuring plan.

Banks running the NPL strategy process for the first time should not solely focus on the short-term horizon. The aim here is to address the deficiencies identified during the self-assessment process and thus establish an effective and timely NPL management framework, which allows the successful implementation of the quantitative NPL targets approved for the medium to long-term horizon.

**Note 1:**

As an illustration, Banks which have internally calibrated (through the cycle) TTC PD's against a validated rating system, should not aim to foreclose accounts, against which a viable restructuring could lead to an ECL output which is less than the internal (if the same has been internally computed) or regulatory loss given default, if legal proceeding were to be initiated against the borrower.

Hence, for instance, by forgiving 20% of the outstanding amount would lead to a risk classification into a grade, which has 16% PD, (ignoring the 12 month period, for which the restructured loan would be classified as NPL, provided performance is satisfactory) and assuming that the internally computed LGD is 36%, the ECL % expected to arise from such a transaction would be around 24.6%, (20 % concession and  $((100\% - 20\% \text{ concession}) * .16 \text{ PD} * 36\% \text{ LGD}) = 4.6\%)$ ) vs an expected LGD for foreclosure of say 43%.

The above is a simplified illustration, SAMA is cognizant that:

- Obligors granted a material concession in course of foreclosures are classified as NPL for provisioning purposes for at least a year, which should be taken into account whilst computing the cost of foreclosure to the bank and;
- Expert Level Judgement or rating system override with respect to grade classification may be warranted whilst making the above assessment

However, the purpose of outlining the above is to endorse a long term vision in terms of making a balanced decision with respect to restructuring a distressed borrower ( i.e. determining the viability of a borrower) rather than seeking outright enforcement proceeding.

### 3.2 Implementing the NPL strategy

Banks should ensure that significant emphasis is placed on communication of the components of the approved strategy to relevant stakeholders across the bank and proper monitoring protocols are established. Following are key components of implementing an NPL strategy:

#### **i. Monitoring of Results**

- a. Banks should establish a proper monitoring mechanism for NPL strategy to ensure it is delivering the expected results. Where any variances are identified prompt corrective action is to be taken to ensure goals/targets are met.
- b. The strategy to be reviewed at a minimum on an annual basis. Where collection targets and budgets will require substantial annual revisions, policies and procedures should be revised as necessary.

#### **ii. Embedding the NPL strategy**

As execution and delivery of the NPL strategy involve and depends on many different areas within the bank, it should be embedded in processes at all levels of an organization, including strategic, tactical and operational.

All banks should clearly define and document the roles, responsibilities and formal reporting lines for the implementation of the NPL strategy, including the operational plan.

Staff and management involved in NPL workout activities should be provided with clear individual (or team) goals and incentives geared towards reaching the targets agreed in the NPL strategy, including the operational plan.

All relevant components of the NPL strategy should be fully aligned with and integrated into the business plan and budget. This includes, for example, the costs associated with the implementation of the operational plan (e.g. resources, IT, etc.) but also potential losses stemming from NPL workout activities. NPL strategy 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.

#### **iii. Operational plan**

The NPL strategy of banks should be back by an operational plan (which is to be approved by the senior management committee). The operational plan should clearly define how the bank would operationally implement its NPL strategy over a time horizon of at least 1 to 3 years (depending on the type of operational measures required).

The NPL operational plan should contain at a minimum:

- Clear time-bound objectives and goals;
- Activities to be delivered on a segmented portfolio basis;
- Governance arrangements including responsibilities and reporting mechanisms for defined activities and outcomes;
- Quality standards to ensure successful outcomes;
- Staffing and resource requirements;
- Required technical infrastructure enhancement plan;
- Granular and consolidated budget requirements for the implementation of the NPL strategy;
- Interaction and communication plan with internal and external stakeholders (e.g. for sales, servicing, efficiency initiatives, etc.).
- The operational plan should put a specific focus on internal factors that could present impediments to successful delivery of the NPL strategy.

#### **Implementing the operational plan**

The implementation of the NPL operational plans should rely on suitable policies and procedures, clear ownership and suitable governance structures (including escalation procedures). Any deviations from the plan should be highlighted and reported to the management.

#### **4. Structuring the Workout Unit**

Effective management of NPL resolution requires that the bank establish a dedicated unit to handle workout cases. Such Workout Unit (WU) should be established as a permanent unit within the bank's organizational structure reporting directly to the Risk Management function rather than the Business / 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. The segregation of duties includes not only relationship management (negotiation of the restructuring plan, legal enforcement, etc.) but also the decision-making process along with support services (loan administration, loan and collateral files, appraisers, etc.) and technical IT resources.

The appropriate 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 separate Working Units or create sub-divisions within a single WU to handle different asset classes

such as Large Corporates, Medium Corporates, Small and Micro loans. Smaller banks may have to follow a simpler structure where a single work unit may handle a wide variety of borrowers.

#### 4.1 Staffing the Workout Unit

##### **Skills Required**

Banks should ensure that the managers of the WU, their team leaders and workout officers are highly qualified professionals, who would be able to discharge their functions effectively and in connection therewith, training needs should be assessed and proper training plans are to be prepared accordingly. Within the individual NPL WUs, more specialization is often useful based on the different NPL workout approaches required per relevant borrower segment.

Such workout officers should have strong analytical and financial analysis skills, understand the depth of the restructuring process and have the ability to work well under pressure.

##### **Remuneration**

Compensation structures for workout staff need to be aligned with long term strategy of the bank. 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 the volume of non-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 loan forgiveness) without provisions to indemnify them for costs and provide legal counsel to defend them in case legal charges are brought against them.

##### **Assigning workload**

Banks should establish policies specifying timelines for assigning stressed accounts to Work Officers, once the account is marked to be stressed.

#### 4.2 Incorporating legal and support functions into Workout Unit

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. It is highly recommended that Banks should maintain a dedicated legal team (or legal experts) within the Workout Unit to:

- i. Assist in the negotiation of the restructuring of those loans that need to be addressed; and



- ii. To be responsible for those loans that require legal solutions to be collected (bankruptcy or foreclosure).

### 4.3 Performance management

For Workout Unit (WU) staff involved in the management of Nonperforming Loans (NPLs), proper performance metrics should be established which should cater not only to the individual's performance but also assess the performance of the team as a whole. Further, the performance of the Workout Unit should be monitored and measured on a regular basis. For this purpose, an appraisal system tailored to the requirements of the NPL Workout Unit should be implemented in alignment with the overall NPL strategy and operational plan.

Further to quantitative elements linked to the bank's NPL targets and milestones (probably with a strong focus on the effectiveness of workout activities), the appraisal system may include qualitative measurements such as level of negotiations competency, technical abilities relating to the analysis of the financial information and data received, structuring of proposals, quality of recommendations, or monitoring of restructured cases.

It should also ensure that the higher degree of commitment, usually required of NPL WU staff is inculcated in the agreed working conditions, remuneration policies, incentives, and performance management framework.

As part of the performance measurement framework, it is recommended that banks' management should include specific indicators linked to the targets defined in the NPL strategy and operational plan. The importance of the respective weight given to these indicators within the overall performance measurement frameworks should be proportionate to the severity of the NPL issues faced by the bank.

Finally, given that the important role of efficient addressing of pre-arrears is a key driver for the reduction of NPL inflows, a strong commitment of relevant staff regarding the addressing of early warnings should also be fostered through the remuneration policy and incentives framework.

#### **Technical resources**

One of the key success factors for the successful implementation of any NPL strategy option is an adequate technical infrastructure. In this context, it is important that all NPL-related data is centrally stored in robust and secured IT systems. Data should be complete and up-to-date throughout the NPL workout process.

An adequate technical infrastructure should enable NPL WUs to:

- i. Easily access all relevant data and documentation including:**

- a) current NPL and early arrears borrower information including automated notifications in the case of updates;
- b) loan and collateral/guarantee information linked to the borrower; or connected borrowers;
- c) monitoring/documentation tools with the IT capabilities to track restructuring performance and effectiveness;
- d) status of workout activities and borrower interaction, as well as details on restructuring measures, agreed, etc.;
- e) foreclosed (foreclosure is the repayment of the outstanding loans to the extent possible through, legal enforcement by a bank) assets (where relevant); and
- f) tracked cash flows of the loan and collateral.

**ii. Efficiently process and monitor NPL workout activities including:**

- a) automated workflows throughout the entire NPL life cycle;
- b) automated monitoring process (“tracking system”) for the loan status ensuring a correct flagging of non-performing and forbore loans;
- c) industrialized borrower communication approaches, e.g. through call centers (including integrated card payment system software on all agent desktops) or internet (e.g. file sharing system);
- d) incorporated early warning signals (see also EWS section);
- e) automated reporting throughout the NPL workout lifecycle for NPL WU management, senior management, and other relevant managers as well as the regulator;
- f) performance analysis of workout activities by NPL WU, sub-team and expert (e.g. cure/success rate, rollover information, effectiveness of restructuring options offered, cash collection rate, vintage analysis of cure rates, promises kept rate at call center, etc.); and
- g) evolution monitoring of portfolio(s) / sub-portfolio(s) / cohorts / individual borrowers.

**iii. Define, analyze and measure NPLs and related borrowers:**

- a) recognize NPLs and measure impairments;
- b) perform suitable NPL segmentation analysis and store outcomes for each borrower;

- c) support the assessment of the borrower's personal data, financial position and repayment ability (borrower affordability assessment), at least for non-complex borrowers; and
- d) conduct calculations of (i) the net present value (NPV) and (ii) the impact on the capital position of the bank for each restructuring option and/or any likely restructuring plan under any relevant legislation (e.g. foreclosures law, insolvency laws) for each borrower.

The adequacy of technical infrastructure, including data quality, should be assessed by an independent function on a regular basis (for instance internal or external audit).

#### **4.4 Developing a written policy manual**

All the banks should have a documented Policy Manual, which evidently mentioned a clear standard timeline for NPL management and resolution. The longer a borrower remains past due, the less likely that the borrower is to repay the loan. A successful resolution, therefore, requires that the bank recognizes the problem early on and adheres to a tight but realistic timetable to ensure that the loan is restructured, sold to a third party, or collected through legal proceedings - in the case of non-viable borrowers) in a timely manner.

### **5. Workout Plan**

#### **5.1 Preparing for the workout process**

As the first step after receiving a new NPL, the workout team should ensure collection of all relevant and necessary information on the borrower's loan and financial details to enable the selection of an appropriate workout plan. The Corporate/MSME team should ensure that the file is transferred with all necessary documentation and a case update summary is attached. 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. All work out exercises should adhere to principles of restructuring outlined in Appendix 3 of this document and abide by Section 5 of the "Rules on the Management of Problem Loans".

