INSOL International

What Will Next Time Look Like?

May 2019

FINANCIERS' GROUP SPECIAL REPORT

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INSOL International
6-7 Queen Street, London, EC4N 1SP
Tel: +44 (0) 20 7248 3333 Fax: +44 (0) 20 7248 3384

Acknowledgement

INSOL International is very pleased to present this Special Report titled 'What Will Next Time Look Like?'

The INSOL International Financiers' Group, which includes representatives from more than 20 different financial institutions, debt providers and professional advisors from around the world devised this technical project to consider the impact of certain changes that have taken place since 2007 in financial institution regulation in relation to capital requirements and impairment recognition and how these changes may affect the way in which restructuring transactions are carried out in the next recession. The topic also formed the basis for a panel discussion at the INSOL International and INSOL Europe Financiers' Groups' inaugural joint seminar which took place in November 2017 at the London office of the Commonwealth Bank of Australia.

Following on from these discussions, the Project Leader, Stephen Foster assisted by Margaret Kemp both of Hogan Lovells, London prepared a set of questions which invited comment on the possible and likely impact of the changes including: the ability of banks to hold distressed debt; the increasing role in the market of alternative investors; the effect of this on the restructuring process (including the effect on debtors) and the behaviour of those credit and financial institutions in the next downturn as a result. A number of different market participants were invited to contribute to the project and this report includes responses from individuals from different types of institution in the credit markets along with relevant professional firms from a number of jurisdictions around the world.

INSOL International sincerely thanks the contributors who included Eric Cloutier, Head of Regulatory Banking, KPMG Ireland, Tom Glynn, Head of Restructuring Banking, KPMG UK and E. M. (Jake) Williams of Standard Chartered Bank, Hong Kong and Anne M. Peterson, VP Senior Legal Counsel, HSBC Bank, US for providing their valuable input in responding to the questions and Stephen Foster for leading the project and for facilitating the compilation of a range of interesting views and reactions from different market participants in relation to a topic that our members will no doubt find extremely interesting.

May 2019

Foreword

Introduction

Following the economic crisis of 2007 / 2008 / 2009, regulators and other bodies have sought to strengthen and safeguard the stability of financial institutions in an attempt to remove the risk of future taxpayer funded bail-outs, to end the "too big to fail" mentality within financial institutions and to restore public confidence in the financial sector. In particular:

- capital requirements for financial institutions have been increased;
- IFRS 9, an International Financial Reporting Standard promulgated by the International Accounting Standards Board (IASB) which came into force in January 2018, introduced a new standard for loan loss provisioning based on "expected credit losses";
- globally, but in Europe in particular, authorities are concerned over the level of non-performing loans (NPLs) held by financial institutions. Retention is seen as impacting the profitability of the financial institutions and their ability to lend, and generally hindering economic recovery. Work is underway on a number of initiatives, including to provide guidance to regulated financial institutions on the way in which NPLs should be monitored and reduced, to investigate ways in which secondary markets for distressed debt can be improved and to impose enhanced disclosure requirements on asset quality and NPLs.

The purpose of this technical project is to bring to the attention of the restructuring community these aforementioned changes to capital requirements and impairment recognition by financial institutions that arise as a result of the introduction of IFRS 9 and to comment on the possible and likely impact of these changes on the ability of banks to hold distressed debt, the increasing role in the market of alternative investors, the effect of this on the restructuring process (including the effect on debtors) and the behaviour of those credit and financial institutions in the next downturn as a result.

INSOL International Financiers' Group, which includes representatives from more than 20 different financial institutions, debt providers and professional advisors from around the world invited a number of different market participants to contribute to the project and provide their responses to a set of questions which invited comment on whether they believe that the changes that have taken place since 2007 in financial institution regulation will affect the way in which restructuring transactions are carried out in the next recession, and if so in what way. The following report includes responses from individuals from different types of institution in the credit markets along with relevant professional firms from a number of jurisdictions around the world.

Impact of IFRS 9 and capital requirements on financial institutions

Change of approach to distressed borrowers

Contributors to the project were invited to consider whether the increased level of capital that has to be maintained by regulated financial institutions (RFIs), when combined with the requirements of IFRS 9 and the pressure, certainly in Europe, for RFIs to reduce the levels of NPLs that they currently hold, will affect the willingness of those institutions to retain debt provided to a borrower which becomes financially stressed.

Will the capital consequences of IFRS 9 in particular cause RFIs to change their approach to supporting distressed borrowers and providing new money, for example, or is it more likely that there will be increased NPL activity to release capital provisions?

The effective date for the introduction of IFRS 9 (which replaces international accounting standard IAS 39) was 1 January 2018. Under IAS 39, RFIs were required to recognise impairments based on objective evidence of credit loss, using an "incurred loss" model.

The limitation of the "incurred loss" model is that it potentially delays the recognition of credit losses until there is evidence of a trigger event. During the financial crisis this ability for financial institutions to postpone losses caused concerns for regulators and led to the call for and eventual introduction of a forward-looking impairment model.

IFRS 9 introduces a new standard for loan loss provisioning based on an "expected credit losses" standard, which requires recognition of the effects of possible future credit loss events in relation to the loan and taking into account factors such as forecast information about the loan and the sector. RFIs can no longer wait for a default or other trigger event to have occurred before making a provision against a loan.

In order to phase in the impact on capital of the introduction of IFRS 9, the Capital Requirements Regulation (575/2013) (CRR) capital rules were amended to allow for a transitional period, during which time RFIs will be allowed to add back a certain amount to their capital position over a five-year period. The transitional period applies to impairments that increase due to IFRS 9. The European Banking Authority EU-wide Stress Test Results in November 2018, covering 48 banks, took into account IFRS 9 for the first time. It found that the negative impact of IFRS 9's first implementation on their capital ratings is 10 basis points (bps) on a transitional basis and 20 bps on a fully loaded basis. However, the stress tests found that the aggregate impairments for performing (as opposed to defaulting) exposures increased by 50%.

Different strategies in relation to loans

It is likely that the increased capital that RFIs will be required to hold against impaired loan assets will result in those RFIs considering different strategies in relation to loans.

One impact of IFRS 9 will be that the cost of providing loans where there is an increased lifetime expected loss will increase. In addition, the credit decision to provide new money lending to a distressed borrower will be made more difficult and capital intensive as a result of the original lending impairment. This may well cause RFIs to reconsider whether new money lending in rescue situations is viable, even if, for example, it has super-senior status.

