

IMF STAFF DISCUSSION NOTE

**Tackling Small and Medium Sized
Enterprise Problem Loans in Europe**

Wolfgang Bergthaler, Kenneth Kang, Yan Liu, and
Dermot Monaghan

March 2015

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Tackling Small and Medium Sized Enterprise Problem Loans in Europe

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Glossary

AQR	Asset Quality Review
EC	European Commission
ECB	European Central Bank
EU	European Union
GDP	Gross Domestic Product
IMF	International Monetary Fund
INSOL	International Association of Restructuring, Insolvency & Bankruptcy Professionals
NPL	Nonperforming loans
SAAR	Seasonally Adjusted Annual Rate
SME	Small and Medium Sized Enterprise
OECD	Organization for Economic Co-operation and Development
UNCITRAL	United Nations Commission on International Trade Law

EXECUTIVE SUMMARY

The global financial crisis has left a large private sector debt overhang and high levels of nonperforming loans (NPLs) in several European countries. Small and medium-sized enterprises (SMEs) represent a significant and weak segment of the nonfinancial corporate sector. SMEs face a number of legal, financial, and regulatory challenges to restructuring that differ from those of larger corporates, such as a rigid and costly insolvency regime, a higher fixed cost to loan restructuring, and the lack of alternative sources of financing. Given SMEs' large presence and close links to the banking system, addressing the SME loan problem in Europe will be critical for strengthening bank and corporate balance sheets and supporting a more robust and sustained recovery.

The European Union and its member states have taken a number of steps to support distressed SMEs, from insolvency reforms and strengthened banking supervision, to financial support, but given the high debt overhang and NPL levels, more is needed to accelerate the resolution of problem loans and assist viable but distressed SMEs.

Based on cross-country experience with distressed SMEs, a comprehensive strategy can help promote NPL resolution and restructuring in Europe. Such a strategy should include tighter regulation and supervision of banks' NPL management, insolvency reform targeted at SMEs, a greater push for out-of-court workouts, and supportive macro policies. The aim should be to provide more cost-effective, efficient tools and to strengthen the incentives for restructuring and resolution. Moral hazard risks should be addressed by ensuring the speedy exit of nonviable SMEs:

- Building on recent insolvency reforms in many European countries, establishing simplified procedures for SMEs would reduce the cost and inefficiencies of SME restructuring. Insolvency regimes should close the gap with international best practices for rapid pre-pack approvals, "fresh start"/debt discharge, and debtor-in-possession financing. Active involvement of public creditors would support the restructuring of viable SMEs. Enforcement and foreclosure systems should be enhanced and made effective. Against the backdrop of a sound insolvency system, guidelines on loan workouts and the increased use of mediation would support more out-of-court debt restructuring.
- Following the completion of the European Central Bank's comprehensive assessment, supervisors should ensure that banks are adequately capitalized and provisioned in a forward-looking manner to provide sufficient resources for case-specific resolution or restructuring. For SMEs in particular, proper collateral valuation is critical. For systemic cases where assessing SME viability is challenging, regulators may need to undertake a "triage" approach to separate nonviable SMEs for speedy liquidation from viable but distressed ones for more standardized loan restructuring and to force loss recognition through time-bound write-offs.
- Other supportive policies include removing tax and regulatory impediments to NPL resolution, improving SME financial reporting and disclosure, and expanding SMEs' access to financing, such as through securitization and active use of government support schemes.

INTRODUCTION

1. **Six years since the global financial crisis, the problems of high levels of corporate debt and nonperforming loans (NPLs) still persist in several European countries.** Nonfinancial corporate debt as a share of GDP rose sharply before the crisis and has come down only slightly from its peak (Figure 1). In many countries, the pressure on corporates to deleverage has held back investment, which remains well below precrisis levels (Barkbu 2015). Reflecting the weak recovery, NPLs in the corporate sector have also risen sharply and, as highlighted in the European comprehensive assessment, have reached systemic levels in some distressed countries (Figure 2).
2. **Small and medium-sized enterprises (SMEs) represent a particularly significant and weak segment of the corporate sector.** SMEs in the European Union (EU) account for 99.8 percent of the 20.4 million nonfinancial enterprises, about 58 percent of value added, and nearly two-thirds of employment (Box 1; EC 2013b). Their share in total business loans range from 20 percent to as high as 75 percent in some countries (Figure 3). Compared with large firms, SMEs in general are more leveraged and reliant on bank financing and have significantly higher NPL ratios (Figure 4).² High SME NPLs reflect in part the deep and prolonged recession that hit SMEs hard, both through the collapse in domestic demand and the tightening of credit conditions (Iyer and others 2014; Presbitero and others 2014). Despite the declines in sovereign yields, SME borrowing rates have declined by much less and remain high compared with those for large firms (Figure 5).

Box 1. Definition of SMEs

The EU definition of SMEs (see EC 2003) includes independent micro, small, and medium-sized enterprises, which may or may not be incorporated. SMEs represent a very heterogeneous segment—ranging from single unincorporated entrepreneurs to medium-sized joint stock companies listed on a stock exchange. The EU definition—an economic rather than a legal category—encompasses a wide spectrum.

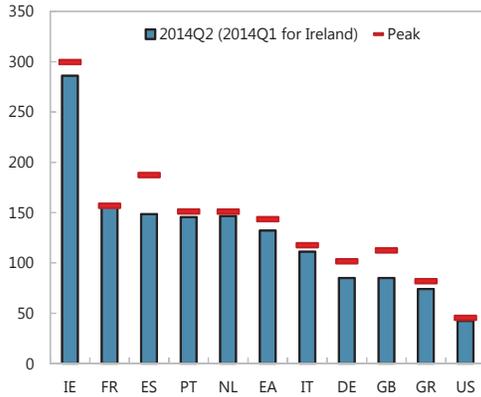
Definition of SMEs			
Company category	Employees	Turnover	Or Balance Sheet Total
Medium-sized	< 250	≤ € 50 m	≤ € 43 m
Small	< 50	≤ € 10 m	≤ € 10 m
Micro	< 10	≤ € 2 m	≤ € 2 m

Source: EC, 2014.

3. **SMEs present a particular set of challenges for NPL restructuring and resolution.** Given the large number of SMEs and their small sizes, lower reporting requirements, and heavy reliance on collateral, SME loan restructuring is more costly and riskier for banks than for large firms. In many cases, insolvency and out-of-court workout frameworks are ill-suited for SMEs, limiting the restructuring options, while difficulties in foreclosing on collateral also prevent speedy liquidation and exit. Business survey studies find the legal systems of several European countries to be weaker than those of other advanced economies and a possible contributing factor to their higher levels of NPLs (Figure 6; IMF 2014c).

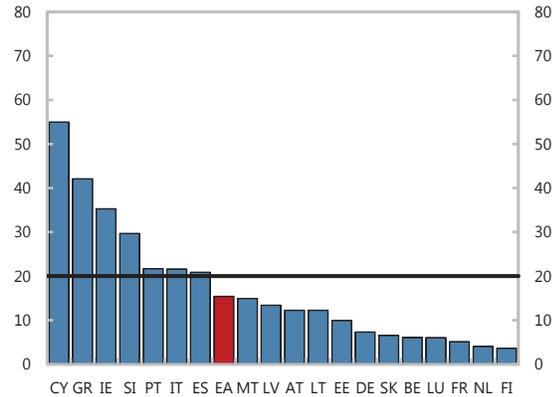
² NPLs are loan exposures that are 90-plus days past due, unlikely to pay, or have been restructured in the last year. Nonperforming exposures is a definition adopted by the European Banking Authority that also considers assets such as off-balance-sheet exposures and those impaired for accounting purposes.

Figure 1. Nonfinancial Corporate Debt
(Percent of SAAR, Annualized GDP)



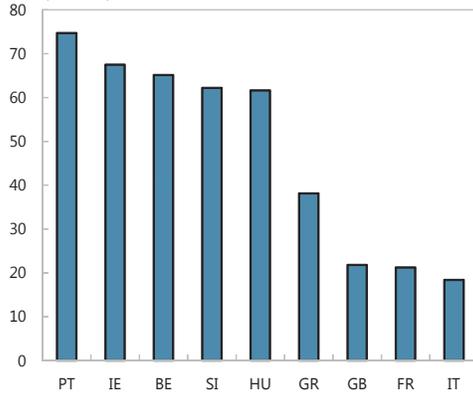
Source: Haver Analytics.
Note: Non-financial corporate debt includes loans and debt securities.