On the bank's side, a thorough preparation includes:

- i. Gathering all relevant information available on the borrower;

- ii. Perform a thorough review of the borrower's historical financials, business viability, business plan and forecast loan service capacity.
- iii. Accurately assessing the value of the collateral securing the loan; and
- iv. Conducting a detailed analysis of the bank's legal position.

These aspects are further explained in the sections below.

#### **5.1.1 Gathering of information about the borrower**

All borrowers and guarantors should be informed promptly (within 5 business days) that responsibility for their relationship has been transferred to the Workout Unit. 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. The Workout Unit should intimate the borrower with any violations and loan covenants or agreements observed at the time of information collection.

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

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

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 loan servicing capability.

During the file review, the Workout Unit should pay close attention to identifying any other significant creditors. These may include other banks and financial

institutions, Zakat/Tax authority, utilities, trade creditors and loans to shareholders, related parties, or employees.

For any missing key information identified during the file review, the Workout Unit should develop a corrective action plan to ensure collection of these documents with the help of the business team. Some of this information should be requested promptly from the borrower or third party sources such as Credit Bureaus.

### **5.1.2 Identifying non-cooperative borrowers:**

The Workout Unit should define non-cooperative borrowers and carefully document their non-compliance. Useful criteria to be used to identify these borrowers are:

- i. Borrowers who default on their loans while having the ability to pay (“strategic defaulters”) in hopes of receiving unwarranted concessions from the bank.
- ii. 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.
- iii. Borrowers who deny access to their premises and/or books and records.
- iv. Borrowers who do not engage constructively with the bank, including those that are generally unresponsive, consistently fail to keep promises, and/or reject restructuring proposals out of hand.

Non-cooperative borrowers are more likely to be transferred to the legal team as it would be difficult to reach a consensual restructuring solution if the Borrowers are not willing to cooperate with the Banks.

However, banks would have to maintain an appropriate audit trail, documenting the rationale for classifying a borrower as “non-cooperative”

### **5.1.3 Determining the bank’s legal rights and remedies**

The banks having reviewed and understood the borrower’s business plan, but before initiating restructuring negotiations with a borrower, must prepare for these negotiations and have a very clear understanding of its bargaining position from a legal standpoint.

The Workout Unit should perform a thorough review of all documents relating to 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 are general indicators that a Workout Unit could pay attention to when reviewing the documentation:

- i. Whether the parties to the loan were adequately described in the loan documentation;
- ii. Whether all key documents were signed by the duly authorized persons under Saudi governing law;
- iii. Whether the bank is in possession of all original documents;
- iv. Whether the collateral has been duly perfected, including registration at the applicable registry
- v. Whether the loan documentation included non-compliance with certain financial indicators as 'events of default', and whether these indicators have been breached;
- vi. Historical financial position, driver of historical underperformance and to what extent this is expected to drive forecast performance:
  - a) **Current market challenges and outlook:** The Banks should form a view on how this has impacted the borrower's historically and how is it expected to impact its forecast performance and ability to repay the loan;
  - b) **The capabilities of the borrower's Management** team and whether they are capable of turning around the business;
  - c) **Strategy and turnaround initiatives:** Does the borrower have a clear strategy or plan to turnaround the business? Has this plan been clearly documented and communicated to banks?
  - d) **Business plan and financial projections:** How is the borrower expected to perform of the medium to long-term? What are the borrower's cash flow projections, which should provide an indication of his loan service capacity going forward? What is the level of sustainable versus unsustainable loan;
  - e) **Alignment with credit terms:** To what extent are all of the above aligned with existing credit terms and repayment plan;
- vii. 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;
- viii. 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.

If the borrower is not fully equipped to provide such information or if the banks would like to independently review such information, they can seek to appoint a financial advisor to perform an independent business review and clarify the above.

Once the Banks have formed a good understanding of the above, it is expected to assist them in identifying sustainable and commercial restructuring options that could align the banks' interest with that of the borrower and maximize recovery. Such options should be continuously evaluated as the WU engage in restructuring discussions and gather further information.

#### **5.1.4 Ensuring collateral's validity**

The workout team should ensure that the collateral taken at the time of loan agreement/origination was formalized and is still valid and enforceable. The banks should complete timely validation of legal documents to evade probable disputes or delay at the time of negotiating restructuring proposal. Furthermore, the banks should establish procedures around periodic (e.g. yearly basis) valuation and monitoring of acquired collateral

The Bank is required to perform detailed collateral analysis for all the accounts referred to WU. The workout team should perform this analysis as detailed out in section 7 of the "Rules on Management of Problem Loans"

#### **5.1.5 Financial viability analysis**

Banks need to conduct a thorough financial and business viability analysis of its borrowers especially MSME NPL borrowers to determine their ability to repay their obligations. In addition, it is important to obtain sufficient insight into the business plan and projected cash flows available with the borrower for loan service. This will entail determining the borrower's forecasted loan service capacity and assessment needs to be performed by the banks to align this with the restructured credit terms.

This analysis serves as the foundation for making an informed decision on the appropriate resolution approach – restructuring , sale to a third party, change of loan type (loan-to-asset or loan-to-equity swap) or legal proceedings. This analysis is required to be conducted by WU not previously involved in the loan approval process.

#### **A. 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. In case of MSME borrowers, in the absence of availability of audited and reliable financial information banks should focus on cash-flow based analysis and should also assess the reasonableness of financial information (where this information is available).

Below are four categories of financial ratios that banks may consider for their initial financial analysis (being illustrated below for indicative purposes and should not be considered prescriptive):

- i. 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 must be recognized that the distressed borrower's ratios will be considerably lower. The Workout Unit should assess how the borrower can 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.
- ii. Solvency or leverage ratios measure the company's reliance on loan rather than equity to finance its operations as well as its ability to meet all its obligations and liabilities.
- iii. Profitability ratios measure the company's growth and ability to generate profits or produce sufficient cash flow to survive, rate of sales growth, gross profit margin, and net profit margin are some of the key ratios to be considered.
- iv. Efficiency ratios measure management's ability to effectively employ the company's resources and assets. These include receivable turnover, inventory turnover, payable turnover and return on equity.

Detailed financial analysis of the borrower needs is to be performed in order to ensure completeness and avoid ignoring important underlying trends. Banks should undertake detailed analysis to understand the interrelation of these financial ratios, which can enable identification of borrower's real problems as well as probable corrective actions to restore the company's financial health.

The workout team should exercise prudence in his analysis and utilize reasonable caps and floors for certain ratios, as these ratios vary across borrower segments and sectors as well as economic conditions.

## **B. Balance sheet analysis**

In addition to computing and analyzing the key ratios, the workout team 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 borrower and the amount of loan that needs to be restructured.

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.

### **C. 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 forecasted cash generation capabilities. 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. 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.

With respect to MSME borrowers, in case reliable and timely financial information is not available, cash flow based assessment is recommended. Banks should incorporate a robust and efficient internal process of cash flow estimation for these borrowers.

### **D. 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 a contingency (or corrective action) plans in place should actual results deviate significantly from the projections. The focus of the Workout Unit will be on validating the assumptions (whether realistically conservative and in line with past performance) 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.

### **E. Cash budget**

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.

In a workout, the ability to generate and preserve cash is the key to the company's survival. All borrowers should be encouraged to prepare a short-term cash budget. The cash budget is similar to the cash flow analysis and 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 loan service. 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 are taken immediately to ensure that the company remains on plan.

#### **5.1.6 Business viability analysis**

Unlike financial analysis, which is highly quantitative, the business analysis is more qualitative in nature. Its purpose is to assess the borrower's ability to survive over the longer term. It focuses not on the borrower's financial performance, but rather on the quality of its management, the nature of the products & services, facilities and the external environment in which the borrower operates (including competition).

The primary cause of a business failure that has been acknowledged is the management of the business. The most common reasons include: (i) lack of necessary management skills required to run an organization; (ii) inability or unwillingness to delegate responsibilities; (iii) lack of experienced and qualified managers in key positions; (iv) lack of skills to run the business; and (v) inadequate management systems and controls.

Product assessment focuses on the nature of the product and its longevity potential. The main considerations include services or products, product mix diversified or reliant on a single product, technical obsolescence, and demand of the product/service.

The primary focus of the assessment of the facilities (physical plant, manufacturing units, etc.) is not on their valuation but rather on their capacity and efficiency. The attempt should be made to evaluate any requirements of significant upgrades or new facility to meet demand for the product presently and in the foreseeable

future. The costs for the same should then be assessed 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 affect the company's performance.

#### **A. Use of outside expertise to prepare business viability assessment**

For large commercial or real estate loans, the business viability portion of the analysis may be performed or validated by an independent third party such as a consultant or a restructuring advisor.

##### **i. Micro and Small Enterprises**

In the case of micro and small companies and subject to the cooperation of the owner or the management, which is trustworthy and provides reliable financial and other information, the use of external consultants may not be efficient in terms of time and costs. Banks are, therefore, encouraged to build internal capacity (or engage with external service providers as necessary) to assess the business viability of this segment and enable reasonable decision making in this regard.

##### **ii. Medium-sized companies:**

Medium-sized companies should be analyzed in more detail and it may be reasonable to use a similar approach as in the case of large companies. This may require 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.

The process can be followed in case where at least one of the following conditions are met:

- i. There is doubt about the reliability of financial and other information;
- ii. There is doubt about the fairness and competence of the management;
- iii. Activity involved of which the bank does not have sufficient internal know-how;
- iv. There is a great probability that the company will need additional financial assets.

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. The procedure guidelines at a minimum should include qualifications of the advisor, selection criteria, evaluation process and approval for these appointments. Whenever possible, Workout team should request proposals from several firms. In addition, these procedures should require that the deliverables (together with their due dates) and the pricing structure, should be clearly laid out. To expedite and further standardize the onboarding process, banks may choose to establish a list of pre-approved vendors.