The other most significant change is likely to be that RFIs will take the decision whether to hold the loan or not at an earlier stage than is currently the case, because the impairment required may increase as a result of the "expected credit loss" standard. RFIs may (to the extent they have not already) divide their book into core and non-core assets and dispose of non-core assets either through a portfolio sale or to an asset management vehicle (AMV) even before a borrower becomes stressed or distressed. This could significantly impact certain market sectors, such as retail or real estate, whose economic performance may be affected particularly badly in a downturn. This will, no doubt, create opportunity for debt funds interested in acquiring NPL portfolios in the future. As more jurisdictions set up AMVs to assist RFIs in the reduction of their NPLs, contributors are asked to consider will a difference of approach develop between debt funds (who have acquired debt from RFIs) and AMVs when it comes to restructuring the debt?

The impact on debtors is likely to be that their lenders may be less likely to provide rescue financing themselves because of the increased capital costs and, if they sell as an alternative strategy there is a higher risk of more participants in the debt structure which could make it more difficult for borrowers to agree a consensual restructuring. The decrease in the regulators' willingness to encourage the following of the London Approach principles[1] by all market participants may also make a work out less feasible. There may need to be an increased reliance on cram down type schemes or equivalent arrangements in non-UK jurisdictions in order to implement restructurings which might otherwise have been consensual. This could make the implementation of a restructuring more cumbersome, expensive and uncertain if a consensual solution cannot be found. In order to retain a level of control over any process, debtors should consider the restrictions in debt documents on trading more carefully with the introduction of "white lists", for example, or other consent restrictions on trading where commercially possible.

Impact of increased levels of distressed debt held by secondary markets

At the moment, many debt sales (whether through the secondary markets or through loan portfolio transactions) are to debt funds who are much less regulated than the RFIs. Although there are a number of jurisdictions where debt funds are not able to hold debt without a licence, the EU is considering ways in which the European secondary market for distressed debt can be improved and that may include the removal or relaxation of such impediments.

Contributors are asked to consider whether as distressed debt funds acquire significant levels of distressed debt in the secondary market, will authorities take steps to regulate those funds? If regulation is thought likely, what form will the regulation take?

Once a borrower's debt starts being traded on the secondary market, the size of the syndicate can increase significantly. The use of sub-participations can mean that a borrower does not have visibility as to who its lenders are. Debt funds can have a different approach to debt restructuring than RFIs. Contributors are asked to consider whether these elements will make it more difficult for borrowers in the future to achieve a successful restructuring of their debts. For example, where the debt is mainly held by debt funds is there a risk that no co-ordination committee will be formed or that no debt fund or funds will be willing to drive the restructuring forward?

If debt trading causes a loss of cohesion in the creditor group, are equity sponsors and other investors (both in place and potential new money providers) less likely to want to make any investment either in terms of time or funding to see through a successful restructuring?

The consequential fragmentation of the pool of loan providers may impact on the ability of a lender group to reach a consensual solution in a restructuring when the value start point for creditors who have bought into debt is different across the creditor group and this may lead to more difficult restructurings. We have seen a developing trend of loan sales when a consensual restructuring begins and we anticipate this trend continuing.

Effect of increased regulation on financial institutions' global growth policy

Increased regulation may hinder the ability of some RFIs to maintain a global growth policy. Contributors are asked whether they agree, and do they think that that might negatively hinder economic expansion for some jurisdictions? Most contributors considered that this may be true at least in relation to the smaller banks and may impact on lending in certain sectors such as SME.

'…If increased regulation, in particular with regard to lending guidelines and restructurings, restricts the flow of capital to businesses and hinders needed corporate restructurings, such regulation would restrict growth.'

[1] A set of general non-binding principles developed in the 1970s by the Bank of England that govern how a company's bankers and, when appropriate, its other creditors should respond to news that a company to which they are exposed faces serious financial problems.

'…Increased capital requirements (and fear of risk) have driven RFIs away from this [SME] space and also away from supporting demonstrably beneficial, but lengthy, restructuring plans.'

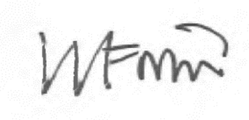
'…I think regulation has hindered economic expansion in some jurisdictions but growth opportunity exists despite these challenges.'

Conclusion

This paper contains the viewpoints and reactions of different types of institutions in the credit markets, along with relevant professional firms. The principals each view the impact of IFRS 9 and increased capital requirements from their own individual perspective as advisors, creditors or funds and each of them see different opportunities or challenges, but are united in their view that it will make a significant change to the credit and restructuring markets.

An equivalent change to IFRS 9 will happen in the US in December 2019 and it will be interesting to see whether the US market reaction mirrors that in Europe. As the transitional arrangements run off, the increasing capital requirements based on additional impairments will certainly have an effect on the behaviour of RFIs which will change the restructuring landscape in the next downturn in the ways highlighted in this paper, creating significant opportunities for buyers of debt, but that poses a question as to whether it may become more difficult to reach agreement on a consensual restructuring without using formal processes such as schemes of arrangement and moratoria. In a complex cross-border restructuring the use of a moratorium-based procedure may therefore become more common to impose restructuring solutions on minority creditor groups, rather than seeking to agree a consensual solution. As a result, restructurings may very well need to be driven more by formal processes next time there is an economic downturn. This is, in all probability, a trend that will continue to grow and develop.

Whilst the following report includes responses from individuals at different types of institutions in the credit markets along with relevant professional firms from a number of jurisdictions around the world, these responses represent the views of the individuals concerned and should not be taken to represent the views of their institutions or firms or of INSOL International.



Stephen Foster[*]
Partner
Hogan Lovells, UK

[*] The views expressed in this Report are the views of the authors and not of INSOL International, London

What Will Next Time Look Like?

1. Financial institutions have traditionally supported stressed and distressed corporate borrowers to allow time either for a turnaround of the business or an orderly liquidation. Do you think that the increased level of capital that has to be maintained by regulated financial institutions (RFIs), when combined with the requirements of IFRS 9 and the pressure, certainly in Europe, for RFIs to reduce the levels of NPLs that they currently hold, will affect the willingness of those institutions to retain debt provided to a borrower which becomes financially stressed? Please give reasons for your views.

1.1 Response from an accountancy firm - Europe

Yes, but a lot of factors are at play.

Firstly, there are numerous distinctions to be made between RFIs, such as whether an RFI is a Significant Institution (SI) supervised by the Single Supervisory Mechanism (SSM); whether it is defined as "High NPL" by the ECB under its Guidance to Banks on NPL management issued in March 2017 (the ECB Guidance); and the actual composition and characteristics of the RFI's non-performing and / or forborne loan book.