Figure 2. Post-AQR Nonperforming Exposures
(Percent)



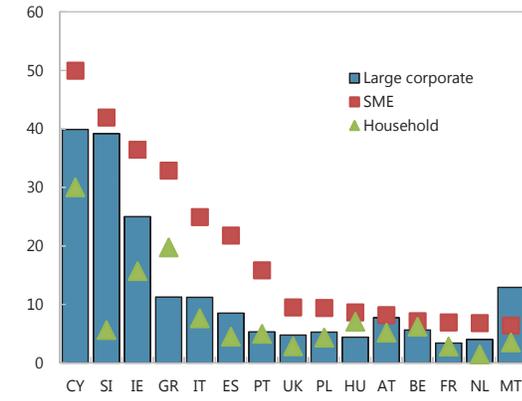
Source: ECB Comprehensive Assessment.

Figure 3. Share of SME Loans in Stocks, 2012
(Percent)



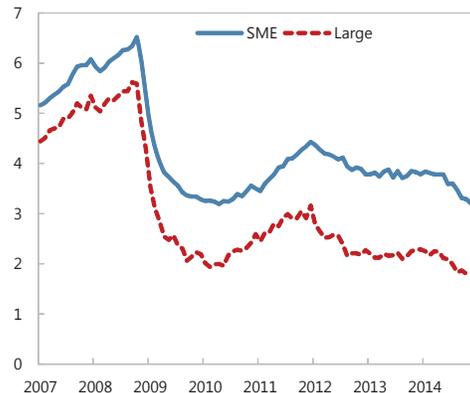
Source: OECD Scorecard, 2014.

Figure 4. Nonperforming Exposure
(Percent, as of Dec-2013)



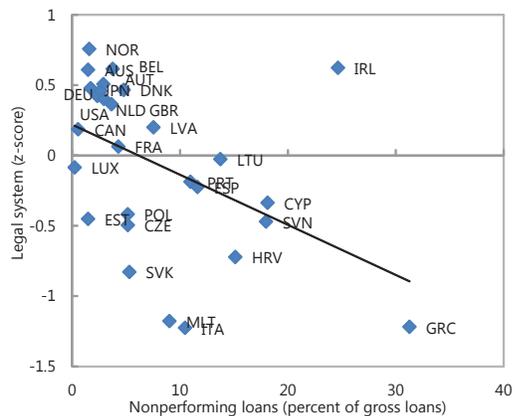
Source: European Banking Authority.

Figure 5. SME and Large Firm Borrowing Rates
(Percent)



Source: European Central Bank.

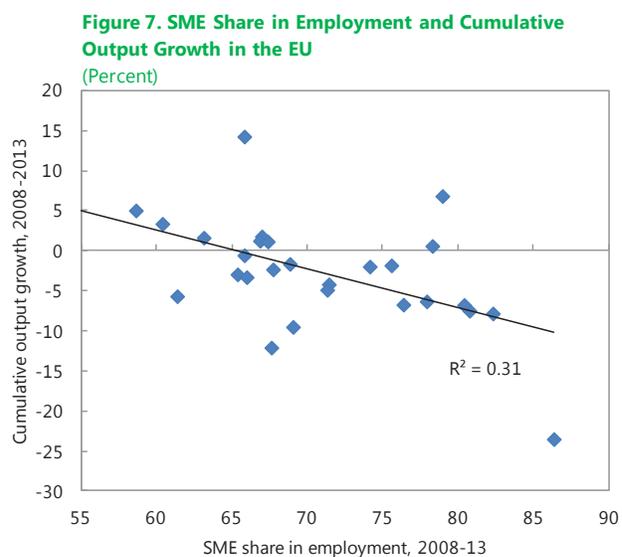
Figure 6. Strength of Insolvency and Legal Procedures and Nonperforming Loans in Advanced Economies, 2014



Source: IMF, GFSR (April 2014); IMF, Financial Soundness Indicators; World Bank Doing Business Survey (2013); national statistics offices; and IMF staff calculations.

Note: The legal system indicator is an average of z-scores from seven different indicators of legal system strength from the Doing Business Survey, relating to resolving insolvency, enforcing contracts, and the strength of legal rights. Differences in definitions of nonperforming loans make cross-country comparisons difficult. Italian nonperforming loans have been adjusted, following Barisitz (2013).

4. **If left unaddressed, the problems of SME indebtedness and NPLs pose a risk to the recovery and financial stability.** High corporate debt and NPLs represent a significant drag on investment, as credit-constrained firms cut back on spending to repay debt. SMEs in particular, given their high leverage and lack of alternative financing, are more vulnerable to a growth slowdown or financial distress (Cingano and others 2014). SME weakness can in turn undermine banks' asset quality and profitability, constraining banks' ability to provide credit. The prevalence of SMEs in EU countries is consistent with macro evidence suggesting that economies with a higher share of SMEs have fared worse during the global crisis (Figure 7; IMF 2014e).



Source: IMF, WEO; and EC's Annual Report on European SMEs, 2012/13.

5. **Addressing the SME debt overhang and NPLs in Europe can help lay the foundation for a more robust and sustained recovery.** Evidence from past financial crises suggests that strengthening bank and corporate balance sheets simultaneously can reinforce them both and allow supportive macro policies to reinvigorate private demand (Chen 2015). A faster cleanup of banks' balance sheets can also free up credit for new lending.³ Over time, progress in corporate restructuring can improve productivity by facilitating the reallocation of resources and the adoption of new technologies. Given the dominant role of SMEs in the corporate sector, a policy strategy targeted to the specific challenges facing SME loan restructuring and resolution can help accelerate the balance sheet adjustment and strengthen prospects for a recovery (IMF 2014c).

6. **The remainder of this note is structured as follows.** The note opens by discussing the challenges in resolving SME problem loans. It then outlines recent policy measures to support distressed SMEs, followed by a discussion of international experience in resolving SME problem loans. The note concludes with recommendations for resolving SME NPLs and the debt overhang.

CHALLENGES IN RESOLVING SME PROBLEM LOANS

7. **The corporate debt overhang and NPLs in EU countries can be broadly separated into two groups.**

- *Balance sheet recession.* The first group consists of those countries where over-leveraged corporates and SMEs (for example, Italy, Portugal, Slovenia, Spain) have weighed heavily on

³ This note does not discuss issues related to bank resolution. It is well understood that policies should first address a number of issues including distressed banks before turning to private sector NPLs (Laryea 2010).

domestic demand, economic growth, and bank lending, but debt and NPL levels do not pose a clear and immediate threat to financial stability.

- *Systemic problem.* The second group consists of countries with systemic levels of corporate debt and NPLs that threaten financial stability. For example, in Greece and Cyprus, SME nonperforming exposures have reached about 30–50 percent of total exposures. The high level of NPLs in these countries reflects both excessive corporate debt and a deep economic recession, and the sheer volume of individual NPL cases that probably cannot be addressed expeditiously using conventional instruments and channels (IMF 2014a; IMF 2014d).

8. In both groups, SMEs face a number of legal, financial, and regulatory challenges to restructuring that are similar to those for large corporate in Europe.