### **B. Documenting the results of the financial and business viability analysis**

The findings of the financial and business viability analysis should be documented in writing and communicated to the credit committee for review. The documentation should have 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. Banks will have its own standard format for documenting the analysis but should ensure that it incorporates, at a minimum, the below information:

- i. Minutes of the meeting with the borrower with a clear identification of the reasons for the problems and the assessment of the ability to introduce radical changes into the operations;
- ii. Exposure of the banks and all other creditors (related persons, in particular);
- iii. 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;
- iv. 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. (these ratios are indicative, banks in practice are free to utilize such ratios, which they deem appropriate).
- v. 3- to 5-year projection (time period is dependent based on the tenor of the loan) 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;
- vi. Analysis of the necessary resources for the financing of working capital and investments (Capex);

- vii. Review of all indemnities (in the case of personal guarantees also an overview and an assessment of the guarantor's property);
- viii. Overview of the quality and assessment of the value of collaterals and the calculations of different scenarios (implementation of restructuring or the exit strategy).

The results of the financial analysis should be updated at least annually or more frequently in conjunction with the receipt of the borrower'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.

Based on the financial analysis, the business plan and the understanding of the borrower's loan service capacity, the banks should consider various restructuring solutions that can offer a sustainable restructuring and align the credit terms with the cash flow forecasts of the business. These solutions could include, but are not limited to:

- i. Grace periods.
- ii. Reduced interest rates or in some cases payment in kind (PIK) (PIK is the option to pay interest on debt instruments and preferred securities in kind, instead of in cash. PIK interest has been designed for borrowers who wish to avoid making cash outlays during the growth phase of their business. PIK is the financial instrument that pays interest or dividends to investors of bonds, notes, or preferred stock with additional securities or equity instead of cash) interest.
- iii. Assessing sustainable versus unsustainable debt.
- iv. Agreeing repayment profiles around sustainable debt in line with forecast sensitized cash flows of the borrower.
- v. Agreeing an asset sale plan.
- vi. Agreeing a debt to equity conversion.
- vii. Agreeing a debt to asset swap.
- viii. Agreeing a cash sweep mechanism (it is the mandatory use of excess free cash flows to pay outstanding debt rather than distributing it to the shareholders) to benefit from any upsides to the borrower's business plan.
- ix. Longer-term tenors when the business plan and financial analysis suggest that this is necessary for a more sustainable restructuring

## 5.2 Identifying the workout options

### 5.2.1 Purpose of workout

Under a best-case workout scenario, the bank and the viable (or marginally viable) borrower will agree on the restructuring strategy aiming to return the 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 restructuring option(s). There is no one standard ("one size fits all") approach and instead, the Workout Unit must choose from a variety of options to tailor a restructuring plan that meets the needs of specific borrower.

For the bank to consider approving a restructuring plan, the borrower must meet two essential pre-conditions: (i) borrower's projected cash flows must be sufficient to repay all or a substantial portion of its past due to obligations within a reasonable time frame; and (ii) borrower 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. Banks are advised to invoke out of court settlements for borrowers willing to cooperate with the restructuring process and are able to demonstrate that the economic loss as a result of any foreseeable restructuring is likely to be lower than seeking foreclosure. Instead, the bank should proceed with restructuring whenever it can reasonably document that the revised terms (which may include conditional loan forgiveness) will result in a greater recovery value for the bank than a legal procedure (bankruptcy or foreclosure).

In a syndicated or multi-bank scenario, wherein minority banks don't agree to a restructured/ work out solution, dissenting banks may utilize the guidelines laid down in the Bankruptcy law.

### **5.2.2 Workout options**

At the initial segmentation stage, the loan-to-value and viability parameters are generally used to help identify potentially viable borrowers (Refer to Chapter 3). This group of borrowers is then subject to in-depth financial analysis and business viability assessment, which narrows the number of candidates for potential restructuring even further. At this stage, the Workout Unit should have a fully informed view as to the nature and causes of the borrower's difficulties. Based on this understanding, the Workout Unit 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 Workout Unit with the flexibility necessary to tailor appropriate restructuring proposals.

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.

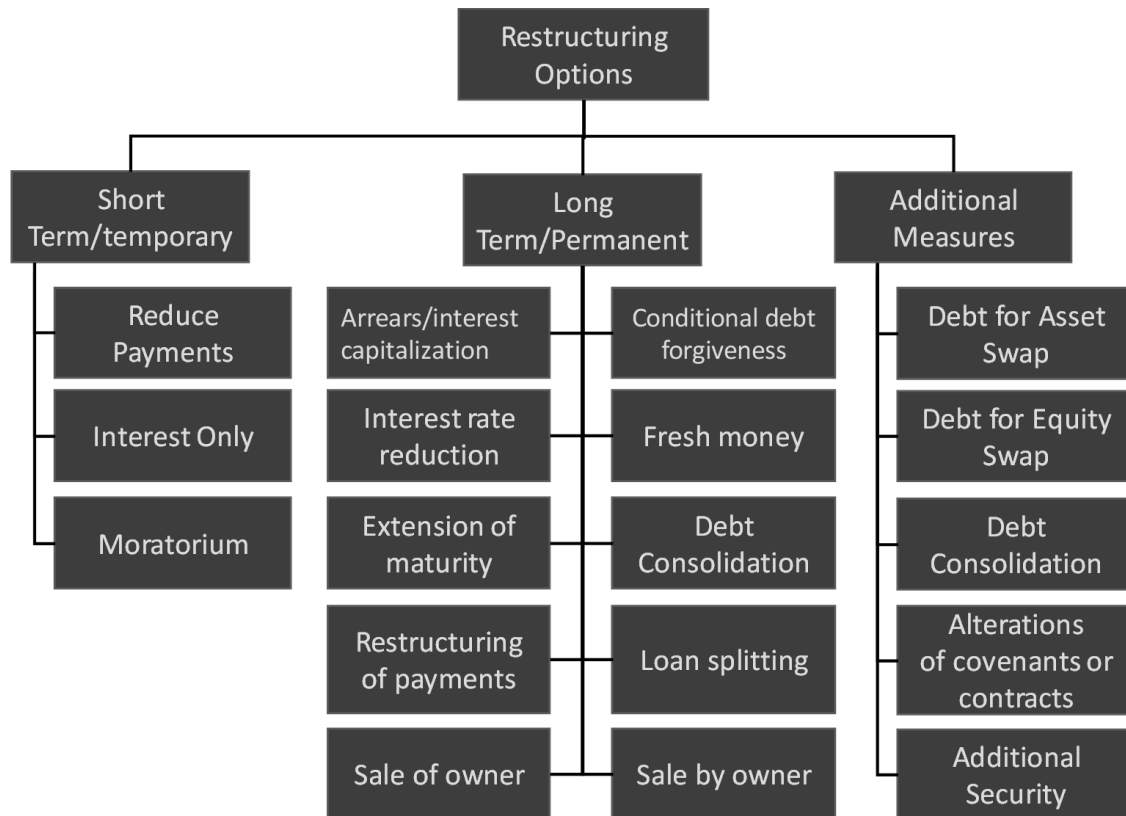
Borrower Type	Workout Measure	Description
Viable	Normal reprogramming	<p>Future cash flows sufficient for repayment of loan until a sustainable level of cash flow reached within the stipulated period (Actual timeline dependent on the profile of the borrower and tenor of the loan).</p> <p>Consider personal 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.</p>
Marginal	Extended repayment period	<p>Extended period of reprogramming (rescheduling) needed to reach a sustainable level of cash flow, i.e., with final payment in equal installments or balloon or bullet payment.</p>
	Loan Splitting	<p>Loan 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 specified maturity date; the remaining portion is considered to be excess loan (which can be subordinated), which may be split into several parts/tranches. These may be non-interest bearing with interest payable either at maturity or from the proceeds of specific asset sales.</p>
	Conditional Loan Forgiveness	<p>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 all collateral and potential cash flow) is lower than the total loan.</p>

		<p>Bank may choose to:</p> <ul style="list-style-type: none"> <li><b>i.</b> 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 loan;</li> <li><b>ii.</b> Partial write-off in the framework of a cash capital increase from a third-party investor where they have not assumed the role of the guarantor;</li> <li><b>iii.</b> 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;</li> <li><b>iv.</b> 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).</li> </ul> <p>Loans can also be written off if the collateral has no economic value, and such action ensures the continuation of the borrower's operations and the bank has confidence in the management or if the cause for the problems came from objective external factors.</p>
	<p>Loan to Equity Swaps</p>	<p>Appropriate for medium-sized companies where the company can be sold, has established products/services, material know-how; or significant market share, etc. However, such measures should be in-line with the requirements stipulated by Banking Control Law (Issued by SAMA) under Article 10 subsection 2 and 4.</p>
	<p>Loan to Asset Swaps</p>	<p>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 bankruptcy</p>



		and enforcement legislation. It may also be used for other real estate cases, equity stakes, and securities with determinable market value.
	Short Term restructuring	Restructuring agreements with a one-year maturity may be appropriate in those cases such as micro and small borrowers, where the bank feels closer monitoring or increased pressure to perform is necessary.
	Loan Sale	Sale of the loan is reasonable under the following conditions: <ul style="list-style-type: none"> <li>• The bank does not have sufficient capacity to effectively manage the borrower;</li> <li>• The buyer has a positive reference; and</li> <li>• The buyer is a major specialist in the area of resolving non-performing loans.</li> </ul>
Non-Viable Borrowers	Collateral Liquidation by owner	MSME 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	To be used when the borrower is not viable or non-cooperative, and no feasible restructuring solution can be put in place.

The below figure 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 loan; and (iii) additional measures, which do not directly lead to repayment but strengthen the bank's collection efforts.



### 5.2.3 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 borrower's cash flow (e.g., event out of the borrower'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 borrower's sustainable cash flow will be strong enough to allow the resumption of its existing payment schedule at the end of the restructuring period. Evidence of such an event should be demonstrated in a formal manner (and not speculatively) via written documentation with defined evidence showing that the borrower's income will recover in the short-term or on the basis of the bank concluding that a long-term restructuring solution was not possible due to a temporary financial uncertainty of a general or borrower-specific nature. 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 restructuring 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:

- i. Reduced payments – the company’s cash flow is sufficient to service interest and make partial principal repayments.
- ii. 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.
- iii. Moratorium – an agreement allowing the borrower to suspend payments of principal and/or interest for a clearly defined period. 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.

The contractual terms for any restructuring solution should ensure that the bank has the right to review the agreed restructuring measures if the situation of the borrower improves and more favorable conditions for the bank (ranging from the restructuring to the original contractual conditions) could, therefore, be enforced. The bank should also consider including strict consequences in the contractual terms for borrowers who fail to comply with the restructuring agreement (e.g. additional security).

