The Financial Restructuring and Recovery (FRR) function in banks

Relevant topics for and recommendations to Ukrainian banks

Rob Wijman

October 2017

Introducing Rob Wijman

- 40 years banking experience in retail and wholesale
- variety of Front Office and Risk Management positions
- 20 years international credit restructuring experience
- 1st position: cashier Nederlandse Crediet Bank (job level 2)
- last position (beginning 2008 – end 2015): global head of global credit restructuring at ING (bank general manager)
- responsibilities included managing the global workout activity, quarterly bankwide setting of loan loss provisions and being core member global credit committee
- Frequent presenter / trainer at various “in house” events (banks, law firms, big four) and international conferences
- Civil law master’s degree from Erasmus University (1986-1991)
- Keen bridge player on national top level

Purpose of the FRR function

Topic

FRR is part of the bank's overall strategy and Credit Culture

Best Practices for FRR – Content, Structure and Culture

Learning objectives: getting an understanding of

- FRR core strategy in a values driven (bank) credit culture
- FRR as key (commercial) pillar in the lending cycle
- FRR place in and support from the organisation
- (The role of) Conflict and some other Critical Considerations for the bank

The time required for this presentation is approximately two hours

FRR function - Agenda

1. Government support?
2. Where does the FRR function sit in the bank organisation
3. Tandem FRR – Front Office (FO) including Golden Rules for Co-operation
4. Internal organisational support for FRR
5. Risk Management tools to monitor possible credit deterioration, when to transfer to FRR, and the 1st, 2nd drill and 3rd drill
6. Sources of Conflict and Dealing with Conflict
7. Critical Considerations for the Bank
8. Do FRR techniques and principles work in Ukraine?
9. Lessons Learned (an overview of bank's repeated mistakes)
10. Summary and conclusions

1 - Government support?

Wijman Advisory & Training

- Government support in a countrywide systemic bank crisis may include:
- Effective clean up and closure of unviable individual financial institutions (ARCO)
- Provide supervision and support over individual corporate problem situations (India)
- Promote an effective, reliable and relative creditor-friendly legal framework
- Create a bad bank to isolate NPA's (Bank NY Mellon (US), Sweden, NAMA (Ireland), Sareb (Spain), Russia): mixed experiences, and increases government debt level
- "Collective" approach hampered by individual banks' disagreements
- In case of debt-to-equity conversion, little natural "problem solving ownership" and/or possibilities to sell equity share
- Conclusion: you're on your own!

2.1 – FRR place in the bank organisation

Wijman Advisory & Training

- First look at overall bank strategic priorities: do they focus on (short term) profitability, asset quality or growth and market share?
- Is the bank's Credit Culture values driven (long term focus), immediate-performance driven (short term focus), volume / production driven or unfocused? A combination is possible!
- When values driven, FRR core business strategy will aim at win-win situations: focus on improving and cementing the client credit relationship, while safeguarding the bank's financial position and reputation
- Realise that the lending cycle has three parts (i) Origination (ii) Monitoring and (iii) Collection
- Loan losses are due to (i) (too agressive or inexperienced) origination (ii) lack of proper monitoring and (iii) inadequate restructuring and recovery function and methods
- FRR staff should be highly qualified, with ample experience in dealing with corporates in distressed times

2.2 – FRR place in the bank organisation

- FRR function in practice is found in FO, RM or Legal – but where should it be?
- FRR, as “Money-saver” and “Money-maker”, is a commercial activity.
- And belongs in the (Commercial) Front Office or in Risk Management. Legal is a support function
- Pros and cons of vesting FRR in FO respectively RM:
- Ability to measure financial results and setting remuneration
- Internal transfer pricing of distressed loan assets
- Agressive / opportunistic (Private Equity style of NPL management – reputation - Tomlinson report) versus defensive / prudent behavior
- Consequences for Client Centricity and One Bank priorities
- Senior management trust in FRR function “doing the right things”
- FRR vested in RM as win-win combination for safeguarding client relationship and (financial) sustainability of the bank

3 - Tandem FRR / Front Office (FO) including Golden Rules for Co-operation

- Front Office (FO) and FFR – different commercial approaches (in (i) Who has the problem? And (ii) Management of other banks)
- FO responsibility to involve Risk / FRR
- FO remains involved in direct client management
- Transfer of total Obligor Group Exposure
- Kick off meeting on deal principals and strategy
- FO deal principal responsible for mid- and back office tasks
- FRR deal principal responsible for all Risk activity and decisions
- End responsibility lies with FRR deal principal
- Troubled client management has priority over new deals
- Vice versa involvement and information sharing between FO and FRR
- Escalation procedure