In general terms, it is expected that the combination of new accounting, supervisory and prudential treatments of NPLs[1] will increase the amount of required provisioning, resulting in increased capital requirements by RFIs. The impact of the increased level of capital requirements must also be evaluated with the broader qualitative regulatory requirements and expectations for NPLs, which together makes it increasingly costly and complex for banks to retain stressed debt on their balance sheets. Ultimately, holding NPL stocks is likely to negatively impact predictability of earnings and to reduce profits.

Thus, it is expected that these factors will increasingly impact the willingness and / or ability of RFIs to retain debt provided to a borrower which is expected to or becomes financially distressed. We have already observed a considerable increase in the level of distressed asset sales in Europe in recent years and we foresee more to follow in coming years (including creative new deal structures to tackle new NPL flows as they arise).

In terms of provisioning for NPLs and managing the capital implications of holding NPLs, RFIs must navigate a broad range of new measures. While High NPL SIs were initially mostly pressured by the SSM to increase their NPL provisioning levels and to deleverage their stocks, the pressure has now extended to all SIs supervised by the SSM. Moreover, recent changes in the Capital Requirements Regulation (CRR), the legal framework governing the prudential rules for credit institutions and investment firms, has introduced another layer of provisioning requirements to be applied uniformly across all institutions of the EU.

- The ECB Addendum to the ECB Guidance, published in March 2018, defines further the ECB's supervisory provisioning expectations for the 118 SIs supervised by the SSM. This guidance applies to all exposures newly classified as non-performing from 1 April 2018 onwards. The ECB requires (in a blended approach) for the unsecured part of exposures to be provisioned at 100% after 2 years and for the secured part after 7 years, starting at year 3 and increasing gradually. Compliance is to be assessed on a bank by bank basis and within the broader supervisory expectations of the ECB. Banks

[1] More specifically for Non-Performing Exposures (NPEs) but for simplification and consistency of terminology across the answers we will refer to NPL.

which are within scope will be required to inform the ECB of any deviations from these expectations from early 2021 onwards, as part of the ECB Supervisory Review and Evaluation Process (SREP) supervisory dialogue, with the expectation that any shortfalls would be reflected in Pillar 2 capital requirements.

- In addition, the ECB provided further bank-specific supervisory recommendations for the minimum provisioning of NPL stocks (i.e. those classified as NPLs prior to April 2018) in the 2018 SREP letters to a large number of the RFIs under its supervision. While this provisioning requirement is bank specific, it follows a similar blended approach. Looking at the results of the SREP letters across RFIs in Europe we can observe an overall trend of requirements for full coverage of the unsecured part of NPLs between 2023 and 2025 (depending on the particularities of the RFI) and between 2024 and 2026 for the secured part.

- In April 2019 the European Parliament also adopted a text amending the CRR, which introduced minimum provisioning levels for newly originated loans that become non-performing. This measure is applicable to all EU credit institutions and investment firms and also covers institutions active in the secondary market. This "backstop" consists in the reduction from CET1 capital to account for insufficient provisioning of individual NPLs (i.e. the difference between the level of actual coverage and a defined minimum coverage requirement over time). Once again, a different provisioning calendar is introduced, but of longer timespan than the ECB calendars. Unsecured exposures are expected to be provisioned at 100% from (day one of) year 4 following NPL classification, while provisioning of secured exposures starts from year 4 with full coverage after 8 to 10 years.

These new regulatory and prudential rules introduce an additional layer of complexity when considered together with the IFRS 9 accounting requirements. While these supervisory and prudential expectations for NPL provisioning do not intend to replace (or conflict with) accounting requirements, they might lead to the need to maintain higher levels of prudential provisioning for some banks, with possible Pillar 1 and Pillar 2 impacts for non-compliance. It is also evident that the European regulators would like to see the prudential capital calculations and the accounting implications align as much as possible.

Moreover, the volatility of earnings resulting from the ongoing application of IFRS 9 is also expected to impact the way in which banks perceive financially stressed exposures. The measures with regard to the impairment of long term NPLs and IFRS 9's requirements to recognise material changes in credit risk are likely to bring the carrying value of distressed credits nearer to market value and thus increase the likelihood that a RFI will want to dispose of such distressed credits.

It is therefore likely that the cost for RFIs of supplying credit through a cycle will increase, as will the volatility of bank earnings, unless NPL pre-emption and management is better embedded throughout the entire credit lifecycle, with a series of integrated measures in place to tackle more efficiently and effectively new flows of different types of NPLs as they arise.

1.2 Response from a multinational RFI - Australia

RFIs will always try and work with and support corporate clients facing distress. This is the case for relationship and brand protection, but also because it is the right thing to do. The increased levels of capital allocation for poorly rated loans will make it far more challenging for RFIs to enter into long term 'workouts', especially in circumstances where rehabilitation to 'good bank' is unlikely. RFIs will therefore be looking for opportunities to recover loans in the shortest possible timeframe, and this will potentially be effected via the debt trade process.

1.3 Response from a debt fund

Increased risk weightings of stressed or distressed debt indeed should result in a more aggressive divestment of such loan positions by RFIs. However, for corporate debt positions, there will continue to be two major mitigants to this incentive for faster divestment of NPLs and stressed loans:

- Reluctance of RFIs to sell at a market-clearing price that would crystalise a substantial write-down.
- Decentralised decision-making that empowers RFI relationship managers to resist the sale of debt of a long-standing client of theirs / the RFI.

I therefore think the more immediate impact of the changes in accounting and regulatory rules will be the continued increased penetration of private lenders into the term loan market. RFIs will be increasingly selective in their corporate lending and continue to move away from the mid-market.

1.4 Response from a multinational RFI - Asia focused

This is absolutely true. RFIs are now far less willing to retain debt owing by distressed borrowers because of the associated (arguably punitive) capital requirements. While any reasonable discount rate could show that the PV of holding and working through a turnaround strategy for a distressed borrower might be better than simply selling, the immediate capital benefit of selling - even at an excessively high discount rate - overwhelms the projected (and uncertain) economic benefit of holding and restructuring the debt. Additionally, selling the debt rather than restructuring it provides a final solution which is much less likely to be second-guessed. There is currently a widely pervasive driver for individuals in RFIs to minimise personal risk by avoiding the personal responsibility of "brave" decisions. This is exacerbated by the depletion over time of experienced workout and restructuring personnel within RFIs as well as the desire and habits of younger staff to seek a quick, digital solution to all problems - despite the fact that these may neither be possible nor provide the best solution.