#### **5.2.4 Long term/permanent restructuring**

Longer-term/permanent options are designed to permanently reduce the borrower’s loan. 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 that may be considered include:

- i. **Interest and Arrears capitalization** – adds past due payments and/or accrued interest arrears to the outstanding principal balance for repayment under a sustainable revised repayment program. Workout Unit 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. This measure should be applied only once, and in an amount that does not exceed a pre-defined size relative to the overall principle as defined in the bank’s Remedial/restructuring policy. The bank should also formally confirm that the borrower understands and accepts the capitalization conditions.
- ii. **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.

- iii. **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.
- iv. **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 loan at risk and to enable a sustainable repayment program for the remaining outstanding amount. This option is generally preferable, from the bank'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. 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 throughout the life of the loan.

These options are generally 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 loan 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.
- v. **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 loan. It is usually combined with the partial repayment option or conditional loan 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.

**vi. Conditional loan forgiveness** – involves the bank forfeiting the right to legally recover part or the whole of the amount of an outstanding loan 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 loan 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 banks. 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 loan. In these cases the bank may consider:

- a) 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 loan.
- b) 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.
- c) 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.
- d) 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).
- e) 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 borrower 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 loan forgiveness options carefully since the possibility of forgiveness can give rise to moral hazard, weaken the payment discipline, and encourage “strategic defaults”. Therefore, banks should define specific forgiveness policies and procedures to ensure strong controls are in place.

**vii. Fresh money** - providing new financing arrangements to support the recovery of a distressed borrower is usually not a standalone viable restructuring

solution but should be combined with other 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 loans with significant amount, independent sector experts should be used to validate the viability of proposed business plans and cash flow projections.

**The Banks are recommended to have strict policies prohibiting lending new monies or allowing roll-overs.** 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.

- viii. **Loan splitting** – is used to address collateral and cash flow shortfalls. In this option, the loan 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; and (ii) the remaining portion represents “excess loan” (which can be subordinated). This portion can be used in combination with payments from the sale of specific assets or bullet payments at the maturity.

### 5.2.5 Additional Measures

Additional measures are not considered to be viable stand-alone restructuring 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.

- i. **Loan-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 loan 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.
- ii. **Loan-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 loan-to-asset swap above, this option may also require the bank to allocate additional resources for managing the new investment. However, such measures should be in-line with the requirements stipulated by Banking Control Law (Issued by SAMA) under Article 10 subsection 2 and 4.

- iii. **Loan Consolidation** – more common for small loans, entails the combination of multiple loans into a single loan or a limited number of loans. This solution should be combined with other restructuring 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 loan than individually.
- iv. **Other alterations of contract/covenants** – when entering a restructuring 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 immovable property) are generally obtained as additional security from a borrower to compensate for the higher risk loan or cure existing defaults in loan-to-value ratio covenants.

### **5.2.6 Utilizing New Information**

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 borrower had been misleading it with certain material information, the approach and the measures must be more conservative. On the other hand, if the borrower puts forward or presents a repayment proposal during the measures, which would considerably improve the bank's position, the bank may mitigate the measures subject to fulfillment of certain conditions or eliminate them completely. This means that there is a certain flexibility of restructuring measures for the company.

Banks generally have a choice of choosing to restructure a loan, sell the loan (note sale), or liquidate the underlying collateral either by sale by owner or legal procedures (e.g. enforcement or insolvency). These guidelines require banks to compare the value of the proposed restructuring option against the other alternatives. 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.

### **Evaluating alternative strategies based on NPV analysis**

**Using a simple Net Present Value (NPV) analysis is recommended in order to provide more quantitative justification for the decision.**

The general formula to calculate net present value is:

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

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. Alternatively, the Banks may also use original effective interest rate used for computation of provisioning under International Financial Reporting Standard (IFRS) 9 guidelines.

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.

For NPV analysis, the bank’s standard risk-adjusted discount rate should be considered. NPV from various options should be considered including below considerations in each option:

- i. **Restructuring:** evaluation based on estimated cash-flows for a period under negotiation for new tenor of contract. The factors to be considered are interest rate of the new term, any other expenses involved in restructuring and business plan or internal estimations of the bank.
- ii. **Enforcement (including legal):** the parameters to be considered includes current value of the property, suitable haircuts to be applied, litigation charges and additional time to be taken to conclude these proceedings.
- iii. **Insolvency:** cost of insolvency procedure, length of time to conclude insolvency proceedings and estimated value to be recovered.

## 5.3 Negotiating and documenting workout plan

### 5.3.1 Developing the negotiating strategy

Restructuring plan should be viable and mutually acceptable. As every restructuring is unique, depending on borrower and the executing team, the



notion of the strategy should keep, following things in mind before drafting the plan:

- Restructuring a loan, which is under stress, means introducing changes that will make underlying business viable and profitable once again and to implement changes so that it will generate enough cash flow to cover the service of loan and satisfactorily returns to shareholders. It is important to understand the underlying causes of the problem.
- The restructuring is more than just changing the terms and structure of the facility, as it focuses on sustainable business.
- Economic profitability should be priorities over accounting profitability while restructuring. The objective is to render the company viable and to ensure its continuity.

#### **A. Better Practices for approaching negotiation in an efficient manner**

- i. Preparation is essential before the negotiation starts: Every negotiation requires preparation and a strategy to implement. During their preparation, the bank can propose and determine how the possible refinancing is going to be distributed, under what conditions, and subject to what limits and guarantees. Negotiating strategy and tactics should include identification of the negotiable points, possible counter-proposals from the banks, and matters kept in reserve (if possible) to be raised during the process.
  - a. Be Prepared – It is not possible to draw up a restructuring strategy without a reliable resolvability analysis. The bank should review all available information of the company and current state of business sector, identify the reason and nature of the distress situation.
  - b. Evaluate the position – Bank should evaluate its ranking in terms of security among the other creditors and stakeholders. The bank should also assess the number and value of secured claims in relation to other secured and unsecured creditors,
- ii. Keep the borrower informed: For a successful negotiation, the bank should inform all the stakeholders and be involved actively in talks about the negotiation progress. Successful restructuring is a team effort. Success requires that borrowers work closely with their investment partners. In a restructuring, investors are not only shareholders but also supporting financial entities. For managers the challenge is always to be a step ahead by preparing the (eventual) next round; to be transparent, and to communicate effectively.

- iii. Consistency will deliver results: At this crucial stage in a company's life, inconsistency in communication or strategy can be detrimental. Some ways to be consistent:
  - a) Draw up a consistent and credible action plan to improve the company's liquidity. Determine the financial needs in the short, medium and long term.
  - b) Be consistent in the plan: try to cover short-term needs with short-term funds, and long-term needs with long-term funds.
  - c) Do not equate restructuring with loan renegotiation. Long-term needs can and must be financed by converting loan to equity, whenever the level of leverage is excessive.
  - d) When converting loan to equity, negotiate in detail the value of the stake held by the new shareholders or look for alternative sources of capital.
  - e) Finally, the success of the restructuring depends to a large extent on the company surrounding itself by qualified advisors who can offer the benefit of their experience.
- iv. A restructuring process consists of reaching a private agreement in order to prevent legal proceedings. It is also possible to base the agreement on corresponding bankruptcy law, although it would have to be under judicial protection and subject to regulations that are often more rigid (creditors agreement).

## **B. SWOT (Strengths, weaknesses, opportunities, threats) Analysis**

While negotiating the rehabilitation plan, the bank should identify and evaluate the strengths and weaknesses in the account. The strengths and weaknesses in the account should be thoroughly evaluated to assess and draft the strategy. Before initiating the negotiations with the borrower, bank should prepare a strategy to discuss and finalize the meaningful and successful plan.

The cases where the borrower is not sound to understand the restructuring, the banks should make all the efforts to educate and represent the facts in full faith and trust. If necessary, bank should involve external party for explaining the plan and reducing the resistance by the borrower in restructuring.

Bank may adopt SWOT analysis to formulate the plan. In SWOT, all internal and external factors are considered for identification of strengths and weaknesses in the account. On critical assessment of these factors, bank can build the plan into negotiating strategy. The strategy should cover the defined objectives along with needs of the borrower, reason for restructuring, root cause analysis of the

problem, proposed solutions, and negotiating parameters. The strategy of the bank should be focused on incentivizing the borrower and must include fees, penalties, and interest. The structure of the new and old facility has to be clearly explained to borrower while negotiating the strategy. A good background check and through homework may reduce the last-minute surprises and enhances the chances of a successful outcome.

Although the borrower should be made aware of deadlines to complete negotiations (i.e., at the specific restructuring plan being offered will expire if not accepted within 30 days), the situation should not end up into a sub-optimal restructuring.

Despite the fact that negotiating with the borrower on restructuring may be heated at times, both parties must understand the need of the situation and work collaboratively in the interest of both the parties and to come to a consensual and mutually acceptable agreement. The negotiation should be drafted as win-win situations for both parties.

### **C. Use of advisor**

After ascertaining the viability of business and ensuring that business plans are sustainable, both parties should come to a negotiable agreement. Depending on the complexity of structure and borrower's financial knowledge and sophistication, an external advisor may be required. Potential areas for advice are: a) drafting the entire restructuring proposal (financial and legal) and b) drafting business plans as a cornerstone for restructuring discussion with the bank.

In order to build trust of borrower in the restructuring plan, especially for less sophisticated borrowers, it is recommended to involve external advisor viz. a lawyer or a financial specialist.

The bank should organize borrower educational unit within the bank that would provide general financial counsel services to borrowers, including NPL resolution.

The bank should also consider providing independent counseling/mediation services to borrowers for finalizing the strategy.

### **D. Involvement of guarantor (/s)**

Depending on the terms of a guarantee, a guarantor is either fully or partially liable for the loan of third party (the borrower). The guarantor, therefore, should be kept fully informed about the status of the loan and the resolution process so that the guarantor 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 the guarantor would not have agreed, without prior knowledge or consent.

### **E Dealing with multi-bank borrowers**

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

- i. As a rule, a coordinator should be appointed within 1 month.
- ii. The coordinator should be appointed for a certain period (no more than 6 months) with the possibility of renewal (3 months).
- iii. 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.
- iv. The coordinator shall be responsible for the assessment of the need to sign a Standstill Agreement, 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 borrower restructuring.
- v. 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
- vi. 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 borrower constantly change their positions without reason, thereby jeopardizing the process, the coordinator transparently informs all creditors and the borrower and is entitled to withdraw as coordinator.
- vii. If appointment of an agent is necessary after the completion of the restructuring, this role can be assumed by the coordinator unless agreed otherwise by the creditors. The coordinator takes over all further communication with the borrower, 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, hence banks are encouraged to explore the same prior to seeking legal recourse

To facilitate the process, the primary bank 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.