- *Weak foreclosure and insolvency regimes.* In many EU countries, rehabilitation and liquidation procedures are lengthy, costly, and ineffective; equally, foreclosure is time consuming and expensive, delaying the realization of collateral. These delays and expenses lead to the rapid loss of value for creditors. Courts dealing with insolvency matters are often overburdened and in some cases lack experienced and specialized judges, while insolvency practitioners may lack capacity and proper supervision and clear incentives for successful rehabilitation (EC 2011b; IMF 2014c). As a result, these regimes limit the ability to restructure viable businesses and liquidate nonviable ones in a timely and effective manner.
- *Banks' restructuring capacity and bank supervision.* Many smaller banks in Europe have little experience or operational capacity to restructure debts, especially for SMEs. They often lack workout units, or such units are either understaffed or under-trained. Some lack the needed capital to recognize losses upfront and engage in voluntary restructuring. Insufficient or different rates of provisioning across banks have also led to collective action problems in restructuring (that is, the free rider problem).⁴ Bank supervisors may also be slow in forcing creditors to recognize losses and write down bad loans, especially if fiscal resources are limited to address banking distress.
- *Nonparticipation of public creditors.* Several European countries suffer from relatively high accumulations of arrears to public creditors (Cyprus, Greece, Latvia, Malta, Portugal, Spain), but tax, social security, and public utility often do not participate to the extent necessary in debt restructurings due to legal and political limitations (for example, prohibition to write down principal or a lack of clear rules of engagement) as well as fiscal constraints. In some countries, tax claims have a priority rank (or even a super-priority rank) in insolvency that in the first place may lead to lax tax enforcement and then create little incentive for tax authorities to participate in debt restructuring. In a number of other countries, public creditors are permitted to opt out of insolvency proceedings, effectively creating a priority (for example, Spain).
- *Regulatory issues form obstacles.* Tax disincentives to engage in a restructuring, such as debt forgiveness taxed as income, may also be an obstacle. Overprotective labor laws (such as tying dismissals to rarely granted ministerial approvals or high severance payments) may prevent

⁴ The free rider problem is manifested in debtors being able to take advantage of lenders' inability to aggressively pursue nonperformance, lest a formal default result in the lender's having to recognize a greater loss than its provisioning (and by extension, its capital) permits.

meaningful restructuring. Governments may also face legal uncertainty to support specific debtors under EU state aid rules.

- *Stigma and delays.* In many EU countries, insolvency attaches a strong stigma, and business failure, even in good faith, is not socially acceptable. This not only decreases entrepreneurial activity but also leads to business rescues being attempted too late to be effective (EC 2011a).

9. **Restructuring distressed but viable SMEs also faces a number of unique challenges.**

- *Lack or inadequacy of a “fresh start” regime.* For unincorporated micro and small SMEs, the treatment of individual defaulters (and in some cases their guarantors) in some European insolvency regimes is very severe, leaving full personal liability for many years beyond liquidation of the business. The lack of a “fresh start” for bankrupt owners who have demonstrated good faith in making payments reduces the incentives to seek protection and restructuring within the courts (Cyprus). For example, Greece allows for discharge but makes fresh start available to only consumers. Other regimes require long repayment periods that tie up entrepreneurs for years, wasting valuable human capital and investment (IMF 2014c). Some personal insolvency regimes also fail to clearly distinguish between bona fide and fraudulent default, resulting in stricter standards for a fresh start (EC 2011b). As a result, progress in reducing unincorporated SME debt through insolvency remains very slow.
- *Complex, rigid, and costly insolvency regimes.* As recognized by EU reports (EC 2011; EC 2013b), the complex, lengthy, and rigid procedures, required expertise, and high costs of insolvency often fail to adequately meet the needs of micro and small incorporated SMEs. Many SMEs are also owned and operated by families who have pledged their personal assets for business credit. In these cases, the insolvency regimes in Europe generally do not well cover the overlap and conflation of business and household assets and liabilities, for example, home mortgages or personal guarantees to cover business debts (EC 2011; EC 2013b). As a result, business insolvency may lead to personal insolvency once a business fails, even where the business is a separate legal entity. In some countries (Italy and Slovenia), SMEs are not eligible to use restructuring process with advantageous features, which are reserved for large corporates.
- *Higher fixed cost to restructuring.* Given that most SME lending is secured by real estate or a personal guarantee, banks have a strong incentive in the event of a loan default to enforce the guarantee or initiate foreclosure to realize the security and collect proceeds. Although individual debt restructuring may lead to higher total recovery value, the fixed cost associated with simultaneously restructuring a large number of distressed SMEs may exceed that of foreclosure, which may be cheaper, faster, and more certain, especially in cases where value of collateral pledged exceeds the loan value.⁵
- *Lack of financing.* Compared with large corporates, SMEs are more leveraged and have less access to outside capital. Their high credit risk makes it difficult to secure needed financing for

⁵ Garcia-Posada and Sanguinetti find that inefficient insolvency regimes in Spain promote over-collateralization, which in times of distress leads to excessive liquidations. There is no structured restructuring vehicle that serves as an alternative to enforcing collateral. Regimes where collateralization prevails therefore have diminished corporate recovery, as Spain demonstrates (Garcia-Posada and Sanguinetti 2012; Garcia-Posada 2013).

restructuring, including debtor-in-possession financing under insolvency, as used under Chapter 11 in the United States.⁶ The lack of reliable SME financial data also makes it difficult to assess their viability and the feasibility of restructuring plans.

RECENT POLICY SUPPORT FOR SMES

10. European countries, the EU, and its member states have taken steps in the area of insolvency reforms, banking supervision, debt restructuring, and direct government support to assist debt-distressed SMEs.

Insolvency Reforms

11. **Insolvency reforms have targeted both SMEs and the broader corporate sector.** While most regimes already carry the main features of an effective insolvency law, such as clear filing criteria, support to rehabilitate viable firms, a stay on enforcement action, inclusion of secured creditors in the insolvency process, majority/class voting, priority status for post-commencement financing, and speedy liquidation of nonviable firms (Liu and Rosenberg 2013; EBCI 2012), recent reforms focused on pre-insolvency procedures and stronger instruments for restructuring.

- *Pre-insolvency regimes.* Croatia (2012), Estonia (2010), Greece (2010), Latvia (2010), Portugal (2012), and Slovenia (2013) introduced pre-insolvency regimes to enable an early rehabilitation of distressed enterprises. Germany (2012), Greece (2010), Italy (2012), Latvia (2010), Portugal (2012), and Romania (2014) adopted so-called pre-packs⁷ to enable a quick in-court approval of a settlement agreed out of court that is binding on dissenting creditors.
- *Financing and other features.* Italy (2012), Latvia (2010), Portugal (2012), and Spain (2014) strengthened incentives for fresh post-commencement financing. Other reforms include the introduction of simplified debt/equity swaps (Germany 2012, Latvia 2010, Slovenia 2013, Spain 2014) or spin-offs (Slovenia 2013).
- *Expanded coverage.* Slovenia expanded its insolvency law to cover all creditors, including secured creditors (but only for large corporates and not SMEs), while Ireland (2013) introduced three new restructuring processes that also cover individuals' business debt (IMF 2013a; IMF 2015).
- *Special in-court procedures for SME.* A number of countries have introduced simplified procedures for SMEs in their general insolvency regimes (Germany,⁸ Greece, Slovenia, Spain) or special processes (Italy). The Italian over-indebtedness agreement (*concordato preventivo*) is specifically designed for micro and small SMEs and is part of the in-court toolkit. It involves a stay and a majority voting process (60 percent of creditors in value).

⁶ See http://ec.europa.eu/enterprise/policies/single-market-goods/fighting-late-payments/index_en.htm.

⁷ Pre-packs refer to procedures under which the court expeditiously approves a debt restructuring plan negotiated between the debtor and its creditors in a consensual manner before the initiation of an insolvency proceeding. This technique draws on the most significant advantage of a court-approved restructuring plan—the ability to make the plan binding on dissenting creditors or cram-down—while leveraging a speedy out-of-court negotiation process.

⁸ In Germany, streamlined household insolvency provisions can also be applied to micro unincorporated SMEs without employees.

