

# Banking Restructuring Techniques in the Economical Crisis Context

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***Abstract.** Banking restructuring regained leading place in commercial banking activities following ongoing crisis. Many debtors are facing serious trouble in normal debt repayment due to increasing number and volume of non performing loans in banks' portfolios.*

*In order to deal with these issues and to secure existing exposures banks use restructuring techniques like payment rescheduling, debt-equity swap and write-offs to ease debtors debts and to help viable businesses to successfully survive recession.*

**Keywords:** restructuring; crisis; non performing loans; debt; restructuring principles; early distress indicators.

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**JEL Code:** G34.

**REL Codes:** 11C, 11G.

The ongoing crisis has a notable impact on economic sectors and many companies are facing difficulties in refunding loans contracted from credit institutions.

Commercial banks are confronting with the increasing number of situations in which financed companies experience difficulties in loans reimbursement due to decreasing business volume especially in the sectors most affected by recession: construction, real-estate, transportation, automotive industry and media.

The increase of payment delays or even temporary or total impossibility to repay debt made necessary to increase the restructurings as a response of reinforcement capacity of banking institutions through the foundation or the extension of the departments specialized in work-out activities.

Problematic loans are analyzed depending on the features of the financed business and divided in two major categories:

- Viable credits that can be recovered after the restructuring of terms and conditions, mostly of interest and principal, while declaring insolvency remains last option,
- Nonviable credits that can not be reimbursed from cash flow generated in the normal course of the business and the options of declaring the anticipated maturity and foreclosure are a priority. In these cases the speed of reaction of the banking institutions can be conclusive and

can mark the difference between the recovery of a bigger or of a smaller part of the due debt.

Forced execution in case of nonviable credits must consider a serious analysis which should mark if the only option is the default and if there are enough collateral in order to allow recovering the loan and to cover the expenses caused by the operation. In the case of real estate properties it should be considered the present lack of liquidity of the market which implies the acceptance of decreasing the nominal value of current assets through important discounts to allow speeding up sales, therefore avoiding ‘wait and see strategy’.

Analysis of the bank in this case concerns the possibility of temporary keeping the assets in the portfolio and selling them in the future under more favorable market conditions, in order to recover a bigger part of the value of credit granted.

In the debtor credit risk review process, banks are concerned with identifying *ex ante* the possible reimbursement difficulties and perform stress tests for identifying the first warning signs which could indicate the occurrence of payment difficulties.

Banks monitor two types of indicators which provide early information about the situation of the analyzed company as follows: First group of indicators are:

- market share;
- income from sales;

- current liquidity ratio;
- cash flow level.

Second category of indicators:

- unit costs;
- level of the provisions;
- financial losses (generated mainly by foreign exchange losses);
- short-term debt;
- fluctuation of personnel.

If at least three of the indicators from first category are situated in the same time at a descending trend and three of the second one are at an ascending trend, the bank will have to investigate the debtors situation closely and to propose already a preliminary action plan in order to secure its exposure and to recover debt.

Causes that generate decline according to DiNapoli and Fuhr can be grouped as follows: loss of market share (29%), inability of management to administer the business properly (24%), financing structure (18%), bad debts (10%), competition (6%) and other causes (13%).

Loan restructuring can take two forms: *soft restructuring* – that concerns only temporary postponements or small waivers granted for credit facility (possibly a short period of grace for the payment of the principal or extension of maturity, without modification of terms and conditions initially agreed) and *hard restructuring* – addresses to debtor that are unable to honor the debt service as it was originally approved, and requires a grace period extended from the payment of the principal (usually at least one year), maturity

extension, partial or total transformation of a short term facility in a medium or long term facility, complete reevaluation of the credit relationship and repositioning of the bank in relation to the debtor: cooperation position based on the determination to pay of the debtor or the force position imposed by the debtor's hostile attitude or the lack of cooperation of it.

Restructuring techniques of the credits used by commercial banks can be grouped into three large categories:

1) Restructuring of the payments and consolidating the debt by defining a new reimbursement schedule in accordance with the real payment possibilities of the debtor. Credit consolidation as a restructuring technique implies transforming all facilities of the debtor in one facility which would simplify the loan administration and monitoring costs of the bank.

2) Cancellation of a part of debt if the debtor is unable to pay but there is the possibility of recovering a part of the granted credit. Bank performs the analysis comparing the value that is possible to be obtained from the execution of potential decreased collateral with the cost of foreclosure.