1.5 Response from a multinational RFI - Africa

Africa, by virtue of the history and economic development journey of each country therein is, in general financial terms, perceived to be both more and less risky than the developed economies of the world. When I say more risky, I mean that the probability of default is higher because of the current status quo; when I say less risky I mean that when you take our young population, the digital revolution and the mineral wealth still to be released, the future trajectory of the Africa economies is perceived to be optimistic because of what can be in the future. One sees Governments across Africa playing significant economic roles – including borrowing against the perceived optimistic future, encouraged by the wash of liquidity from developed first world markets chasing yield. Whilst lenders may consider that they are being responsible by allocating only small portions of their portfolio to high risk bets and mitigating the risk through making the bonds long dated to (hopefully) catch the upward African wave, any delays in realising the future, triggering default, can be catastrophic to the country and millions of people concerned. Mozambique is one instructive example with the delayed development of its gas economy and the Tuna bonds. From an Africa perspective expect to see large scale Sovereign level / State owned entity business restructuring featuring over the medium term. In a more traditional sense, whether the introduction of IFRS 9 is likely to have a material impact – particularly given that these are higher risk / higher default portfolios – remains to be seen, It may potentially introduce unintended increased volatility into commercial banks – many countries have highly competitive banking markets characterised by a high number of small local competitors so one outcome might be local consolidation in the sector, with that taking place before central banks look to set up asset management vehicles. Another outcome might be that Central Banks delay implementation and maintain or tighten traditional regulations that have required aging based impairment-taking (90 days 10 / 20%; 180 days 50% and 365 days 100% and write off compulsory a year later) and which have worked very well, rather than risk the shock to capital when bucket 2 under IFRS 9 is triggered.

The situation in Africa is no different other than that higher lending spreads allow higher NPL ratios – a number of countries have central banks exerting pressure / implementing regulations to keep NPL ratios below 5%. Banks are highly geared, highly regulated businesses – the increased capital requirement drives down return on equity resulting in short and long-term measures to cover costs of capital. One option is to sell off triggered debt. Another is to reduce costs elsewhere – most likely staff and rental costs – to counteract the increased cost of capital. This means that there may be increased pressure to move to automation / digitisation and focus on vanilla product delivered online / via app.

1.6 Response from a multinational RFI - USA

RFIs may be rethinking their approach to troubled credits, but not giving up on companies because of the new requirements. Consider, for example, the oil & gas industry. Traditional lenders are still very much involved in the distressed credits. IFRS 9, while it may mean provisioning occurs sooner than under GAAP, the amount of such provisioning may be less than GAAP. Lenders are likely becoming more creative in approach particularly with shorter maturity credits.

2. If yes to question 1 above, do you think those RFIs will look to dispose of the debt on the secondary market or perhaps commence insolvency or enforcement proceedings at an earlier stage than is currently the case? In other words, are RFIs less likely to be willing to offer support to a distressed borrower? If a syndicate is comprised of RFIs, are they all likely to want to sell debt at the same time and is that going to affect the price of that debt?

2.1 Response from an accountancy firm - Europe

As for question 1, there is no plain vanilla answer. Overall the answer is yes, but the level will depend on the particularities of the RFI and the jurisdiction in which it is located.

The location of the RFI, its level of NPLs, the actual size and composition of the NPL portfolio, the capital robustness of the RFI, the proficiency of the RFI's NPL management practices (including whether the RFI has people in the team with the right skills and suitable infrastructure) and the particularities of the secondary market and the local servicing market will all contribute to defining the institution's NPL and non-core strategy. It will also depend on the broader strategy of the RFI with regard to each particular distressed borrower, and the assessment of whether a better recovery would be made internally, having the exposure serviced (restructured) externally or by selling the debt to a third party.

As a result of regulatory pressures to de-risk their balance sheets, high NPL SIs in Europe have been very active in recent years, disposing of assets earlier and more frequently than lower NPL SIs. The larger institutions with high level of NPL stocks were able to put large NPL portfolios to the market, attracting international investors and contributing to a now relatively robust transaction market for most EU jurisdictions. Smaller institutions, therefore, also now find it easier than in the past to offload their (smaller) NPL portfolios.

The supervisory and prudential provisioning requirements put in place recently in the EU are expected to further fuel the NPL transaction market, with RFIs as a result more willing to dispose of their NPL portfolios as provisioning increases over time (especially if the costs of keeping the assets on their balance sheets outweigh the foreseen upsides).

European markets however still remain fragmented in terms of national legal systems and the capacity of the judicial process. Impediments (direct or indirect) such as inadequate enforcement and insolvency regimes and / or long enforcement and court proceedings still make it harder for institutions in these jurisdictions to sell on the secondary market.

In the case of syndicated loans, it depends greatly on the syndication agreement and the direction the syndication agent takes with the credit. It also depends on the composition of the syndicate (the number of RFIs and the level of each RFI's commitment). That said, overall, more aligned provisioning pressures (resulting from the prudential and accounting requirements) will minimise discrepancies in recovery expectations by the individual participating RFIs in the syndicate, facilitating the alignment of the RFIs' interests and objectives to sell the exposure when necessary. For example, the potential movement of a credit to stage 2 or stage 3 might lead a syndicate comprised of RFIs to seek to sell the debt at the same time, temporarily lowering the price in the secondary market of that debt.

2.2 Response from a multinational RFI - Australia

The appetite for RFIs to dispose of debts on the secondary debt markets (SDM) will increase. I think that the SDM will be far more appealing for RFIs, in most cases, than relying on the enforcement of security. RFIs are loath to enforce in the current environment unless left with no alternatives.

2.3 Response from a debt fund

As noted above, I am sceptical that bank behaviour will be noticeably different than it has been during the last three years with respect to stressed and distressed large corporate loans. However, I do think we will see more rapid disposals of distressed SME and consumer loans.

2.4 Response from a multinational RFI - Asia focused

I agree. RFIs will look to dispose of the debt on the secondary market or perhaps commence insolvency or enforcement proceedings at an earlier stage than is currently the case, with earlier sales being driven by both IFRS 9 and risk-weighted asset (RWA) requirements. Again, the desire to achieve a quick (digital) solution that cannot be easily or immediately criticised is a big driver. I think that a “herd mentality” is perhaps contributing to depressed secondary distressed debt market prices.

2.5 Response from a multinational RFI - Africa

It depends on the business strategy followed by the affected RFI – is it a relationship strategy or a commoditised product strategy? RFIs that follow a relationship strategy may be able to use those relationships and become smarter at identifying and addressing distress before bucket 2 triggers occur, but absent that they expect to see customers through the cycle. Where there are no deep relationships, we may see more encouragement by RFIs for customers to rebank or see the sale of debt by the RFI.