12. **Out-of-court restructuring schemes ranged from nonbinding guidelines to enhanced/hybrid⁹ restructuring, some specifically targeted to SMEs.**

- *Out-of-court regimes.* Albania (2013), Austria (2013), Latvia (2010), Portugal (2011), Romania (2012), Serbia (2010),¹⁰ and Slovenia (2014) adopted nonbinding guidelines for out-of-court debt restructuring for all business entities (including SMEs) in line with the International Association of Restructuring, Insolvency & Bankruptcy Professionals (INSOL) principles for multicreditor workouts. Iceland (2010) supervised the adoption by individual commercial banks of out-of-court restructuring guidelines. Outside the crisis context, mediators have also been used (for example, France) to facilitate a debtor/creditor agreement.
- *Special SME workouts.* Portugal (2012) adopted a formal out-of-court restructuring regime tailored to SMEs through mediation by a government agency. This formal regime features a creditor standstill and requires tax and social security authorities to participate in the negotiations. There is no majority voting and the agreement binds only participating creditors (IMF 2013c).¹¹ Spain (2013) introduced a time-bound, out-of-court agreement on payments tailored for micro and small SMEs. In 2015, this mechanism was reformed under which the Chamber of Commerce or a mediator appointed by the registrar or a notary takes the lead in negotiating a settlement, and except for public creditors, a stay on enforcement actions is in effect for three months.¹² Payments cannot be postponed for more than ten years, while debts may be totally written down or converted into equity. A 60 percent or 75 percent majority of creditors (in value) is required to approve and extend the plan to dissenting or non-participating creditors (60 percent for stays up to 5 years and 75 percent for other operations). These majorities are respectively increased up to 65 percent and 80 percent for secured creditors (just for the part of the credit covered by the guarantee). Italy (2012) established an out-of-court procedure for SMEs where an independent expert appointed by the debtor may facilitate an agreement, but which binds only participating creditors. Greece (2014) adopted an out-of-court framework for SMEs that enables the reduction of debt for SMEs according to economic indicators, as well as a corresponding tax credit for creditors and a restructuring of public creditors' claims according to installment schemes for public claims (with an extra 20 percent benefit); it entered into force in March 2015. In Ireland, the resolution of SME NPLs is guided by lender-specific workout targets, with the two main SME lenders expected to have completed the workout plans of almost all SME loans by end-2014.¹³
- *Standardized regime with arbitration for SMEs.* In 2010, the Icelandic government, banks, and social partners entered into a voluntary debt restructuring scheme based on "joint rules on the financial restructuring of companies" specifically targeting SMEs with less than ISK 1 billion of liabilities, aiming at writing down debt to the value of the SME (that is, no equity value is created). Viability was determined to exist when the projected liquidation value was less than the going

⁹ "Hybrid" procedures are all procedures where the involvement of the judiciary or other authorities is an integral part of the procedure, but is less intensive than in formal insolvency proceedings.

¹⁰ The Serbian out-of-court regime was enacted by law and is facilitated by the Serbian Chamber of Commerce.

¹¹ The formal out-of-court regime was amended effective March 1, 2015, to among other things improve the viability diagnosis, adjust the majority voting process to the insolvency regime (which was also amended at the same time), enhance the priority of new money provided to the debtor, or end enforcement actions for the debtor's guarantors.

¹² See: Royal Decree Law 1/2015, February 27, 2015.

¹³ Implementation of loan restructurings typically spans a number of years as SMEs take actions such as asset disposals.

concern value. For SMEs below a certain debt-to-equity ratio threshold, liabilities were restructured based on the SMEs' capacity to pay. For SMEs with a high debt-to-equity ratio, the feature of "deferred loans" (that is, reduced interest rates for three years) was used. The scheme included an arbitration committee to resolve disputes among parties involved. The government supported the scheme through various tax incentives. Banks were subject to monthly targets to successfully restructure SMEs (IMF 2011; IMF 2012a).

Banking Supervision

13. **EU bank regulators have taken action to tackle corporate NPLs.** National supervisory authorities have conducted various asset quality reviews, including in the most recent ECB comprehensive assessment, to harmonize and strengthen loss recognition and inform banks' workouts. Supervisors have also strengthened supervision and instructed banks to enhance their workout capabilities. For instance, Ireland, Cyprus, and Greece have introduced specialist functions and supervisory expertise and required banks to develop strategies and NPL resolution plans. Ireland has also set debt resolution targets on a per-bank basis. The Central Bank of Cyprus (in 2013 for mortgages arrears only), the Central Bank of Ireland (in 2012 for mortgages arrears only), and the Bank of Greece (2014) adopted a code of conduct to standardize the engagement between creditors and debtors for NPLs resolution.

Institutional Support

14. **Many EU countries have strengthened the institutional setting for debt restructuring.**

- *Data.* The information gap on SMEs has narrowed, but still remains substantial. There are credit assessments from third-party providers, and the ECB has started to conduct surveys on the access to finance for SMEs (ECB 2014b).
- *Tax.* Iceland (2010), Latvia (2010), and Portugal (2012) amended their tax codes to remove disincentives for debt restructuring. Italy (2013) also relaxed the limits on tax deductions for loan loss provisioning to encourage faster write-offs.
- *Institutions and debt enforcement.* Portugal (2013) adopted a new legal regime for insolvency administrators in addition to a new supervisory authority that supervises and monitors insolvency administrators. Ireland (2012) established the Insolvency Service of Ireland, which licenses and regulates personal insolvency administrators. Portugal (2013) and Italy (2013) engaged in wide-ranging judicial reform to increase court performance management and the specialization of the judiciary (IMF 2013c; IMF 2014g). Latvia (2010), Portugal (2012), and Serbia (2014) also strengthened their debt enforcement frameworks (IMF 2013b).

Government Support for SMEs

15. **Government intervention for SMEs has so far been limited to legal reforms and other governmental support,** including temporary moratoria on mortgage foreclosures and targeted schemes for households; governments have so far not intervened directly into market-driven debt restructurings for SMEs (Liu and Rosenberg 2013).

16. **The EU has developed a number of initiatives, including a distinct policy platform for SMEs under its Enterprise and Industry Department.** The basis of EU policy is the so-called 2008 Small Business Act, which outlines a set of recommendations, based on cross-country experience and good practices (EC 2011a). In addition, EU structural funds, the European Investment Bank, or the European Investment Fund¹⁴ provide financing (such as loans, guarantees, structured finance, or trade financing) to the SME sector in certain EU crisis countries (OECD 2009). The Late Payments Directive aims at protecting SMEs by reducing SME vulnerability to insolvency triggered by liquidity constraints (EC 2011b). Finally, in April 2014, the European Commission issued a recommendation on a new approach to business failure and insolvency targeted at SMEs (see Box 2).

Box 2. EC Recommendation for a New Approach to Business Failure and Insolvency

The European Commission (“Commission”) issued a nonbinding Recommendation on a New Approach to Business Failure and Insolvency on March 12, 2014 (“EC Recommendation”). This Recommendation is based on previous reports on the treatment of enterprise failure in Europe, with specific references to SMEs. It signals the Commission’s first step toward establishing general principles in the area of substantive insolvency law and may be followed up by further proposals for legislation in the future. The EC Recommendation will be assessed by the European Commission in September 2015, with EU member states being invited to implement the principles contained in the EC Recommendation by March 2015.

The EC Recommendation is limited in scope and essentially addresses two main issues: first, the features of a restructuring mechanism with minimal court intervention (hybrid mechanism); and second, the availability of a discharge for individual entrepreneurs within a short time frame. The EC Recommendation does not include any provisions on formal insolvency proceedings (rehabilitation and liquidation). Recognizing the subsidiarity principle, the EC Recommendation omits certain details and thus only highlights the essential issues to be addressed, and EU member states are given the possibility of “filling the gaps” with national rules that are consistent with their legal traditions and national circumstances.

The restructuring mechanism with minimal court intervention should be preventative and as informal as possible. In this regard, the mechanism should be available to distressed entrepreneurs as early as possible, leave the debtor in control (debtor in possession) during the restructuring process, and, to the extent possible, be as informal as possible to reduce costs. It should include the following features:

- The EC Recommendation envisages a (court-intervened) stay of all creditor actions, limited to four months (extendable to no more than 12 months). Court-appointed mediators could be used if necessary.
- The EC Recommendation suggests that all creditors abide by a restructuring plan if approved by a majority of creditors’ in value (as determined under national law) divided into separate classes (at a minimum, secured and unsecured creditors). It includes protective measures for dissenting creditors, namely the provision that no dissenting creditor may receive less under the plan than in a liquidation of the enterprise. Although there is no explicit reference to the treatment and inclusion in a plan of public creditors, the absence of a distinction suggests that public creditors shall be included in the plans.
- The EC Recommendation underlines the importance of protecting new financing during debt restructuring, especially against the risk of avoidance actions in a subsequent insolvency process, and against any potential criminal or civil liabilities (for instance, for wrongful trading or lender liability). However, the EC Recommendation does not specify safeguards for existing creditors, which is left to national laws.