4 - Internal support for FRR

- FRR as Centre of Excellence
- From the dark side to the spotlights (since the 2008 financial crisis)
- Need to act rather quick (sometimes “on the spot”) and therefore requires adequate credit approval authority – with direct access to most senior decision makers
- Transparency and accessibility within the bank – in all directions
- One Bank principles – positioned above individual Business Unit (interests), focus on total bank interest
- Board and other senior management participation in (FRR) team meetings
- Lessons Learned – feedback to the bank organisation
- Staff exchange – need for strong core with additional “fire brigade” task force
- FRR experience as career enhancing move

5.1 - Risk Management tools to monitor credit deterioration

- Responsibility (FO and RM) to monitor and maintain quality of (credit) relationship
- Risk Awareness (“Crisis Timeline”) for Early Warning Signals
- Rating scale and reasons for downgrades
- Watch List as interim phase between “healthy” and FRR portfolio
- Watch List triggers and consequences (payments, quarterly review)
- Watch List migration as KPI for RM
- Mandatory checks on documentation and collateral – at the moment of labelling “Watch List”
- Transfer to FRR memorandum contents

5.2 - When and why to transfer to FRR - the 1st, 2nd and 3rd drill

- Whenever the loan may be or become no longer “money good”
- Good Times Bad Times - ample experience with heavy weather banking and dealing with complicated “multi-creditor workouts”
- Awareness of the Crisis Timeline and consequences
- More distant and objective client relationship
- Balancing the client and the bank interest
- First Drill – the internal “desk top” analysis
- Second Drill – take all necessary (external) steps to identify the root causes of the problems (management, market, industry, balance sheet). Preserve (short term) liquidity, retain professional advisers and organise multi-creditor situations
- Third Drill – implementation and execution of turnaround measures

6.1 - Sources of Conflict

- Transfer to FRR normally comes with internal *and* external tension
- FRR capacity in times of (too) big problem loans inflow
- Denial of problem situations, “Problem” Labels and Downgrades, Image of “Business Prevention Unit”
- Realistic and perceived Enterprise and Equity value
- Disparity in creditors’ ranks (different positions / agendas)
- Legal and financial advisors, other outside experts and their costs
- Bringing in outside investors
- Compliance, Confidentiality and Publicity constraints (lithmus test: “How would this look in the newspaper?”)

6.2 - Dealing with Conflict

- FRR = Balancing Act – Stick and Carrot - but don't misuse power
- Acting too soft leads to a sub-optimal deal for the bank. Acting too hard leads to (more) conflict, legal actions and negative press
- Manage expectations in a professional way – professional communication often makes the difference between success and failure
- Professional communication means clear, consistent and candid communication
- Sharing in (some of) the burden
- E = Q x A (!)
- 1st law in problem solving
- Don't take it personally

7 - Critical Considerations for the Bank

- First dilemma: do I continue support - or do I withdraw and may have to liquidate at the moment the company’s assets have their lowest value?
- Financial and reputation damage control
- Where are we on the Crisis Timeline (and who is in control)
- Position shareholder and other creditors
- Making the right choices: Plan A – Plan B – Plan C
- Plan A / B going concern (B: Lender Led) and Plan C exit / recovery
- In Plan A / B: align stakeholders to keep confidence and stay with the company
- Show leadership and promote leadership in the creditor group

8 - Do typical restructuring tools and techniques work in Ukraine?

Wijman Advisory & Training

- ***Standstill***: often informal / unilaterally announced rather than formally agreed
- ***Retaining financial and legal advisors:*** choice of advisor and mandate
- ***Independent Business Review:*** time consuming process
- ***Transparency and full disclosure***
- ***Cash control***
- ***Amend and Extend:*** or rather “Delay and Pray”?
- ***New equity***
- ***Going concern solution with existing management and UBO (Plan A)***
- ***Lender led solution (Plan B)***: the pros and cons of having shares and control
- ***An improved Risk/Reward balance***
- ***Sharing the burden principles:*** requires reliable estimations of enterprise value, equity value and where the value breaks, transparency and a clear, creditor-friendly (Ch. 11 type of) insolvency framework

9 - Lessons Learned (an overview of banks' repeated mistakes

- Early warning signals / Red Flags
- Leverage / debt structural issues
- Liquidity / cash flow issues
- Documentation issues
- Syndication / other lenders issues
- Ownership / Management issues
- Industry / Market specific issues
- Collateral / Legal issues
- Creative Accounting / Fraud
- Other reasons for loan losses

And remember, it's the bad times when lessons are learned…

10 – Summary and Conclusions

- **Content**
- Monitor (deteriorating) risk profiles - and act upon them
- Make the right choices (Plan A – Plan B – Plan C)
- Restructuring principles and tools
- Lessons learned
- **Structure**
- FRR as key commercial activity needs independent senior level in the bank and an appropriate approval mandate
- FRR has strategic lead in workout situations, in tandem with FO
- **Culture**
- FRR profile, visibility, transparency and accessibility
- FRR core business – balancing the bank interest and the client interest – should fit in a values driven bank strategy / credit culture and should safeguard both client / relationship banking as well as the bank's financial position (win-win)