2.6 Response from a multinational RFI - USA

Agree that there are too many other factors to consider than IFRS 9 implications. The overall prognosis for a counterparty's return to sustainability will remain the driving factor but other influences like sector outlook and portfolio concentrations will continue to be important. Notwithstanding, if all traditional lenders are seeking to sell debt at the same time, the dramatic increase in supply is sure to have an impact on pricing.

3. Do you think RFIs will (to the extent they have not already) divide their book into core and non-core assets and dispose of non-core assets either through a portfolio sale or to an asset management vehicle (AMV) even before a borrower becomes stressed or distressed? Please give reasons for your views.

3.1 Response from an accountancy firm - Europe

It depends and is impacted by a series of intertwined factors as explained above.

As mentioned earlier, it is becoming increasingly complex and costly for RFIs to hold NPLs, which we foresee will increase the need for these institutions to be more pragmatic and systematic with new flows of NPLs. More embedded NPL solutions will be required, to be closely linked to the exposure's life cycle and aligned (amongst others) with the broader strategy and risk appetite framework of each institution. Structural solutions (such as the transfer of assets into an AMV or other vehicle) are therefore expected to continue to be relevant on a case-by-case basis, but also more elaborate deleveraging structures will continue to develop.

In addition to the more stringent provisioning requirements, more prescriptive regulations are also now requiring RFIs to implement and imbed robust NPL management practices within their business and operations. These bring another level of complexity and costs to holding NPLs and are already seen to contribute to further transactions. For example:

- The publication in March 2017 of the ECB Guidance to Banks on NPL Management (ECB Guidance) requires the SSM supervised banks to align to defined best practices. Compliance is assessed on a case-by-case basis by the ECB as part of the SREP review and via on-site inspections. Non-compliance (and failure to explain discrepancies) can lead to Pillar 2 impacts. These rules have already been putting additional pressure (and will continue to do so) on SIs to be more strategic and pragmatic about their approach to 'unlikely to pay' (UTP), distressed and forborne exposures.

- The European Banking Authority (EBA) also published guidelines on non-performing and forborne exposures, effective from June 2019, which will extend similar rules to the ECB Guidance to all RFIs in the EU. While the concept of proportionality will be applied, it is likely that smaller RFIs will find it more difficult to retain debts relating to borrowers which become financially stressed due to the added complexity and costs their management entails. Many of these smaller RFIs' operations and procedures will not be aligned to the regulatory requirements and will require levels of improvements and scale of investments that they will not be able to afford. These RFIs will therefore have to revisit their risk appetite for some asset classes and ensure that they systematically divest UTP and new NPLs. We are already seeing smaller RFIs exiting some markets and this will add to that pace.

- The upcoming (2019) EBA guidelines on loan origination, monitoring and internal governance will also link better credit underwriting practices to the need to implement pre-emptive and forward looking NPL resolution and deleveraging strategies per clusters of risks.

RFIs must therefore now carefully weigh more closely benefits and costs of holding vs selling sub-portfolios, considering the added complexity of managing such exposures and the potential capital implications of keeping them on the books. The way in which these assets will be managed and / or disposed of will, however, depend on a broad range of considerations. The decision as to whether to sell loan portfolios (stressed or distressed) will depend amongst other things on the broader strategy of the RFI, its risk appetite framework, its internal operating structure, the composition of its actual portfolio and the demand in the NPL market for acquiring (and servicing) such portfolios. The division of assets into core and non-core (as opposed to simply selling portfolios) will also be a function of these broader strategic and structural considerations.

We have already observed a broad range of deleveraging solutions (in addition to simple disposal) being implemented in Europe in diverse shape and form, mainly until now to tackle the high stock of NPLs prevailing in the RFIs. Looking to the future, we can anticipate that similar solutions will continue to be implemented by RFIs to deleverage remaining stocks but also to tackle new flows of NPLs.

Many RFIs have for example started implementing automated models and decision trees to support assessment and selection of portfolios to sell. Some banks are also implementing structural solutions to transfer these assets into specialised AMV, which are streamlined and dedicated to deleveraging these portfolios.

We also see more and more capital optimisation structures being implemented in Europe and we expect this trend to continue as banks' regulatory requirements increase. Such structures include (for example) placing the assets into private AMVs, NPL securitisation, the sale of shares in the new vehicles to external investors and partnership with third party servicers. But the decision to move towards a capital optimisation solution and which structure to implement also depends on numerous factors, such as the cost and complexity of implementing such a solution when compared with the potential benefits that such a solution will bring. Once again, the upside will be a function of the size and type of portfolio, defining the structural options available as well as the possibility of removing the assets from the RFI's balance sheet and allowing capital and liquidity relief. In addition, there are still regulatory limitations to such options, particularly as most require regulatory approval (or, at a minimum, positive acknowledgement).

3.2 Response from a multinational RFI - Australia

This is definitely a possibility, as it may enable a RFI to trade parts of its book without the restrictions caused by having 'inside' information. This is not something that is being actively contemplated by my own RFI.

3.3 Response from a debt fund

I do think that largely RFIs have assessed, and continue to assess, which loans, regardless of performance, generate a requisite ROE in light of the capital they are required to hold under IFRS 9 and that they have sold, or will sell, those that they view as economically uncompelling to hold.

3.4 Response from a multinational RFI - Asia focused

I think that most RFIs will do this - and it makes sense, lest the mixing of the two portfolios has a negative impact on both marketing and recoveries.

3.5 Response from a multinational RFI - Africa

RFIs should be doing this anyway as their businesses evolve - regardless of distress of any particular borrower.

3.6 Response from a multinational RFI – USA

The key driver will be the timing and magnitude of the next downturn. If rapid and severe, then the chances of partitioning off and / or "bulk-selling" will be higher, but this would not likely be the case if the next downturn is more moderately paced, such that NPLs can be managed in the ordinary course, barring a major strategic change such as the RFI exiting certain markets or sectors.

4. Do you think more jurisdictions will set up AMVs to assist RFIs in the reduction of their NPLs? If so, do you think that a difference of approach will develop between debt funds who have acquired debt from RFIs and AMVs when it comes to restructuring the debt? If so can you explain what that difference might be?

4.1 Response from an accountancy firm - Europe

We expect to see more AMVs created by RFIs themselves rather than set up on a national level.