A discharge for individual entrepreneurs should be available after a maximum period of three years. The Recommendation emphasizes the need of making discharge available only to honest entrepreneurs.

¹⁴ European Investment Fund. [http://www.eif.org/what we do/where/index.htm](http://www.eif.org/what_we_do/where/index.htm).

17. **At the national level, countries have put in place different schemes to support distressed SMEs.** These schemes range from provision of SME credit guarantees (Austria, Belgium, France, Greece, Hungary, Italy, Luxembourg, Netherlands, Spain), establishment of financing funds for SMEs (Belgium, Germany, Greece, Ireland, Portugal), provision of credit mediation services (Belgium, France) or debt counseling services for micro and small SMEs (Italy), to postponement of tax or social security payments for SMEs in financial difficulties (Belgium, Denmark, Greece, Italy; OECD 2009).

Early Assessment

18. **While adopted only recently, insolvency law reforms and out-of-court mechanisms have increased the number of successful rehabilitations in some countries.** In Portugal, for example, by end-August 2014, about 530 successful business restructurings (including SMEs) were reported under the new pre-insolvency and pre-pack process.¹⁵ Iceland's SME standardized regime has recorded an encouraging number of 870 restructuring proposals since May 2011 (IMF 2012a). The Portuguese formal regime has concluded about 100 successful restructurings of SMEs as of end-June 2014, despite some capacity constraints.¹⁶ The Greek out-of-court mechanism entered into force only in March 2015, and it is too early to assess its impact. In other countries, however, SME-specific processes were sometimes abused and thus did not help rehabilitate many SMEs.¹⁷ Data on informal out-of-court mechanisms are difficult to collect, given the informal nature of these restructurings.

19. **Despite these positive steps, the pace of resolution remains slow, suggesting a more comprehensive approach toward SMEs is needed.** Insolvency reforms have aimed to facilitate court-led reorganization and pre-insolvency solutions, but still are far short of addressing the high cost and complexity of the procedures, limiting their use by small firms. Given the large backlog of insolvency cases and limited court capacities in several countries, there is an urgent need for more efficient foreclosure and out-of-court restructuring, particularly in the systemic cases. Banking supervision has taken the important first step of identifying the scale of the NPL problem and strengthening capital buffers under the comprehensive assessment, but banks still lack strong incentives to proactively resolve problem loans and assist distressed but viable SMEs. Government support through loan guarantees and financing has helped stabilize weak SMEs, but has not led to a broader restructuring of the sector. Given the large scale and slow pace of resolution, a stronger push across several fronts—regulatory, supervisory, and judicial—tailored toward the needs of SMEs is required. In this regard, international experience in addressing distressed SMEs may provide some insights on ways to accelerate the resolution process.

¹⁵ http://www.dgpj.mj.pt/sections/siej_pt/destaques4485/sections/siej_pt/destaques4485/estatisticas-trimestrais8246/downloadFile/file/Insolv%C3%A2ncias_trimestral_20141030.pdf?nocache=1414772236.64.

¹⁶ http://www.iapmei.pt/resources/download/SIREVE_062014.pdf?PHPSESSID=5c8acef36dd5345e15b78c0a21abdc7c.

¹⁷ See <https://area.cervedgroup.com/news/FormularioOsservitaliaPostEvento.phtml>. Only 13 percent of SMEs that presented *concordato preventivo* petitions between 2008 and 2011 were still operating after three years of presenting a plan; 53 percent were no longer operating (because they were in liquidation). One-third were subject to other proceedings. Out of the *concordato in bianco* petitions between 2012 and 2013, 36 percent ended in bankruptcy proceedings; in more than a third of cases the enterprises presented a plan.

LESSONS FROM INTERNATIONAL EXPERIENCES

20. **Countries in past crises have pursued varied approaches to addressing distressed SMEs.** International experience includes insolvency reform and out-of-court mechanisms mostly benefiting the entire business spectrum but also specifically targeting SMEs, as well as a more centralized, “across-the-board” approach for systemic cases.

Insolvency Reform

21. **Most countries experiencing high levels of NPLs or corporate distress first strengthened their formal insolvency systems** (Indonesia 1999, Thailand 1999, Turkey 2002, Japan 1999 and 2008, Korea 1998 and 2006); very few countries, however, adopted specialized in-court frameworks for SMEs. Countries strengthened their insolvency laws to encourage rehabilitation while creating a credible threat of bankruptcy for recalcitrant debtors, thus setting the incentives and expected payouts for negotiating agreements out-of-court (IMF 1999). Reform measures, among other things, (1) allowed speedy liquidation of nonviable debtors or debtors that could not agree on a reorganization plan, (2) enabled the change in the debtor’s management or control of shareholders, and (3) set up pre-pack procedures for quick court approval of debt restructuring plans negotiated between the debtor and a majority of its creditors. Insolvency reforms were complemented by other reforms such as specialized courts (Indonesia, Thailand), reform of insolvency administrators (Indonesia), and the removal of tax and other regulatory impediments (Indonesia, Thailand).

22. **Only a few countries introduced special in-court processes for SMEs.** For instance, the Japanese Civil Rehabilitation Act (1999) adopted a simplified and speedier debtor-in-possession restructuring process for SMEs; secured creditors, however, were not covered (IMF 2009a, Annex). The few cases of separate SME insolvency systems may reflect the desire to preserve the simplicity and efficiency of the insolvency process and avoid risks of delay from switching from multiple tracks.

23. **Outside the crisis context, the United States introduced simplified procedures within its insolvency laws for SMEs.** In 2005, the United States introduced in Chapter 11 of the U.S. Bankruptcy Code (see Box 3) special provisions for SMEs, such as standardized forms, simplified procedures, and no requirement of a creditor committee or trustee oversight. Studies, however, found that SMEs’ use of Chapter 11 did not increase because of the high cost, excessive influence of secured creditors, monitoring difficulties, and other procedural obstacles.¹⁸ Subsequently, an initiative to amend the provisions of Chapter 12 (a simplified procedure for family farmers or fishermen, see Box 3) was launched but was not adopted (Small 2010).

¹⁸ See studies cited in Small 2010.

Box 3. Main Features of U.S. Bankruptcy's Chapters for Small and Medium Sized Enterprises

Chapter 11 for Small Business Debtors. Chapter 11 of the U.S. Bankruptcy Code provides for a simplified reorganization process for “small business debtors,” defined as businesses engaged in non-real estate activity with total fixed debts of \$2,490,925 or less. Under this process, the reorganization process is simplified, deadlines are changed, oversight is increased, reporting requirements are expanded, and incentives are put in place to prevent proposal of infeasible plans. Specifically:

- The process simplifies plan preparation and voting. Unlike other Chapter 11 debtors, the small business debtor may propose plans without additional disclosure statements, thus saving time and effort.
- Plan deadlines are changed. Small business debtors have more time in which only they may file a plan (180 days versus 120 days for other debtors). This benefit comes with burdens: under pain of dismissal, the small business debtor must file a reorganization plan within 300 days of commencing the case, and must then confirm any plan filed within 45 days after the plan is filed.
- During the case, oversight is increased beyond that required for other Chapter 11 debtors. The U.S. Trustee must conduct an initial interview with the debtor, investigate its viability, inquire about its business plan, and review and monitor the debtor's activities. It also must seek dismissal of the case if it reasonably believes cause exists, including a belief that the debtor is not viable or otherwise unable to confirm a plan.
- Reporting requirements are increased. When filing for relief, the debtor must include its most recent balance sheet, statements of operations, cash-flow statement, and federal income tax return to the petition. During the case, the small business debtor must file periodic financial and other reports regarding its cash flow and its profitability.
- There also are disincentives to propose quick, infeasible plans. A small business debtor does not receive the benefit of the automatic stay against collection activity if it or a successor files another case.

Chapter 12 for Family Farmers and Fishermen. Chapter 12 of the U.S. Bankruptcy Code offers a more debtor-friendly form of reorganization, although it is limited in scope: it is available only to “family farmers” (or their closely held entities) whose fixed debts do not exceed \$4,031,575 (family fishermen are also eligible, but their debts cannot exceed \$1,868,200) and who have sufficient “regular annual income” to fund a plan. Under Chapter 12, debtors may propose a repayment plan to unsecured creditors over three to five years, and to secured creditors over a longer time.