#### **F. Bearing the costs of the workout**

Formalizing a workout implies incurring multiple costs that may significantly compromise the financial position of the parties involved in the workout.

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:

- a) 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.
- b) When engaging the external consultants, throughout the course of the workout process, creditors must strive to help the borrower control and manage such costs, and should not incur any costs that may not be considered reasonable.

For MSME borrowers, banks are required to streamline workout processes, review existing processes to ensure that any cost levied to the borrower is kept at manageable levels

#### **G. Checklists for Negotiations**

Best practice in the recovery of distressed business loans is based on ensuring that ample effort goes into preparing for negotiations. To prepare for negotiations bank must have a

- i. Know loans and security position.
- ii. Know the mindset of each negotiating borrower.
- iii. Have a realistic assessment of counterparties' other personal or psychological attributes.
- iv. Know the main negotiating points critical to the success of the workout, and how each negotiating point is likely to be perceived by the borrower.
- v. Determine the overall posture best to adopt in conducting the negotiations.
- vi. Detail the relative merits of your chosen "posture" in terms of flexibility.
- vii. Separate the counterparties and their representatives from the problems caused by differences in positions.

- viii. Focus on each borrower's needs and interests rather than their stated or presumed position.
- ix. Look for solutions with mutual benefits (win-win strategies).
- x. Push for objectivity in judging proposals.

## **H. Pricing the workout**

While considering the price of the workout, the banks should consider cash flow, net present value, involvement of other banks (share, interest rate), and collateral value. The pricing should also factor in the risk in the proposal i.e. the change in risk profile of the borrower and waiver/ sacrifice amount while finalizing the work out strategy.

## **I. Maintaining fallback strategies**

Fall-back strategies are important because of the potential fluidity of any workout. The following are worth keeping in mind as strategy is being developed:

- a) Workout strategies can be rendered ineffective suddenly, without warning and often as the result of revisions to what were previously believed to be immutable facts.
- b) The importance of comparing options carefully during initial strategy selection – The scope for different views and approaches is ample. While occasionally some solutions will so clearly dominate all others as to not require deep discussion of alternatives, more often the best course of action is not so immediately obvious. In such cases, a thorough analysis and discussion of the strategy options will be an indispensable part of the asset recovery process. Best practice also involves formalizing the process, by holding the type of decision meeting appropriate for removing ambiguity as to what was decided and by recording the decision.

Comparisons of the various asset recovery options should involve quantification. As a minimum, each strategy option considered should be presented in terms of its internal rate of return (IRR) and/or its net present value (NPV). However, to the extent that certain aspects of risk and uncertainty play an important role yet are not always easily quantified, the framework for analysis and presentation should accommodate important qualitative considerations as well. The SWOT framework may be useful for comparing alternative workout strategies. Regardless of the framework used, it is important to ensure that all main assumptions are set in writing. Over time, assumptions that appear obvious early on are altered and rendered inapplicable. The workout specialist will appreciate having a record of the changing assumptions as the workout plan evolves.

Clear communication helps keep market participants informed, build confidence in the resolution strategy and maintain public support. Authorities gather a large amount of information in the process of assessing the NPL problem and play a strong coordination role in the resolution strategy. They are therefore best placed to explain to market participants how the NPL crisis is developing, and to propose and implement solutions. Communication is essential to build public support, given that public sector intervention will have fiscal implications, as well as an impact on borrower companies and households. Finally, communication of the resolution strategy creates a basis for a subsequent policy review, thus keeping the authorities accountable.

#### **J. Documentation of plan**

Banks must document each loan workout determination as part of the formal record. This includes documented communication with the borrower demonstrating the borrower has a renewed willingness and ability to repay the loan. Further, sufficient documentation of the ability to repay the loan must be on records for the options evaluated for assessing the borrower's ability to repay.

The bank should establish comprehensive management and internal controls over loan workout activity. This includes establishing authority levels and segregation of duties over the various types of workouts (modification, refinance, adjusting due dates, etc.). In addition, the policy needs to specify volume thresholds tied to financial performance elements such as net worth, delinquency and/or net charge off rates, etc. that trigger enhanced reporting to SAMA.

The contract and documentation should include a well-defined borrower milestone target schedule, detailing all necessary milestones to be achieved by the borrower in order to repay the loan over the course of the contract term. These milestones/targets should be credible, appropriately conservative and take account of any potential deterioration of the borrower's financial situation.

Based on the collective monitoring of the performance of different restructuring options and on the examination of potential causes and instances of re-defaults (inadequate affordability assessment, issue with the characteristics of the restructuring treatment product, change in the borrower's conditions, external macroeconomic effects etc.), banks should regularly review their restructuring policies and products.

For the cases, where the borrower has experienced an identifiable event which has caused temporary liquidity constraints. Evidence of such an event should be demonstrated in a formal manner (and not speculatively) via written documentation with defined evidence showing that the borrower's income will recover in the short-term or on the basis of the bank concluding that a long-term

restructuring solution was not possible due to a temporary financial uncertainty of a general or borrower-specific nature.

Greater transparency on NPLs can improve the viability of all resolution options, as well as market functioning in normal times. In cases where the ownership of the NPL passes from the originating bank to an external party, information limitations play an important role. To help overcome this problem, some standardization of asset quality data, as well as completeness of legal documentation on the ownership of these loans, would help buyers and sellers agree on pricing. In addition, co-investment strategies in securities originated from a pool of NPLs may reduce information asymmetries between buyers and sellers. This could increase transaction volumes, or facilitate sales at higher prices. A third option is the establishment of databases for realized prices of real estate transactions, given that real estate is the most widely used form of collateral. A transparent and sufficiently large database on real estate sale prices would, therefore, enhance the stability and reliability of NPL valuations, ultimately facilitating the NPL disposal process and leading to smaller price discounts. This would encourage market-based solutions for NPL disposal.

#### **K. Information Access:**

One of the key success factors for the successful implementation of any strategy option is adequate technical infrastructure. In this context, it is important that all cases related data is centrally stored in robust and secured IT systems. Data should be complete and up-to-date throughout the workout process. An adequate technical infrastructure should enable units to easily access all relevant data and documentation including:

- i. current NPL and early arrears borrower information including automated notifications in the case of updates;
- ii. loan and collateral/guarantee information linked to the borrower or connected borrowers;
- iii. monitoring/documentation tools with the IT capabilities to track restructuring performance and effectiveness;
- iv. status of workout activities and borrower interaction, as well as details on restructuring measures, agreed, etc.;
- v. foreclosed assets (where relevant);
- vi. tracked cash flows of the loan and collateral;
- vii. sources of underlying information and complete underlying documentation;



- viii. access to central credit registers, land registers and other relevant external data sources where technically possible.

#### **L. External Information**

As a minimum, the following information should be obtained when restructuring a non-retail loan:

- i. latest audited financial statements and/or latest management accounts;
- ii. Verification of variable elements of current income; assumptions used for the discounting of variable elements;
- iii. overall indebtedness;
- iv. business plan and/or cash-flow forecast, depending on the size of the borrower and the maturity of the loan;
- v. latest independent valuation report of any mortgaged immovable properties securing the underlying facility;
- vi. information on any other collateral securing the underlying loan facilities.
- vii. latest valuations of any other collateral securing the underlying loan facilities;
- viii. historical financial data;
- ix. relevant market indicators (unemployment rate, GDP, inflation, etc.).
- x. In case of MSME's access to bank statements of all accounts maintained by the borrower may also be necessary.

#### **M. Internal Information**

Banks should maintain in the credit file of the transactions the documentation needed so that a third party can replicate the individual estimations of accumulated credit losses made over time. This documentation should include, inter alia, information on the scenario used to estimate the cash flows it is expected to collect (going concern vs. gone concern scenario), the method used to determine cash flows (either a detailed cash-flow analysis or other more simplified methods), their amount and timing as well as the effective interest rate used for discounting cash-flows.

Banks should maintain all internal supporting documentation, which may be made available for review by the supervisory authority upon request. It should include:

- i. the criteria used to identify loans subject to an individual assessment;
- ii. rules applied when grouping loans with similar credit risk characteristics, whether significant or not, including supporting evidence that the loans have similar characteristics;

- iii. detailed information regarding the inputs, calculations, and outputs in support of each of the categories of assumptions made in relation to each group of loans;
- iv. rationale applied to determine the considered assumptions in the impairment calculation;
- v. results of testing of the assumptions against actual loss experience;
- vi. policies and procedures which set out how the bank sets, monitors and assesses the considered assumptions;
- vii. findings and outcomes of collective allowances;
- viii. supporting documentation for any factors considered that produce an impact on the historical loss data;
- ix. detailed information on the experienced judgment applied to adjust observable data for a group of financial assets to reflect current circumstances.

#### **N. Restructuring documentation**

Important documents in any workout will be the term sheet, the loan agreement, and the security documents. Even before the banks have determined that a going concern solution is feasible and indeed preferable and the transaction starts crystallizing, they will want to start preparing documents.

The documentation will also determine the conditions of effectiveness of the restructuring. Before these have been met, the restructuring is not complete and it is theoretically possible to revert to the default and real bankruptcy.

The proposal should contain the following elements:

- i. Full description of the borrower
- ii. Amount(s) of the loan(s) to be restructured
- iii. Restructuring fees and expenses, if any
- iv. Name(s) of the bank(s)
- v. Anticipated date of closing
- vi. Representations and warranties
- vii. Repayment schedule(s)
- viii. Mandatory repayment(s), if any
- ix. Cash sweep mechanism, if any
- x. Interest rate(s) and applicable margin(s) if floating rate
- xi. Default interest
- xii. Interest payment dates
- xiii. (Revised) events of default
- xiv. (Additional) security

- xv. List of documentation
- xvi. Taxes
- xvii. Governing law

#### **O. Checklist:**

- i. Establish parties to be part of the workout transaction
- ii. Establish what minimum terms acceptable to parties other than the borrower
- iii. Prepare draft term-sheet
- iv. Negotiate draft term-sheet among parties other than borrower and reach tentative agreement
- v. Submit draft term-sheet to borrower
- vi. Negotiate, agree, and initial term-sheet
- vii. Have lawyers prepare draft legal documents for workout, including new or amendatory loan agreement and security documents, based on initialed term-sheet
- viii. Negotiate, agree, and sign legal documents for workout
- ix. Determine when conditions of effectiveness have been met and workout is complete.