These AMVs are more likely to be set up by the RFIs themselves, rather than under the National Asset Management Company (National AMC) framework put forward by the European Commission (the technical guidance on AMC Blueprint published in March 2018). National AMCs are usually most useful when RFIs are stressed or distressed, as they can receive government assistance (for example, state guarantee) to help them free their balance sheets of NPLs more rapidly and attract investors. Participating RFIs are however subject to EU state aid and bank resolution rules, which can have important consequences.

RFI driven AMVs are better structural solutions for viable RFIs, usually starting organically with a single RFI wanting to solve its own problems. This option provides an alternative to direct NPL sales by attracting different stakeholders (i.e. RFIs, investors and servicers) into an optimised and dedicated structure which owns the NPL portfolio and is responsible for managing and deleveraging them. This allows the risks and upsides to be shared and kick-starts investments in unproven or undeveloped NPL markets. This can also allow countering market impediments in some jurisdictions, such as where there are limitations on the transfer of certain asset classes to non-banking institutions. Moreover, these structures might prove attractive as they may potentially allow more portfolios to be added into the AMV in the longer term (from the same RFI or other RFIs).

The creation of AMVs in itself should not impact the way in which debt funds restructure the debt. When debt funds acquire NPL portfolios they do so by creating or using specialised structures, resources and infrastructures, adapted to the portfolio needs to ensure optimum recovery. The decision to restructure or enforce / liquidate depends on the composition of the portfolio rather than the way in which the debt has been acquired. The fact that they acquire shares in existing AMVs or debts from these AMVs should not impact – in essence – how they approach strategy, oversight, or restructuring of the underlying assets. There might however be new structures of partnership created between RFIs, investors and servicers, making the process more efficient and also allowing the debt funds to leverage on the RFIs' resource when relevant.

4.2 Response from a multinational RFI - Australia

Not applicable for my RFI.

4.3 Response from a debt fund

I think we likely have seen the last of the AMVs to resolve the GFC and 2012 / 2013 crises, with the Portuguese Central Bank working through its sale of the BES bad bank assets. With the European economy having shown 2+ years of strength, there is greater resistance than at any point in the last ten years to the state aid that typically accompanies the transfer of assets to AMVs.

4.4 Response from a multinational RFI - Asia focused

I think that more AMVs will be set up. This will not represent a different approach to that taken by debt funds - as long as the applicable local regulations are similar and the AMVs are set up and behave in a commercially sensible manner, rather than with political or other goals. There is, however, no certainty that this will happen in all jurisdictions - and it has not in the past.

4.5 Response from a multinational RFI - Africa

I think more jurisdictions will set up AMVs to assist RFIs in the reduction of their NPLs and that a difference of approach will develop between debt funds that have acquired debt from RFIs and AMVs when it comes to restructuring the debt. Funds are interested in delivering returns to their funders. AMVs are interested in protecting the wider economy – preserving jobs and maintaining financial stability, for instance. The types of people and skillsets / motivations working in funds when compared with those working in AMVs will be quite different.

5. At the moment, many debt sales (whether through the secondary markets or through loan portfolio transactions) are to debt funds that are much less regulated than the RFIs. Although there are a number of jurisdictions where debt funds are not able to hold debt without a licence, the EU is considering ways in which the European secondary market for distressed debt can be improved and that may include the removal or relaxation of such impediments. If that does happen, do you think that there will be an increased appetite for debt funds to acquire distressed debt in the European markets?

5.1 Response from an accountancy firm - Europe

Yes, but more than just ease of licensing is required.

Opportunities will grow for distressed debt funds for the reasons already outlined. The removal or relaxation of impediments such as licensing requirements is likely to improve access to markets and lower cost barriers to entry which were until now more restrictive. That said, we expect this will take some time as most restrictions apply to sensitive areas such as retail and residential mortgages. There are numerous other impediments that affect the successful operation of the secondary markets, both sell-side and buy-side, that need to be kept in mind. Many of these impediments are interconnected and must be tackled simultaneously if any benefit is to be perceived. For example, there must also be:

- adequate and effective enforcement and insolvency regimes;
- absence of tax disincentives (for banks, borrowers or investors);
- transparency of information; and
- an ability for third party servicers to operate in the market (and the availability of such servicers).

As the main impediments are being resolved, as access to the market for investors is facilitated for a broader range of asset classes, as costs of managing the assets by the funds decreases, and as recovery expectations increase, it is likely that credits and markets will broaden and continue to become more attractive over time. It is expected that a broad range of investors and funds will continue to be attracted to investing in what are traditionally less attractive markets and / or difficult asset classes.

The volume available in the market is another limiting factor for many investors, making it difficult to justify investments in embryonic and difficult markets (i.e. no economy of scale possible). In addition to the new European regulatory and prudential provisioning requirements, the foreseen impacts of IFRS 9 of bringing the carrying costs of debt on RFIs' books more in line with market prices is likely to increase potential supply and make volumes more attractive to investors, hopefully contributing to the further attractiveness of these smaller markets.

5.2 Response from a multinational RFI - Australia

I think on most transactions, there is a reasonable appetite. As the debt funds become more knowledgeable about how they value the underlying assets, I am not sure that increased competition will naturally lead to increased prices being offered or more market being created.

5.3 Response from a debt fund

The removal of the requirement of a banking license or fronting bank should increase the appetite of credit funds to purchase distressed debt in Europe.

5.4 Response from a multinational RFI - Asia focused

I believe that this is true, and it would generally be helpful to the banking system and the economy overall. This would be especially true if debt funds develop both the expertise and inclination to consider longer term solutions to unlock the enterprise value in distressed borrowers (both are now increasingly less available within RFIs).

5.5 Response from a multinational RFI – Africa

Lower regulatory cost will generally result in increased returns. Funds and fund managers are driven by / rewarded for returns achieved and if the markets open up there will inevitably be certain funds who are interested in looking at whether the new investment opportunities provide them with the level of return needed.

5.6 Response from a multinational RFI - USA

If the removal or relaxation of impediments such as licensing requirements happens, there will be an increased appetite for debt funds to acquire distressed debt in the European markets.

6. Part of the reason for the increased regulation since 2008 is to remove or at least reduce the systemic risk which can arise when a RFI becomes distressed. If distressed debt funds acquire significant levels of distressed debt in the secondary market, do you think that authorities will take steps to regulate those funds? Please give reasons for your views and if you do think regulation is likely, what form will the regulation take?

6.1 Response from an accountancy firm - Europe

Shadow banking regulation has been in place for some time and is not a considerable concern. In recent years the focus of European regulators has been the deleveraging of NPL risks from the European banking system and improving the resilience of the RFIs. Investments from debts funds have therefore been crucial and heavily regulating shadow banking would have been counter-productive. That said, as NPLs in RFIs continue to decrease and volumes of distressed debts owned by debt funds continue to increase, we may see some further regulations implemented in this sector in Europe over time.