- Oversight is more enhanced. When a Chapter 12 petition is filed, even though the debtor normally remains in possession, a standing trustee is appointed in every case. The trustee monitors the case and can be heard at any hearing involving the valuation or sale of assets, or the confirmation of a plan. The standing trustee provides a reliable source of information on the debtor's viability and limits the influence of secured creditors.
- Deadlines are shorter. Chapter 12 sets forth strict deadlines on the submission of the plan of reorganization: the debtor must file a plan within 90 days. The plan must be either confirmed or rejected no more than 45 days later. The tight deadlines reduce administrative costs.
- Repayment plans are more flexible. Under Chapter 12, the debtor's owner can retain his or her ownership interests in the business so long as the plan pays secured creditors in full and unsecured creditors receive all of the debtor's disposable income for up to five years. Secured creditors may be paid beyond the five years if feasible and the court may reduce secured claims to the value of the collateral. Any unpaid claims to unsecured creditors after five years are discharged.
- Procedures are more flexible and less costly. Chapter 12 provides debtors with broader flexibility in handling administrative expenses and delinquent taxes by permitting them to be paid in installments.
- **Chapter 13 for Smaller Sole Proprietors.** Chapter 13 also provides some measure of relief for smaller sole proprietors (corporations and partnerships are not eligible). The debtor limits are less than in Chapter 12: Chapter 13 is available only to those individual debtors who have unsecured debts of less than \$383,175, and secured debts of less than \$1,149,525 (as of 2014). Chapter 13 procedure and substance is the essentially the same as in Chapter 12, with the major exceptions being that in Chapter 13: (1) a debtor's mortgage or security interest on his or her principal residence (or recently purchased car) cannot be modified without the consent of creditors (but arrearages may be cured, and the mortgage or security interests reinstated); (2) any debt modified by the plan must be paid within five years of the filing of a case; and (3) the requirements for filing a plan are relaxed.

Out-of-Court Workouts

24. **International experience shows that out-of-court schemes facilitate consensual corporate debt restructuring (including SMEs) that is more efficiently and less costly (Altman 1984; Betker 1997; Gilson and others 1990; Franks and Sussman 2001).** These schemes vary from purely voluntary schemes to enhanced/hybrid schemes with more formal government involvement (Garrido 2012). The former includes the London Approach, which was administered under the leadership of the Bank of England and targeted at large corporate debt restructuring by using suasion on banks and the INSOL Principles for Multi-Creditor Workouts that set out guidelines emphasizing transparency and disclosure and a (consensual) temporary standstill to negotiate in good faith. Crisis countries have also used temporary, formal, and hybrid frameworks with government involvement (Korea, 1997 and 2004, Indonesia, 1997, Thailand, 1998, Malaysia, 1998, Turkey, 2002), with some of these initiatives starting out consensual (Indonesia, Thailand). Some common features included the following: (1) keeping restructuring voluntary, usually initiated by the debtor; (2) applying to debtors with more than one financial creditor, (3) assigning a lead bank to coordinate all financial creditors using binding/guiding principles or an agreement promoted by the bank supervisory body/bankers' association; (4) providing regulatory/tax incentives, (5) setting up a committee (either government or creditor-led) to monitor or facilitate deal making, and (6) relying on mediation/arbitration to resolve debtor-creditor and inter-creditor dispute resolution.¹⁹ Experience shows that these hybrid schemes involve less fiscal resources, protect debtors better without entirely shifting the burden to creditors (Hagan and others 2003), and deliver encouraging results, mostly when used for large corporates (Mako 2005).

25. **Crisis-related, SME-targeted out-of-court mechanisms range from providing fresh money to formal legal regimes.** In Malaysia (1999), SMEs could seek bridge financing from the Loan Monitoring Unit of the central bank while undergoing a debt restructuring. The Bangkok Approach (1999) in Thailand provided a simplified and time-bound process for SMEs under the direction of the central bank. While not a crisis response, the Reserve Bank of India (1999) established a special framework for SMEs covering both incorporated and unincorporated SMEs.

26. **Only a few countries introduced temporary out-of-court restructuring regimes for SMEs featuring simplified processes and shorter timeframes.** These included the following: (1) government instructions to restructure the SME debt (Japan 2009, Korea 1997, Turkey 2003); (2) fresh money to support SMEs either by the government (Korea 1997, Japan 1997 and 2009) or by banks (Turkey); (3) incentives for banks to restructure SME debt (Japan 2009, Korea 1997); and (4) assistance through support centers to prepare restructuring plans (Japan 1997, Korea 1997, Thailand 1997). While Japan and Turkey permitted only debtors to request restructuring, Korea (2008) adopted a creditor-driven approach. The degree of focus on the element of inter-creditor coordination also varied, and only Korea (2008) and Thailand emphasized the element of "collective

¹⁹ In some cases, frameworks went further by introducing majority creditors' voting (55–75 percent, and 75 percent in Turkey in 2004 and in Korea in 1997) or significant fines for noncompliance (Korea in 1997) (IMF 2000b; IMF 2009b; IMF 2010).

creditor action” through a committee and use of a lead bank in the specialized SME out-of-court framework.

27. **These specialized out-of-court frameworks for SMEs, which were temporary, had limited success.** This was partly because the debt restructuring was financial (not operational), with insufficient emphasis on the viability of the business. The high level of SME state support was believed to have inhibited restructuring (Korea), or regulatory incentives granted to banks to restructure SMEs were viewed as damaging bank soundness (Japan) (IMF 2009; IMF 2012b). Support to micro SMEs (Turkey) was seen as indirect support to the household sector, fraught with moral hazard, thus limiting the support from banks.

Systemic Approach to Indebtedness

28. **In severe crisis cases, an across-the-board approach was used.** In Chile (1982) and Mexico (1982), a large share of the debt was in foreign currency and the government provided direct support to corporations using a preferential exchange rate, covering foreign exchange, or postponing foreign exchange losses (Hagan and others 2003). Fiscal costs in Chile were enormous (33 percent of GDP) but were less in Mexico (2 percent of GDP). The systemic approach, however, faced a number of risks. Across-the-board solutions have the disadvantage that they do not distinguish between viable and nonviable enterprise and thus, by providing support to all businesses, extend the lifeline of nonviable ones. They also create risk of undermining credit discipline, delaying restructuring by raising expectations of a bail-out and thus increasing moral hazard.

International Lessons for SME Problem Loan Resolution

29. **International experience with distressed SMEs highlights the importance of ensuring that the resolution framework focuses first and foremost on the viability of firms.** For insolvency procedures, the focus should be on creating simpler, more cost-effective instruments tailored to SMEs, rather than creating multiple insolvency tracks, which may delay the exit of nonviable firms and reduce their recovery value. Out-of-court workouts have proved to be successful at promoting more efficient and less costly debt restructuring (in particular when supported by features such as a pre-pack, arbitration, a government agency, or majority voting processes). The focus should be on both operational and financial restructuring—to exit promptly insolvent SMEs, while assisting viable but distressed firms. In systemic cases, an across-the-board approach may have the benefit of expediency but should guard against the risk of propping up weak SMEs and exacerbating moral hazard risks.

30. **International experience also suggests greater benefits from NPL resolution and debt restructuring when done within a comprehensive strategy** (Hagan and others 2003; Liu and Rosenberg 2013). Such a comprehensive strategy should begin with a thorough diagnosis of the weaknesses in the SME sector and obstacles to restructuring. In addition to supportive macro policies, governments should look to strengthen insolvency and foreclosure systems targeted at SMEs, as well as promote more efficient out-of-court workouts to relieve the burden on the courts.

At the same time, supervisors should ensure that banks face the proper incentives for restructuring through strengthened capital and provisioning. Finally, governments should strengthen the framework for SME debt restructuring, such as by involving public creditors and removing tax and regulatory obstacles.