#### **5.3.2 Drafting the restructuring agreement**

A typical restructuring agreement at minimum should include: Purpose, Restructuring Fees and Expenses, banksLenders, Nature and Amount of Current Principal Loan, Role of External Counsel, Signing Date of the Loan Restructuring Agreements and other Documentation, Conditions of Effectiveness, Representations and Warranties, Repayment Schedule, Mandatory Prepayments, Cash Sweep Mechanism, Interest Rates, Applicable Margin – Base, Default Interest, Interest Periods, Shareholder Loan, Emergency Working, Deferral of Principal Payment, Undertakings, Events of Default, Security, Documentation, Taxes, Withholdings, Deductions and Relevant Governing Law.

#### **A. Determining required documentation**

Every restructuring transaction is different in its own way, and these differences lead to defining the type and number of documents required to formalize the workout. Factors like the number of creditors, the size of the loan restructured and the type of collateral used in the original lending transaction determine the complexity and number of documents required to formalize a workout.

Regardless of the number of creditors and complexity of loan structure, the restructuring documentation will determine the conditions and effectiveness of the restructuring, and it is essential that all parties should agree and sign the documents before implementing the workout. Until all documents have been

formalized, it is still possible that the restructuring negotiations fail and initiating the bankruptcy proceedings.

The documentation formalizing the workout should always be prepared by a legal practitioner. While the legal practitioner should be primarily responsible for elaborating this documentation, close collaboration is required with the Workout Unit in charge of negotiating the workout.

In the case of MSME workouts, the banks are encouraged to explore developing restructuring documentation, which 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 further guidance on relevant agreements refer to Appendix 4.

### **B. 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. Communication with borrowers should be as per the procedures outlined in the bank's code of conduct. This should include; timelines for responding to borrower's requests/complaints, identify who within the bank is responsible/authorized to issue various types of communications to the borrowers, documenting process for all communications to/from the borrowers, signing/acknowledgement protocols with timelines, approval requirements for all workout proposals, templates to be used for communication with the borrowers.

With respect to borrowers, transferred to the specialized unit, some of the basic principles are as follows:

- i. Work out unit must act honestly, fairly, and professionally at all times.
- ii. RM should avoid putting excessive pressure on the borrower and/or guarantor. All contacts with the borrower should take place at reasonable times) and at a mutually convenient location.
- iii. Documenting all the communication with the borrowers (and guarantors) and retaining for an appropriate time. Notes to the credit file should be factual.
- iv. Sign all communications of a legal nature such as commitment letters, demand letters, or other communications with respect to legal proceedings by those individuals authorized to do so by policy.
- v. All written communications from the borrower should be acknowledged within (5) business days.

- vi. RM 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.
- vii. 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 costs arising from the transaction.
- viii. Notify borrowers in writing if their restructuring proposal is declined, including the reasons for rejection.

### **C. Resolution of disputes**

When the bank and the borrower fail to reach an agreement or the borrower considers the proposed restructuring plan of the bank 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 specialized unit. General established practice is for the borrower to write directly to the CRO. It should be ensured that the dispute is being reviewed independently of the personnel/team against whom the appeal has been filed.

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 indicative example of a more formal process can be summarized as follows:

- i. An Appeals Committee consisting of at least three senior officers is formed.
- ii. The members of the Committee should be knowledgeable about the credit granting process but be independent of the credit origination, workout, and risk management functions.
- iii. 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.

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.

- a) Acknowledgment of submission of appeals in writing.
- b) The decision of the Appeals Committee should be announced within one (1) month from the date of submission and should be in writing and include the reasons for the committee's decision.

c) The borrower would have a right to appeal on a specific issue only once.

Educating borrowers, especially in the MSME category may be required that restructuring of loan obligations is a concession provided by the bank and not a legal right of the borrower.

#### 5.4 Monitoring the restructuring plan

SAMA expects banks to maintain effective controls in relation to restructured loans and in connection therewith, have laid out regulatory expectations regarding monitoring performance in accordance with the restructuring agreements once the new workout “regime” has been decided and implemented.

The monitoring function will need to address several aspects, the tracking of both how and when will the cash be generated is important.

The approval of the restructuring agreement is only a part of the resolution, whereas the bank must continue to monitor the borrower to ensure timely reprogramming of payments and meeting of commitments. If reasons exist on the part of the borrower 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 fulfillment of all commitments and timely payments must be ensured by the bank by setting up appropriate IT and Organizational support. If there is no confidence in the management, the bank should strive to involve an external consultant or authorized person to periodically monitor the company's operations on behalf of the bank.

For MSMEs, a short quarterly review may be the most cost-efficient manner, namely in the form of meetings with the key staff and inspecting the documentation, analyzing the financial statements in order to obtain an overview of a realistic business and financial situation of the borrower.

#### **Tracking financial obligations and managing cash flow during the workout**

Note: The below is not illustrated with a purpose of regulating borrowers, but rather as a guideline to banks to ensure that cash-flows management pertaining to restructured borrowers, is subject to adequate and proper oversight by the bank’s staff, within the legal rights given by the restructuring agreement.

During a workout, managing cash becomes even more critical because the company as a borrower must concern itself not only with the overall manageability of its loan levels and timeliness of loan servicing payments but also with questions of fairness and equitable treatment among its various creditors and other payees

as cash becomes available and decisions are taken as to how it is to be applied. Sales of assets, which during good times would have happened without issue, now must be subjected to additional scrutiny to ensure that they do not trigger alarms of “fraudulent conveyance.”

Careful cash flow forecasting should be accompanied by sound cash controls within the borrower company. This can be achieved either within the borrower’s own systems or by introducing special organizational arrangements that effectively cordon off the cash management function.

When cash continues to be managed within the borrower company, the following is strongly advisable:

- i. Establish expenditure thresholds for different levels of review and control.
- ii. For expenditures over a certain threshold, ensure that double signatures are required to authorize payment.
- iii. Depending on the nature of the business, either centralize approvals and handling of expenditures or set regular budgetary guidance and spending “envelopes” for unit or department managers with appropriate procedures for enforcing spending/budgeting reconciliation and accountability.
- iv. Rationalize approvals and payments system.
- v. Use a third-party consultant or auditor or bank’s internal independent resource to perform periodic operational audits as part of an ongoing monitoring process tailored to the key aspects of the workout and distinct from other audit and financial reporting functions.

#### **5.4.1 Monitoring arrangements for restructured loans**

Restructured borrowers should be subject to intensive monitoring to ensure their continued ability to meet their obligations. The specialized team should use the bank’s EWS system to alert business segments 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 loan together with the level of risk inherent in the credit. Those loans which are material in nature and pose the greatest risk to the bank 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 loans might be monitored semi-annually for the first year with annual reviews thereafter. Finally, the smallest loans could be subject to an annual review of their financial statements.

Senior management should also be monitoring closely the key performance indicators (KPIs) of specific portfolio segments to ensure that the goals embedded

in the strategic plan are on track. Deviations from the plan should be identified and appropriate time-bound, corrective action plans put in place and monitored.

#### **A. 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 loan'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. It 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 borrowers 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 loan is not considered as impaired or defaulted;
- iii. there is no past-due amount on the loan;
- iv. the borrower has demonstrated its ability to comply with all other post restructuring conditions contained in the master restructuring agreement; and
- v. the borrower does not have any other loans with amounts more than 90 dpd or 180 dpd (as the case may be) at the date when the loan is reclassified.

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 large payment at the end of repayment period can be questionable.

#### **B. Transferring the borrower back to the originating unit**

The following criteria should be applied when transferring a borrower back to the business unit:

- i. The borrower regularly meets all its obligations from the restructuring agreement;



- ii. At least one year has passed from the beginning of validity of the restructuring and
- iii. The borrower has repaid at least 10 percent of the restructured principal in that period;
- iv. The borrower's indebtedness, measured with the net financial liabilities/EBITDA indicator, etc.;
- v. The transfer had been approved on the basis of the analysis of the borrower'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 loan, and no longer displays any of the signals which would cause automatic transfer to the specialized team, 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.

### **C. Monitoring of workout activities**

Banks should establish a robust set of metrics to measure progress in the implementation of their work out strategy for all the accounts.

The monitoring systems should be based on targets approved in the risk strategy and related operational plans which are subsequently cascaded down to the operational targets of the business and specialized teams. A related framework of key performance indicators (KPIs) should be developed to allow the senior management committee and other relevant managers to measure progress.

Clear processes should be established to ensure that the outcomes of the monitoring of restructured indicators have an adequate and timely link to related business activities such as pricing of credit risk and provisioning.

Restructuring related KPIs can be grouped into several high-level categories, including but not necessarily limited to:

- i. Bad/ stressed loan KPI's;
- ii. Borrower engagement and cash collection;
- iii. Restructuring activities;
- iv. Liquidation activities;
- v. Other (e.g. NPL-related profit and loss (P&L) items, foreclosed assets, early warning signals, outsourcing activities).

#### **D. Bad/ stressed loan KPI's:**

Banks should define adequate indicators comparable with the portfolio should be monitored on a periodic basis.

Banks should closely monitor the relative and absolute levels of stressed loans and early arrears in their books at a sufficient level of portfolio granularity. Absolute and relative levels of foreclosed assets (or other assets stemming from workout activities), as well as the levels of performing forbore loans, should also be monitored.

Another key monitoring element is the level of impairment/provisions and collateral/ guarantees overall and for different NPL cohorts. These cohorts should be defined using criteria which are relevant for the coverage levels in order to provide the senior management and other relevant managers with meaningful information (e.g. by number of years since NPL classification, type of product/loan including secured/unsecured, type of collateral and guarantees, country and region of loan, time to recovery and the use of the going and gone concern approach).

Coverage movements should also be monitored and reductions clearly explained in the monitoring reports. Where possible, indicators related to the NPL ratio/level and coverage should also be appropriately benchmarked against peers in order to provide the senior management with a clear picture on competitive positioning and potential high-level shortcomings.

Finally, banks should monitor their loss budget and its comparison with actual. This should be sufficiently granular for the senior management and other relevant managers to understand the drivers of significant deviations from the plan.

Key figures on NPL inflows and outflows should be contained in periodic reporting to the senior management, including moves from/to NPLs, NPLs in cure period, performing, performing forbore and early arrears. Inflows from a performing status to a non-performing status appear gradually (e.g. from 0 dpd to 30dpd, 30dpd to 60dpd, 60dpd to 90dpd, or 180 days as the case may be etc.) but can also appear suddenly (e.g. event-driven). A useful monitoring tool for this area is the establishment of migration matrices, which will track the flow of loans into and out of non-performing classification.