6.2 Response from a multinational RFI - Australia

I think that the authorities should ensure that the RFIs and debt funds are regulated on a level playing field. Investors' funds are still held in debt funds and those proceeds also need to be protected. For the reasons mentioned later, and the negative impact that debt funds may have on a restructuring, I think authorities need to make it harder not easier for debt funds to have a seat at the creditors / syndication table.

6.3 Response from a debt fund

I believe that, despite some negative public rhetoric regarding alternative lenders and distressed funds, bank regulators appreciate the needed capital that these funds bring to distressed situations and will not take significant steps to make it more difficult for these funds to effect restructurings. The impediments to timely restructurings, including lengthy court insolvency processes and substantial one-time redundancy costs, remain significant in many European jurisdictions.

6.4 Response from a multinational RFI - Asia focused

I do think that increased regulation of debt funds is likely if they become bigger players in the distressed debt market. Failure of such funds could constitute a significant systemic risk.

6.5 Response from a multinational RFI - Africa

Not more so than already the case, provided the funds do not become deposit taking institutions – it all depends on how the funds attract investors rather than what they invest in.

6.6 Response from a multinational RFI - USA

At least in the USA, I do not see new or enhanced regulation with the current administration despite opposition attempts to impose further regulations on the financial industry here. As was the case following the last economic downturn when the negative ramifications became clear, the legislators will consider implementing rules to prevent a recurrence. If for example, secondary lenders are found to move more quickly to liquidation and it drives a measurable loss of overall productivity, then the legislators will consider new ways of ensuring the debtors are adequately protected.

7. Once a borrower's debt starts being traded on the secondary market, the size of the syndicate can increase significantly. The use of sub-participations can mean that a borrower does not have visibility as to who its lenders are. Finally, debt funds can have a different approach to debt restructuring than RFIs. Do you think that these elements will make it more difficult for borrowers in the future to achieve a successful restructuring of their debts? Are there any particular areas that you can see being an issue – for example, where the debt is mainly held by debt funds is there a risk that no coordination committee will be formed or that no debt fund or funds will be willing to drive the restructuring forward?

7.1 Response from an accountancy firm - Europe

In principle "too many cooks spoil the broth", but it depends on the funds sub-participating.

IFRS 9 and the more rigorous regulatory and prudential requirements will make RFIs more forward-looking and proactive. The likelihood that more debt may trade more quickly to distressed funds, combined with the pricing of the debt on the balance sheets of distressed funds and the expectation that RFIs will become more closely aligned as a result of the increased regulatory requirements may all impact coordination between creditors. Overall, this should allow faster and more extensive restructurings. This may negatively impact the original equity holders but create more viable companies coming out of restructuring.

Creditor cohesion is not solely dependent on the type of entity holding the debt and differences in approaches to restructuring should lessen as a need for restructuring becomes more severe. Such coordination should bring relief to those worried about the lack of coordination on committees. As creditors needs become apparent, parties will align to the economic reality of what is needed.

In the more distressed credits, we can even expect growing opportunities for private equity funds and distressed funds that have longer time-horizons and are interested in "loan to own" types of purchases of distressed debt in order to gain controlling interests. In the likely transition, this new model of work-out / restructuring will require many distressed funds to move more quickly to become engaged in the restructuring process in order to create a viable coordinated committee.

7.2 Response from a multinational RFI - Australia

It is true that the creditor group / syndicate can become very dysfunctional when traditional RFIs are replaced with debt funds. The debt fund may not have the appetite or experience to form coordination committees and may not be prepared to put in the effort to restructure the business. This will lead to loan losses, and also have a social impact given the loss of jobs and the knock-on effects to associated businesses and subcontractors. This is what authorities need to consider if they do not provide a level playing field in terms of the regulation and capital requirements that apply to the RFIs.

7.3 Response from a debt fund

Removal of the need for fronting banks, a change which has already taken place in Italy, removes a significant impediment to prompt closing of trades and coordinated restructurings. I expect we will see similar loosening of this requirement in other jurisdictions.

7.4 Response from a multinational RFI - Asia focused

I do think that this potentially represents a risk due to increased complexity driven by varying opinions and goals - however, this has occurred in the past even with purely RFIs and has been successfully resolved. However, the increased number of players, the current inability of regulators to influence or "lean on" or exercise an element of moral persuasion on all lenders in a syndicate and the absence of experienced restructuring leaders could make this all the more difficult next time around. Proliferation of credit derivatives and the resultant potential non-alignment of economic and voting interests also represent a threat.

7.5 Response from a multinational RFI - Africa

We are already seeing that this is a challenge in a number of matters – particularly when the funds are not local. Business problems are generally best solved as close to the company as possible, and consultants (who are invariably engaged when funders do not feel close enough to the situation) are yet to discover that model solutions that work in Europe do not necessarily work in Africa – indeed each African country is so different that what works in South Africa almost certainly will not work in Nigeria or Kenya and vice versa. Recovery outcomes from the restructuring of debt are sub optimal as soon as any cross-border elements are introduced. We have very few formal co-ordinating committees in Africa – more often than not the commercial banks with the largest exposures take the lead in both standing still and providing new money on a bridge basis to the sale of assets / equity investment.

7.6 Response from a multinational RFI - USA

There have been syndicate difficulties in restructuring but pre-negotiated restructuring arrangements have helped. I also believe that the funds can be even more creative in approach (typically at a greater cost to the company). This creates struggles among the lenders but the funds also recognise that they need the RFIs for banking and other expertise that the funds cannot provide. It seems to me that the groups are starting to find common ground.

8. If debt trading causes a loss of cohesion in the creditor group, do you believe that equity sponsors and other investors (both in place and potential new money providers) are less likely to want to make any investment either in terms of time or funding to see through a successful restructuring? Please explain your views.

8.1 Response from an accountancy firm - Europe

Yes, particularly when banks and funds are both on the coordination committee.

In normal terms, the willingness of investors to provide more time or funding will be a function of the potential upsides and additional risks of the restructuring. This will also be a function of reliable and transparent procedures and an adequate institutional framework that supports the smooth coordination of the many creditors. Many other factors may also impact creditor cohesion and funding in restructuring such as, inadequate enforcement or insolvency regimes; absence of protection of new money in the restructuring; or if the tax authorities have super-priority and do not participate in the restructuring.