POLICY RECOMMENDATIONS FOR TACKLING SME PROBLEM LOANS IN EUROPE

31. **In light of the previous discussion, a comprehensive strategy in Europe should aim to address the high cost and inefficiencies of SME loan restructuring and resolution, while incentivizing debtors and creditors to engage in meaningful debt restructuring.** The recommendations should be tailored to country-specific circumstances and give special attention to a country's legal system and tradition, institutional capacity, fiscal space, restructuring experience, and practice in designing and sequencing the measures to ensure their success. For systemic cases where assessing SME viability is problematic, policymakers should consider a “triage” approach to separate nonviable SMEs from viable but distressed SMEs for more standardized loan restructuring. The common elements of a comprehensive strategy toward distressed SMEs should prioritize the following:

Simpler and more flexible insolvency/foreclosure systems

32. **The focus should be on categorizing SMEs, possibly differentiating the approach based on business size, turnover, or amount of liabilities (rather than number of employees²⁰), or prioritizing on an especially vulnerable segment.** International experience suggests avoiding multiple insolvency tracks by introducing SME-specific instruments, but instead establishing a simplified process within the current insolvency regime targeted at micro and small businesses and using segmentation primarily by amount of an SME's liabilities (for instance, Iceland, Japan, and Korea used a cap of SMEs' liabilities to determine eligibility).

33. **In Europe, reforms should aim to close the gap in insolvency law against international best practices.**²¹ Some key features of modern insolvency law—which benefit the entire business segment—include the following (see paragraph 11): (1) a rapid pre-pack in-court approval process, (2) permitting the restructuring of secured (and public) creditors in insolvency, (3) a temporary stay

²⁰ The number of employees is typically not indicative of the financial complexity of an SME; also, such an indicator, if applied too strictly, may discourage hiring employees.

²¹ Best practice lessons can be drawn from international best practices on orderly and effective insolvency frameworks and out-of-court workout procedures. International best practice in the area of the general insolvency law can be found in the UNCITRAL Legislative Guide (UNCITRAL 2004), the World Bank principles on effective insolvency and creditor rights systems (World Bank 2007), and IMF's publication on orderly insolvency procedures (IMF 1999). With respect to out-of-court workouts, the INSOL principles for multicreditor workouts are generally perceived as international best practice. For SMEs, UNCITRAL is currently engaged in a project to establish whether the *Legislative Guide* should be enhanced to include specific recommendations for small firms (UNCITRAL 2014). These guidelines have served as the basis for undertaking insolvency and workout reforms for countries looking to address debt overhang problems.

on all enforcement actions, and (4) meaningful priority and protection for post-commencement financing to enable the financing of working capital (see Box 4). Specifically for SMEs, the following features are essential:

- *Liquidation and foreclosure.* For nonviable SMEs, an efficient liquidation and foreclosure process is essential. Rehabilitating nonviable micro and small incorporated SMEs (whose liquidation value is higher than their going concern value) makes little economic sense because their assets should be returned to useful economic life quickly to minimize further losses to creditors. This is a high priority in systemic European cases where high NPLs have held up the flow of new financing. In this regard, legal techniques that enable rapid enforcement/foreclosure out of court of collateral such as fiduciary arrangements should be explored (IMF 2014g).²²
- *Simplified SME process.* For viable but distressed SMEs, the goal is to establish a tailor-made simplified process for micro, small SMEs that would enable their quick and cost-effective rehabilitation. Elements should include the following: (1) a trustee or administrator to closely supervise the process and keep the courts continuously informed (possibly supported or subsidized by a public fund); (2) relatively short and strictly enforced deadlines, (3) availability of debtor-in-possession processes (see Box 4); (4) ability to combine personal and business bankruptcy processes; and (5) more flexibility to repay administrative expenses (for instance, installment payments under a plan) (Collett and others 2014).
- *Fresh start.* In line with the EC recommendation and recent cross-country experience, a debt discharge or fresh start should be afforded to honest entrepreneurs within a reasonable period of time (that is, three years) that strikes an appropriate balance between debt discharge and debt recovery.²³ About one-third of SMEs are “unincorporated SMEs” (that is, entrepreneurs operating without a legal entity), such as either sole proprietors (19 percent of all SMEs) or partnerships (14 percent of all SMEs; EC 2010). For these unincorporated SMEs if they are nonviable with little prospects for recovery, a fresh start through liquidation may be personally, societally, and economically more desirable than rehabilitation.

34. **More harmonization on the EU level for insolvency system should be pursued.** Different legal regimes in EU countries for insolvency and foreclosure weaken comparability across borders, increase costs, and inhibit cross-border assessment and debt resolution of distressed firms. Accordingly, building on the EC recommendation, the EU could explore whether insolvency and even enforcement/foreclosure systems could be further harmonized in targeted areas across EU countries. Enhanced EU-wide coordination beyond the SME platform, specifically on SME debt restructuring, should be considered to enable an assessment across borders and to implement standardized and unified proposals. In particular, UNCITRAL’s work on specific recommendations for SME insolvency regimes should be pursued. Data collection of SME insolvency and foreclosure, such as recovery rates,

²² Of course such techniques may change only the legal basis for out-of-court enforcement/foreclosure.

²³ The lack of such a discharge substantially undermines the efficacy of a restructuring, as it removes any incentive to restructure. In addition, it leaves debt overhang in place, so that the balance sheet of the enterprise remains in need of continued deleveraging. New credit is not available to an enterprise that is still obligated to repay old debt. Finally, entrepreneurs are discouraged from taking business risk because the economic price of the risk is too high.

number of cases, and lengths of proceedings, should be collected across EU countries on a unified basis to ensure appropriate monitoring and corrective actions.

Box 4. Priority and Protection of Provision of Fresh Money to Distressed Small and Medium Sized Enterprises

In order to rehabilitate an insolvent business through insolvency, access to fresh financing for purposes of working capital is essential. International best practice recommends that such post-commencement financing be granted priority at least ahead of unsecured creditors and that, should the rehabilitation for which fresh financing is provided fail, such priority should carry over into a subsequent liquidation. Further, post-commencement financing can also be secured by previously unencumbered assets; however, unless the relevant secured creditors agree, post-commencement financing should normally not have priority over existing secured creditors. Beyond that, countries may consider a U.S. Bankruptcy Code-style “super-priority” for post-commencement financing, which permits the debtor to petition the court to grant priority of post-commencement financing over existing secured creditors without their agreement subject to judicial control and safeguards (such as adequate protection for such secured creditors and the debtor’s inability to access post-commencement financing otherwise).

Different considerations apply to pre-insolvency fresh money financing, which should largely be protected against avoidance procedures provided it is furnished in good faith. The March 2014 EC Recommendation provides similarly for such protection.

At the same time, the government may need to take further measures to enable or encourage pre-insolvency or post-commencement financing.

- First, to the extent the banking regulatory framework prohibits banks from extending credit to an insolvent (or pre-insolvent) business or requires (full) provisioning for such credit, such regulatory prohibition or requirement may need to be loosened subject to adequate safeguards.
- Second, to the extent that pre-insolvency or post-commencement fresh money financing vehicles do not exist in specific EU countries, consideration could be given to EU-wide operating funds (including with government facilitation) to enable sufficient economy of scale and spread of risk.

More efficient out-of-court workouts

35. **For SMEs, (hybrid) out-of-court debt restructuring frameworks, which, with the assistance of a mediator or expert enable debt restructuring as consensually, efficiently, and less costly as possible, should be promoted.** It is important that out-of-court debt restructuring occurs against the backdrop of or in the shadow of an efficient and robust insolvency law. To promote SME workouts, the out-of-court framework could include:

- *Hybrid features.* Out-of-court frameworks are most efficient if they embed features of in-court processes, such as a stay or majority voting (see EC Recommendation). Further, these frameworks should be enhanced by arbitration or government support in the form of an agency that takes the lead in facilitating discussions between creditors and debtors.
- *Principles and templates.* Out-of-court restructuring guidelines in line with the INSOL principles should be issued to guide restructuring negotiation. Bankers’ associations across Europe or other representative agencies should disseminate standard inter-creditor and restructuring agreements that could be readily used by banks and other creditors.

- *Mediators.* In this regard, government involvement through, for example, mediation, or leadership of an agency that may be able to assert moral suasion on creditors (such as a central bank), could enhance the effectiveness of out-of-court frameworks; this is particularly true for SMEs, which in many cases lack the necessary legal and financial expertise and may also be in a weaker negotiating position due to their sizes.²⁴ As part of existing European SME schemes, government support for or subsidization of mediation services should be considered.