Banks should estimate the migration rates and the quality of the performing book month by month so that actions can be taken promptly (i.e. prioritize the actions) to inhibit the deterioration of portfolio quality. Migration matrices can be further elaborated by loan type (housing, consumer, real estate), by business unit or by other relevant portfolio segment to identify whether the driver of the flows is attributed to a specific loan segment.

## **E. Borrower's engagement and cash collection**

Key operational performance metrics should be implemented to assess the specialized unit or employees' (if adequate) efficiency relative to the average performance and/or standard benchmark indicators (if they exist). These key operational measures should include both activity-type measures and efficiency type measures. The list below is indicative of the type of measures, without being exhaustive:

- i. Scheduled vs. actual borrower engagements;
- ii. Percentage of engagements converted to a payment or promise to pay;
- iii. Cash collected in absolute terms and cash collected vs. contractual cash obligation split by:
  - Cash collected from borrower payments;
  - cash collected from other sources (e.g. collateral sale, salary garnishments, bankruptcy proceedings);
- iv. promises to pay secured and promises to pay kept vs. promises to pay due;
- v. total and long-term restructuring solutions agreed with the borrower (count and volume).

## **F. Workout activities**

One key tool available to banks to resolve or limit the impact of NPLs is restructuring if properly managed. Banks should monitor workout activity in two ways: efficiency and effectiveness. Efficiency relates mainly to the volume of credit facilities offered restructuring and the time needed to negotiate with the borrower while effectiveness relates to the degree of success of the restructuring option (i.e. whether the revised/modified contractual obligations of the borrower are met).

In addition, proper monitoring of the quality of the restructuring is needed to ensure that the ultimate outcome of the restructuring measures is the repayment of the amount due and not a delaying of the assessment that the loan is uncollectable.

In this regard, the type of solutions agreed should be monitored and long-term (sustainable structural) solutions should be separated from short-term (temporary) solutions.

It is noted that modification in the terms and conditions of a loan or refinancing could take place in all phases of the credit life cycle; therefore, banks should ensure that they monitor the restructuring activity of both performing and non-performing loans.

## **G. Efficiency of workout activity**

Depending on the potential targets set by the bank and the portfolio segmentation, key metrics to measure their efficiency could be:

- a) the volume of concluded evaluations (both in number and value) submitted to the authorized approval body for a defined time period;
- b) the volume of agreed modified solutions (both in number and value) reached with the borrower for a defined time period;
- c) the value and number of positions resolved over a defined time period (in absolute values and as a percentage of the initial stock).

It might also be useful to monitor the efficiency of other individual steps within the workout process, e.g. length of decision-taking/approval procedure.

#### **H. Effectiveness of workout activity**

The ultimate target of loan modifications is to ensure that the modified contractual obligations of the borrower are met and the solution found is viable. In this respect, the type of agreed solutions per portfolio with similar characteristics should be separated and the success rate of each solution should be monitored over time.

Key metrics to monitor the success rate of each restructuring solution include:

- i. **Cure rate** (the rate arrived at by conducting performance analysis of the forborne credit facilities after their designated cure period) **and re-default rate** (the rate arrived at by performing a performance analysis of the forborne credit facilities after their designated cure period):

Given the fact that most of the loans will present no evidence of financial difficulties right after the modification; a cure period is needed to determine whether the loan has been effectively cured. The minimum cure period applied to determine cure rates should be minimum for 12 months. Thus, banks should conduct a vintage analysis and monitor the behavior of forborne credit facilities after 12 months from the date of modification to determine the cure rate. This analysis should be conducted per loan segment (borrower with similar characteristics or basis industry segment) and, potentially, the extent of financial difficulties prior to restructuring.

Cure of arrears on facilities presenting arrears could take place either through restructuring measures of the credit facility (forborne cure) or naturally without modification of the original terms of the credit facility (natural cure). Banks should have a mechanism in place to monitor the rate and the volume of those defaulted credit facilities cured naturally. The re-default rate is another key performance indicator that should be included in internal NPL monitoring reports for the senior management and other relevant managers.

- ii. **Type of workout measure:** Banks should clearly define which types of workout measures are defined as short-term versus long-term solutions. Individual characteristics of workout agreements should be flagged and stored in the IT systems and periodic monitoring should provide the senior management and other relevant managers with a clear view on what proportion of restructuring solutions agreed are:
  - of a short-term versus long term nature; and
  - have certain characteristics (e.g. payment holidays  $\geq$  12 months, increase of principal, additional collateral, etc.).
- iii. **Cash collection rate:** Another key metric of workout activity is the cash collection from restructured credit facilities. Cash collection could be monitored against the revised contractual cash flows, i.e. the actual to contractual cash flow ratio, and in absolute terms. These two metrics may provide information to the bank for liquidity planning purposes and the relative success of each workout measure.
- iv. **NPL write-off:** In certain cases, as part of a workout solution, banks may proceed with a restructuring option that involves NPL write-off, either on a partial or full basis. Any NPL write-off associated with the granting of these types of restructuring should be recorded and monitored against an approved loss budget. In addition, the net present value loss associated with the decision to write off unrecoverable loans should be monitored against the cure rate per loan segment and per restructuring solution offered to help better inform the banks' restructuring strategy and policies. All NPL write off policies developed by banks are required to follow the rules defined under the circular on "Credit Risk Classification and Provisioning".

Indicators relating to workout activities should be reported using a meaningful breakdown which could for instance include the type and length of arrears, the kind of loan, the probability of recovery, the size of the loans or the total amount of loans of the same borrower or connected borrowers, or the number of workout solutions applied in the past.

### **I. Liquidation activities**

Provided that no sustainable restructuring solution has been reached, the bank is still expected to resolve the stressed loan. Resolution may involve initiating legal procedures, foreclosing assets, loan to asset/equity swap, and/or disposal of credit facilities.

Consequently, this activity should be monitored by the bank to help inform strategy and policies while also assisting with the allocation of resources.

## **J. Legal measures and pre-closure**

Banks should monitor the volumes and recovery rates of legal and foreclosure cases. This performance should be measured against set targets, in terms of number of months/years and loss to the bank. In monitoring the actual loss rate, banks are expected to build historical time series per loan segment to back up the assumptions used for impairment review purposes and stress test exercises.

For facilities covered with collateral or another type of security, banks should monitor the time period needed to liquidate the collateral, potential forced sale haircuts upon liquidation and developments in certain markets (e.g. property markets) to obtain an outlook regarding the potential recovery rates.

In addition, by monitoring the recovery rates from foreclosure and other legal proceedings, banks will be in a better position to reliably assess whether the decision to foreclose will provide a higher net present value than pursuing a restructuring option. The data regarding the recovery rates from foreclosures should be monitored on an ongoing basis and feed potential amendments to banks' strategies for handling their loan recovery / legal portfolios.

Banks should also monitor the average lengths of legal procedures recently completed and the average recovery amounts (including related recovery costs) from these completed procedures.

## **K. Loan to asset/equity swap**

Banks should carefully monitor cases where the loan is swapped with an asset or equity of the borrower, at least by using the volume indicators by type of assets and ensure compliance with any limits set by the relevant national regulations on holdings. The use of this approach as a restructuring measure should be backed by a proper business plan and limited to assets where the bank has sufficient expertise and the market realistically allows the determined value to be extracted from the asset in a short to medium-term horizon. The bank should also make sure that the valuation of the assets is carried out by qualified and experienced appraisers.

## **L. Other monitoring items**

### **i. P&L-related items**

Banks should also monitor and make transparent to their management bodies the amount of interest accounted for in the P&L stemming from restructured loans. Additionally, a distinction should be made between the interest payments on those restructure actually received and those not actually received. The evolution of loan loss provisions and the respective drivers should also be monitored.

### **ii. Foreclosed assets**

If foreclosure is a part of banks' strategy, they should also monitor the volume, aging, coverage and flows in their portfolios of foreclosed assets (or other assets stemming from restructured loans). This should include sufficient granularity of material types of assets. Furthermore, the performance of the foreclosed assets with respect to the predefined business plan should be monitored in an appropriate way and reported to the senior management and other relevant managers on an aggregate level.

### **iii. Miscellaneous**

Other aspects that might be relevant for reporting would include the efficiency and effectiveness of outsourcing/servicing agreements. Indicators used for this are most likely very similar to those applied to monitor the efficiency and effectiveness of internal units, though potentially less granular.

Generally, where restructuring-related KPIs differ from a regulatory and an accounting or internal reporting viewpoint, these differences should be clearly reported to the senior management and explained.

#### **5.4.2 When restructuring fails**

It is to be expected that a certain number of restructurings will fail. If the restructured borrower does not perform his obligations, the bank 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 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.

## Appendix 1: Samples of Early Warning Signals

The Following are illustrated for indicative purposes and are not intended to be prescriptive, as stated in the rules of Management of Problem Loans, banks should establish EWS that are suitable to their portfolio:

<b>EWS At Borrower Level from External Sources</b>	
External Sources	Debt and collateral increase in other banks
	Past-due or other NP classifications in other banks
	Guarantor default
	Debt in private central register (if any)
	Legal proceeding
	Bankruptcy
	Changes in the company structure (e.g. merger, capital reduction)
	External rating assigned and trends
	Other negative information regarding major clients/counterparties of the debtor/suppliers
<b>EWS at a borrower level from internal sources</b>	
Companies	Negative trend in internal rating
	Balances not appearing in current account / lower balances in Margin account / Negative own funds
	Significant change in liquidity profile
	Liabilities leverage (e.g. equity/total < 5% or 10%)
	Number of days past due
	Number of months with any overdraft/overdraft exceeded
	Profit before taxes/revenue (e.g. ratio < -1%)
	Continued losses
	Continued excess in commercial paper discount
	Decrease of turnover
	Reduction in credit lines related to trade receivables (e.g. year-on-year variation, 3m average/1y average)
	Unexpected reduction in undrawn credit lines (e.g. undrawn amount/total credit line)
	Negative trend in behavioral scoring
Individuals / sole proprietors	Negative trend in probability of default and/or internal rating
	Mortgage loan installment > x time credit balance