3) Debt-equity swap. This can be achieved by converting a part of debt in capital (debt versus shares) and by mobilizing new capital in the form of issuance of bonds or shares. Debt-equity swap has the main advantage of restoring confidence in the company as a result of

the involvement of shareholders and allows management to focus on the ongoing business.

The main feature of this restructuring technique lies in the complex mix which implies high expertise but also additional costs.

Choosing the modalities of restructuring depends on the concrete situation of the debtor, the degree of indebtedness of and the ability to generate cash flow.

Restructuring the credit facility is a very complex process and the proposed solution must be adapted to the specific debtor as the case might be. At the same time it should be considered that the subject of the restructuring process must agree to the solution proposed by the bank, avoiding a voluntary declaration of insolvency by the debtor.

Bank analyses before starting the restructuring process if the initiation of it will improve its position and will allow realizing and respecting of an output from the credit relationship without turning to the expensive process of executing warranties.

The risks assumed by the bank in the restructuring process are of multiple origins and come from the financial area, as well as business and reputation area. In order to limit the risks it is requested the improvement of the own funds level requested of the debtor through additional capital contribution, the increase of the engagement of it along with accepting not to distribute dividends in the phase of

restructuring loans and to better control costs.

Restructuring is required in the most frequent cases by the debtor itself in order to reduce the financial burden by redistributing over a greater period of time principal and interests.

A particular approach to financial restructuring is the so-called London Approach which had its basis in the support of Bank of England. Following the financial crisis in the 70's, the Bank of England encouraged the promotion of a set of good practices regarding the restructuring of loans. It was found that both banks and financed companies were facing a lack of quality financial information on which to base their strategic decisions. Also the real level of debts was generally underestimated by the loaners, as well as the terms and the conditions associated to the credit.

London Approach is an informal mechanism by which creditors agree over a form of restructuring which implies the sharing of potential losses. Bank of England became involved suggesting to commercial banks new refinancing terms and has been making lobby around creditor banks to accept. Restructuring that has taking place from the perspective of London Approach showed the need for a mediator, which may be a public or private institution and may get involved in the process of arbitration between debtor and creditor and also the possibility of the state to get involved by co-financing the restructuring process.

In the restructuring process there can be highlighted a few general principles whose application makes the difference between success and failure of the operation:

1. The purpose of restructuring must be the viability of the business not only resolving the financial aspects.
2. If the subject of restructuring is a company which gives correct information, the creditors may agree on a defined period in which they will not exercise their right to request for insolvency or to prosecute enforcement execution of the warranties.
3. Bank restructuring should not be done in order to conceal inefficient loans gathered in portfolios.
4. Erasing the debts is the last measure considered by the creditors and this only in exchange with participation rights (shares) and warrants.
5. The success of restructuring depends on choosing one of the creditor banks as a leader in order to supervise the process and coordinating all creditors' actions.
6. The decisions will be taken only on the basis of well checked information and certified by an external auditor.
7. Changing the credit terms and conditions must take into consideration rather to be covered with collateral than the increase of credit that pushes more the burden of the

debt and puts in danger the positive effect expected from restructuring process.

8. Selling the debts to third parties on the secondary market will be made under the condition that the new creditor will not stop the restructuring process approved at the beginning by old creditor.

Banking restructuring aims to achieve several often conflicting objectives: avoiding bankruptcies of the credit through accumulation of inefficient credits, avoiding the credit crunch, improving the efficiency of the banking intermediation level.

Banks are in front of two major categories of issues: stock and flow as follows: the stock problem implies the banking balance sheet administration so that the volume of own funds will increase and the inefficient credits will be eliminated. The flow problem is addressed to improve efficiency, the methods of evaluating the credit quality so that the banking balance sheet will not be deteriorated again.

The lesson drawn from the recent global crisis showed the necessity of a stronger government intervention in key domains of the economy (financial, industrial, transportation) through massive injections of capital to blur the effect of the crisis and initiate economic recovery.

The crisis can be seen as a restructuring opportunity for the sectors marked by low efficiency and high costs

and a separation of business with growth potential, circumscribed to the concept of sustainable development from the areas already marked by decline.

Restructuring will also distinguish the banks that will be appreciated in light of the number of business saved and made viable after the transit of the crisis.

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