For the reasons mentioned above, we believe creditor cohesion in the early stages of distressed debt negotiations may be more difficult where RFIs and funds are both on the committee and the carrying values (and changes in carrying values (costs) due to things such as forbearance or a RFI's overall NPL ratio) are quite different. In these early stages the investor group may have different views on granting initial forbearance as this may have different impacts on the carrying value of their positions. As credits become more distressed the differences in approaches to restructuring by RFIs and funds are likely to lessen.

8.2 Response from a multinational RFI - Australia

I think that it is true to say that once a creditor group becomes fragmented (which is often the case when traditional RFIs are replaced by debt funds) then equity investors will be loath to put further money into the business. In the circumstance where the company is in need of 'new money', then it will likely be the debt funds that put that money in, sometimes in the form of DIP funding. If the debt funds become the new money-lenders, then it will normally be on a super senior secured basis, which will only cause them to have more control and power over the company and over the creditor group. This can be a major disadvantage in a workout scenario.

8.3 Response from a debt fund

I don't expect a trend towards less cohesion in creditor groups. In fact, distressed funds tend to be more like-minded than banks. Banks with different exposure levels and varying political and relationship considerations due to home jurisdiction requirements, for example, often behave quite differently from each other. One recent example: an Italian distressed situation where the Italian branches of non-Italian banks were willing sellers, while Italian banks were not at any price.

8.4 Response from a multinational RFI - Asia focused

I agree with this, but think that the current general unwillingness (for individuals) to (personally) take the risk of a more complex, protracted (but potentially economically better) solution is a more significant impediment to this type of approach.

8.5 Response from a multinational RFI - Africa

In business you are always dealing with people and you need to know them, and their institutions, well to be able to close deals successfully. If the individuals or the institutions keep changing then this becomes difficult, particularly for the persons managing the business. Very few distressed businesses attract funding – more often it is the right go-forward management / business plan that attracts funding.

8.6 Response from a multinational RFI - USA

I think this can happen, but similar to the issues raised in number 2 above, the strategy of each deal is based upon many factors not just the willingness of the lenders or the equity.

9. Increased regulation may hinder the ability of some RFIs to maintain a global growth policy. Do you agree, and do you think that that might negatively hinder economic expansion for some jurisdictions?

9.1 Response from an accountancy firm - Europe

It depends how far we go in Europe and how this is perceived internationally.

At the moment, we do not anticipate that the level of regulation will considerably hinder the ability of Global Systemically Important Institutions (G-SIIs) to continue their growth policy, mainly because these truly global RFIs are already significantly ahead of the curve both in terms of their capital adequacy and the proficiency of their NPL management practices and procedures, both domestically and cross-border. It is possible that the effect will be felt more at the national level, by smaller RFIs and challengers, who will need to compete on these levelled fields with G-SIIs (European and foreign).

9.2 Response from a multinational RFI - Australia

I think that this is true and may also impact some industry segments that RFIs may no longer want to lend into.

9.3 Response from a debt fund

If increased regulation, in particular with regard to lending guidelines and restructurings, restricts the flow of capital to businesses and hinders needed corporate restructurings, such regulation would restrict growth.

9.4 Response from a multinational RFI - Asia focused

In my opinion this is already occurring, especially in the SME space. Increased capital requirements (and fear of risk) have driven RFIs away from this space and also away from supporting demonstrably beneficial, but lengthy, restructuring plans.

9.5 Response from a multinational RFI - Africa

I agree that increased regulation may hinder the ability of some RFIs to maintain a global growth policy and that might negatively hinder economic expansion for some jurisdictions.

9.6 Response from a multinational RFI - USA

I think regulation has hindered economic expansion in some jurisdictions but growth opportunity exists despite these challenges.

10. Please provide any other thoughts that you may have as to how the next recession may be different.

10.1 Response from an accountancy firm - Europe

No views on what the next recession will bring but hopefully banks will be better prepared.

Accurate forecasts are impossible, but hopefully RFIs will be better equipped to cope in the future, with more robust capital levels, more proficient NPL management capabilities (or easier access to third party servicing), more fluid secondary markets with the main impediments having been resolved and a more standardised banking union. Better credit underwriting practices are also a top priority for the European regulators, which should also contribute to greater resilience of the RFIs to the next crisis.

10.2 Response from a multinational RFI - Australia

I think the next recession will be different because the RFI will be loath to enforce its security, even in a recession, due to brand / relationship protection. Yet, we will see more debt trading and potentially, as a result, more insolvencies. I think the industries that will be most affected will be retail, construction and digital.

10.3 Response from a debt fund

A US perspective: while the last recession was driven most directly by bloated consumer / household balance sheets and related leverage in the global banking system, the next recession likely will be driven by excessive corporate leverage. With less structured leverage in the corporate market and corporate risk held by a more diffuse group of investors, I think the workouts should be less complex and the impact less systemic.

Unquestionably, alternative lenders will play a very important role on both sides of restructuring negotiations in the next recession. This dynamic should lead to relatively more expeditious and reasonable solutions. I think the wave of oil and gas restructurings we have witnessed during the last two years in the US and Europe has to a large extent illustrated the relative efficiency of working out over-levered companies with sophisticated debt investors on both sides: capital has flowed to the most efficient producers and service providers, with consolidation and some creative destruction removing excess capacity from the market.

10.4 Response from a multinational RFI - Asia focused

The market for distressed debt must open up and allow trades to clear at realistic market rates with minimal regulatory interference – this requires realistic provisioning requirements to be enforced by regulators and sufficient capital maintained by the RFIs to allow sales to occur at those levels. Certain jurisdictions still do not have those two ingredients. Chinese regulators are pushing hard on realistic provisioning levels by financial institutions and clamping down on "shell game" movements of NPLs – and bank capital ratios in China are adequate. Indian regulators are trying to enforce realistic provisioning levels by RFIs, but aggregate bank capital in India is currently insufficient to allow the banks fully to "take the hits".

10.5 Response from a multinational RFI - Africa

In much of Africa the State is a key economic player and debt levels have been rising – in many cases to levels that are concerning at both Government and State-owned corporation levels. Africa largely avoided the last global recession. Arguably the increased liquidity has seen cheap money into Africa chasing yield. Next time Africa is unlikely to escape.

10.6 Response from a multinational RFI - USA

In my opinion, we are likely to continue to see large scale fraud schemes (the tighter the rules the greater the desire to break them). These cases will test the beefed-up policies and rules put in place by governments and the financial industry regulators. The goal will always be to prevent market hysteria and collapse.

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INSOL International™

6-7 Queen Street, London, EC4N 1SP
Tel: +44 (0)20 7248 3333   Fax: +44 (0)20 7248 3384

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