	Mortgage and consumer credit days past due
	Decrease in the credit balance > 95% in the last 6 months
	Average total credit balance < 0.05% of total debt balance
	Forborne Exposures
	Nationality and related historic loss rates
	Decrease in payroll in the last 3 months
	Unemployment
	Early arrears (e.g. 5-30 days of past due, depending on portfolio/borrower types)
	Reduction in bank transfers in current accounts
	Increase of loan installment over the payroll ratio
	Number of months with any overdraft exceeded
	Negative trend in behavioral scoring
	Negative trend in probability of default and/or internal rating

### **EWS at a portfolio/segment level**

Portfolio Distribution	Size distribution and concentration level
	Top X (e.g. 10) groups of connected borrowers and related risk indicators
	Asset class distribution
	Breakdown by industry, sector, collateral types, countries, maturities, etc.
Risk parameters	PD/LGD evolution (overall and per segment)
	PD/LGD forecasts and projections
	Default loan
	Volumes and trends of significant risk provisions on individual level
NPL/restructuring status/foreclosure	NPL volume by category (>90 past due, etc.)
	Restructuring volume and segmentation ( workout, forced prolongation, other modifications, deferrals, >90 past due, LLP)
	Foreclosed assets on total loans
	NPL ratio without foreclosed assets

### **EWS by specific type of borrowers/sectors**

General	Customizable index data (GDP, stock markets, commodity prices, CDS prices, etc.)
Real estate	Real estate-related indexes (segment, region, cities, rural areas, etc.)
	Rental market scores and expected market value changes
Aviation	Airline-specific indicators (passenger load, revenue per passenger, etc.)
Energy	Index data on regional alternative energy sources (e.g. wind quantities, etc.)
	Information-gathering system on potential technical or political risks on energy

## Appendix 2: Loan Life Coverage Ratio

### Application and computation of the ratio

Loan Life Coverage Ratio (LLCR) should be used by Workout teams to assess the viability of a given amount of debt and consequently to evaluate the risk profile and the related costs. Unlike Debt Service Coverage Ratio (DSCR) which captures just a single point in time, LLCR allows for several time periods more suitable for understanding liquidity available for loans of medium to long time horizons. Thus, given its long-term nature, this ratio should be used for project finance and other multi-year loans, where long term viability needs to be assessed.

The LLCR is a financial ratio used to estimate the solvency of a firm, or the ability of a borrowing company to repay an outstanding loan. LLCR is calculated by dividing the net present value (NPV) of the money available for debt repayment by the amount of outstanding debt.

The Formula for the computation is as follows:

*Present value of total available cash flow (ACF) during the loan life period (including interest and principal) + cash reserve available to repay the debt (the debt reserve)*

LLCR = -----

Outstanding loan Amount at the time of assessment

$$\text{Present value of cash-flows: } PV = \sum_{t=s}^{S+n} \left( \frac{CF_t}{(1+i)^t} \right)$$

Where,  $CF_t$  = cash – flows available for debt service at year t

t = the time period (year)

s = the number of years expected to pay the debt back

i = the weighted average cost of capital (WACC) expressed as an interest rate

In this calculation, the weighted average cost of debt is the discount rate for the NPV calculation and the project "cash flows" are more specifically the cash flows available for debt service. The loan life coverage ratio is a measure of the number of times over the cash flows of a project can repay an outstanding debt over the life of a loan. The higher the ratio, the less potential risk there is for the bank.

### Appendix 3: Restructuring Principles

The guidelines set out below a set of generic principles that banks are encouraged to follow and adopt as part of their culture in relation to restructuring activities. These principles include, but are not limited to:

- i. Restructuring activities should not be viewed as a cost center. Restructuring measures can allow the banks to maximize their recovery and maintain a good and long-term relationship with their borrowers.
- ii. Restructuring can allow the borrowers to survive and potentially return to a sustainable and growth path that would benefit the borrower, the economy and the banks.
- iii. If banks are effective in identifying early warning signs, addressing the issues and engaging in early restructuring solutions, this could prevent long-term default and losses and result in higher profit for both banks and borrowers.
- iv. Restructuring should be done in utmost good faith and both banks and borrowers should show seriousness and commitment to lead a successful process.
- v. Negotiations must be in the best interest of the borrower and the bank.
- vi. Transparency and regular communication should take place between various stakeholders in a restructuring situation.
- vii. Transparency and full disclosure of information, when appropriate, should take place between the borrower and the banks to ensure both parties can make informed decisions for the best interest of both parties.
- viii. The banks should aim to provide a prompt response to the borrower's proposal for a restructuring solution.
- ix. The borrower shall have reasonable and sufficient time to provide the requested information and consider the restructuring proposal.
- x. Banks and borrowers should seek sustainable solutions and avoid repeated short-term fixes.
- xi. Confidentiality should be respected throughout the process.
- xii. Consensual but sustainable out-of-court restructuring solutions are considered the best and most favorable outcome when it comes to restructuring. Banks are expected to exhaust all consensual options before deciding to follow a court-led process or enforcing on securities.

## Appendix 4: Details of Relevant Agreements

### Standstill Agreement

In 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 banks, confirming that they will not enforce their rights against the borrower for any default during a limited period. 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 MSME 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, a simplified 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:

- i. Not to start enforcement actions against the borrower or his assets;
- ii. Not to declare the loan agreement breached, or accelerate the loan;
- iii. Not to take additional collateral or improve his position with respect to other creditors;
- iv. Not to charge additional fees or penalty interests;
- v. 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.

## **Restructuring Agreement**

The restructuring agreement is the main document that regulates all the details of the workout. In the case of MSMEs, 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 be captured accurately, not just in connection with the payment obligations of the borrower but also with his behaviour 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 of modification in the maturity dates as well as the principal and applicable interests of the loan agreement, drafting a new agreement will probably be necessary. In this case, it is highly advisable that the legal department of the lending banks is brought on-board 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 loan restructuring techniques. 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.

## **The Restructuring Proposal – Term Sheet**

The term sheet is the most important piece of the workout documentation, as all further documentation will find their origin therein. A draft term sheet drawn up right at the beginning of the workout process provides banks with a useful checklist of parties involved in the workout process and of the terms that will have to be agreed upon with the borrower, other banks, and stakeholders. The draft term sheet is revised at every stage of the workout process, particularly during negotiations. In addition, before drafting the final and formal workout documents, including the new or amendatory loan agreement, lawyers will want to make sure that they can see the full picture of the proposed workout and can iron out any discrepancies and controversial points.

Term-sheets are a common feature in project lending or in the structuring of term loans. They facilitate the negotiations in that the various terms that have been discussed and agreed upon during the progress of the negotiations can be laid down until the final deal or transaction is agreed.

Term-sheets are particularly useful in workouts, as they allow the borrower and bank to spell out what has been agreed upon and move on to the next item to be negotiated. In a workout, it may be necessary to include more than one creditor or stakeholder in the transaction, and the term-sheet allows the parties to agree on the main terms of the proposed restructuring transaction before the lawyers are asked to prepare the legal documents.

After determining, that a workout will be feasible, banks will want to put a proposal on the table. For smaller borrowers, this may take the form of a conversation between the bank and the borrower, to be confirmed in writing. For medium to large companies, where the terms are likely to be more complex and there is a need for the borrower to carefully study and absorb them, the proposal will more typically be in the form of a draft term sheet spelling out the conditions on which the bank is willing to restructure or reschedule the loan(s).

### **The Restructuring Documents:**

#### **– Loan Agreements**

The complexity of the restructuring dictates which documents will be necessary. For a simple rescheduling of maturities, a letter may suffice and will have legal validity. However, if the face value of the loan and basic terms such as maturities and interest are changed, there may be a need for a new agreement. Legal practitioners are better placed to determine whether this will take the form of an amendatory agreement, where the body of the original loan agreement is left intact and the terms and conditions to be changed are covered in an additional agreement, amending the original.

## – Security Agreements

In the event that there is additional security under negotiated strategy, additional agreements will be required to have such security registered. Particular care will be necessary to ensure that the existing rights of the senior, secured banks are honored and are not diluted or set aside in favor of those of the junior and unsecured banks.

## – Ancillary Agreements

These will include additional overdraft agreements, guarantee agreements, share pledge agreements, security-sharing agreements, and the like, all in line with what has been agreed among the borrower and banks.

## Key covenants

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

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 2:1, 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 banks 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, completely or in part, without prior approval of bank. Covenants for larger, more complex borrowers need to be specifically tailored to meet their individual situations. Bank should include covenants pertaining to but restricted to 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. Bank should also develop an internal process to be able to monitor adherence to these covenants.



## Appendix 5: Glossary of Technical Terms

For the purpose of this document, the terms and phrases used in these guidelines have the following meaning:

Term	Definition
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	Whose value can be considered whilst computing the recoverable amount for workout cases or foreclosed cases, on account of meeting the stipulated conditions laid out in these rules, as would be applicable based on the nature of the collateral.
Collateral enforcement	The exercise of rights and remedies with respect to collateral that is pledged against a loan.
Conditional loan forgiveness	A bank forfeiting the right to legally recover part or the whole of the amount of an outstanding loan upon the borrower's performance of certain conditions.
Cooperative borrower	A borrower which is actively working with a bank to resolve their problem loan.
Cure rate	The percentage of loans that previously presented arrears and, post restructuring, present no arrears.
Covenant	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 signals	Quantitative or qualitative indicators, based on liquidity, profitability, market, collateral and macroeconomic metrics.

Failed restructuring	Any restructuring case where the borrower failed to repay the revised contractual cash flows as agreed upon with the bank and has transitioned into default.
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.
Problem Loans	Loans that display well-defined weaknesses or signs of potential problems. Problem loans shall be classified by the banks in accordance with accounting standards, and consistent with relevant regulations, as one or more of: <ul style="list-style-type: none"> <li>a. non-performing;</li> <li>b. subject to restructuring (including forbearance) and/or rescheduling;</li> <li>c. IFRS 9 Stages 2; and exhibiting signs of significant credit deterioration or Stage 3;</li> <li>d. under watch-list, early warning or enhanced monitoring measures; or</li> <li>e. where concerns exist over the future stability of the borrower or on its ability to meet its financial obligations as they fall due</li> </ul>
Restructuring	An agreement between the bank 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.
Unsuccessful restructuring	The cases where the bank and the borrower are not able to reach any restructuring agreement.

Viability assessment	An assessment of borrower's ability to generate adequate cash flow in order to service outstanding loans.
Viable borrower	Wherein the loss of any concessions as a result of restructuring, is considered to be lower than the loss borne due to foreclosure.
Watch list	Loans 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 loans.