More incentives for banks to restructure

36. **International experience suggests that a more active role by banking supervisors can help tackle problems of high NPLs while keeping financial stability concerns in mind.** Following the ECB's comprehensive assessment, supervisors should ensure banks are adequately capitalized to weather unforeseen losses and are appropriately provisioned against problem loans. To the extent necessary, regulators may need to force loss recognition on banks through write-offs (especially for "zombie" firms) and ensure that provisioning approaches are consistently applied across banks, with attention given to whether going-concern or liquidation valuations are appropriate, and whether any assumptions are prudent and fully reflect the economic environment. Regulatory forbearance should be avoided to the extent possible.

37. **In particular with respect to SMEs, banking regulators should focus on the following issues:**

- *Collateral.* Banking regulators need to ensure the value of any collateral used for the purposes of loan loss mitigation is current and reflects the economic reality. This is of particular importance for SME loans in Europe, as collateral plays a significant role in SME lending. Consideration could be given to developing fiduciary loan contracts to facilitate collateral enforcement in countries where court involvement is high, for example, in Italy (IMF 2014g).
- *Provisioning rules.* Rules should be conservative enough to ensure banks have sufficient reserves to restructure or liquidate individual cases, but also be flexible enough to give banks space to maneuver concerning distressed loans.
- *Strengthen capacity.* Banking regulators need to ensure that banks have adequate operational capacity and expertise to restructure loans in-house. In cases where NPLs have reached systemically dangerous levels, regulators should require banks to segregate the NPL management to a dedicated division, establish strong governance structures dedicated to NPL management, and maintain detailed debt resolution strategies and action plans with operational targets. To the extent banks do not have such capacity, it needs to be developed or outsourced to third-party experts.

²⁴ Mediation in general works best when there are credible threats on both sides. Thus, mediation is likely to be more effective when lenders are presented with unpalatable alternatives, usually an available restructuring law that permits alternation of the secured position of the lender. Viable creditor remedies also need to be readily available (especially effective foreclosure laws), for the same reason.

- *Data reporting and disclosure.* Supervisors should enhance the standard reporting process by introducing detailed NPL status and operational management reports, as well as require banks to enhance disclosure through the publication of annexes with regular public financial statements. As little is currently known about debt recidivism, authorities should track this more carefully.

38. **Supervisors should follow up the European comprehensive assessment with a broader diagnostic of the NPL problem, particularly for SMEs.** The combination of risk assessment, asset quality review, and capital stress test was applied to the 120 largest banks in the euro area. It provided a first consistent view of euro area bank NPLs while ensuring the banks are adequately capitalized to absorb medium-term losses. The exercise needs to be complemented with a similar assessment of smaller banks within the euro area and also by macro-financial analysis to assess the linkages between NPLs, asset price declines, credit growth, and economic performance, as well as micro-level diagnosis of the obstacles to debt resolution.

Government support for SMEs

39. **Government efforts should aim to involve public creditors and remove tax and regulatory obstacles to restructuring.**

- *Public creditors.* All creditors (including public creditors²⁵) should participate in debt restructuring on equitable terms, and insolvency laws should enable involvement (including being bound to a collective decision) of public creditors. To encourage and enable public creditors (such as tax and social security authorities) to participate in restructurings, consideration should be given to issuing clear guidance to specify the conditions under which public creditors may participate in debt restructuring. A safe harbor could be created in terms of liabilities for officials that apply such guidance in good faith. This would reduce or eliminate (super) priorities for tax and social security claims and avoid weak tax enforcement and undermining incentives of creditors in general to participate in debt restructuring.
- *Adequate incentives.* The government should actively address issues of competition law/state aid, data protection laws, overly protective labor laws, and tax laws, which may be perceived as obstacles to efficient workouts. In particular, the tax regime should not penalize debt write-offs by making it excessively difficult for creditors to obtain tax relief or by imposing an undue tax burden on debtors. Such work may need to be coordinated with the EC to ensure compliance with EU state aid rules.²⁶

²⁵ It is recognized in many countries that it is the practice to exclude withholding taxes, such as payroll taxes, or value-added tax from debt restructuring either because they are collected by debtors on behalf of third parties (employees), or because their burden is intended to fall on others (customers).

²⁶ The European Commission sets the conditions under which state aid for rescuing and restructuring nonfinancial undertakings in difficulty may be considered to be compatible with the internal market on the basis of Article 107(3)(c) of the Treaty on the Functioning of the European Union. In this regard, the European Commission issued Guidelines on State Aid for rescuing and restructuring nonfinancial undertakings in difficulty (2014/C 249/01). These guidelines enable member states to provide for ex ante support schemes for SMEs without notifying the European Commission on a case-by-case basis.

- *Financing.* To the extent fiscal space is available, country authorities can explore whether temporary financing needs could be provided through a government fund. Funding mechanisms could include government guarantee schemes, securitizations, and other schemes in collaboration with development banks and agencies, consistent with EU state aid rules. However, such schemes should be administered with great caution as not to prop up nonviable SMEs or to increase moral hazard. The development of a market for SME debt securitization could also help improve financing for SMEs (IMF 2014b). The European institutions could further explore whether European funding sources are available (European Investment Bank, European Investment Fund, structural funds) to further assist SMEs with temporary liquidity shortages.
- *Support.* Also, the government could establish centers that provide (legal and financial) expertise, assistance, or debt counseling to micro and small SMEs (such as Japan).²⁷

Systemic cases

40. **A government-led mechanism for viable SMEs that involves all creditors and employs standardized debt restructuring solutions (rather than a case-by-case approach) could be explored** (see Box 5).²⁸ In the case of SMEs, the large volume of cases may demand standardization of assessments and restructuring products as well as decision processes. A case-by-case approach may overwhelm a judiciary that cannot cope with the enormous amount of cases. Any large-scale mechanisms also will likely necessitate significant capacity building. However, across-the-board solutions covering all existing SMEs (including nonviable ones) need to be avoided since they can increase moral hazard if not carefully designed (Japan, Korea) and may come at a significant fiscal cost (Chile, Mexico). Particular emphasis should be given to triage to ensure that “zombie” firms are identified and liquidated so as to return their resources to the productive economy.

²⁷ In systemic cases, a public asset management company could facilitate the removal of bad assets or noncore assets from banks’ balance sheets and, for larger distressed but viable SMEs, promote corporate restructuring with outside investment. Research shows that only a few of the asset management companies have actually succeeded in achieving their objectives; this has been the case, among other things, when the governance structure was adequate and transparent, asset prices were realistic, or assets were liquefiable and from the same asset class (for example, real estate, Klingebiel 2000).

²⁸ Specific to SMEs, the World Bank Principles provide that, “[i]n the containment phase of a crisis, preservation of asset values may call for across-the-board rescheduling of principal or interest (or both) for small and medium-sized enterprises, as well as special financing schemes.”

Box 5. A Standardized Approach to SME Debt Restructuring in Systemic Crisis

A standardized approach for SME debt restructuring could include the following features:

- *Government-led.* The government needs to take charge, enable creditor coordination, and rapidly remove any disincentives for debt resolution. Solutions should be designed to deal with the debt overhang within a specified time frame.
- *Agency/committee.* An effective and credible standing agency/committee should take the lead but the process should continue to be creditor driven. Such agency/committee should be led by the creditor with the largest credit exposure and comprise the key creditors (such as banks or the bankers' association, public creditors, trade creditors), representatives from key ministries (Ministry of Finance, Ministry of Economy, Ministry of Justice), and the central bank or the banking supervisor. It should be able and empowered to engage independent financial and legal experts (preferably including international experts) that advise on the feasibility of restructuring plans and formulate agreements. The agency/committee should develop guidance in the form of templates, master standstill, and restructuring agreements.
- *Public creditors.* The government should facilitate participation of public creditors (tax and social security) on equitable terms as other creditors.
- *Moral hazard.* The scheme should be by application only and creditor approved so as to minimize moral hazard.
- *Arbitration/mediation.* The mechanism should provide for a dispute resolution mechanism, such as arbitration or mediation, possibly as part of the agency/committee.
- *Feasibility/viability.* Only viable SMEs should be supported. However, such viability may be challenging to establish in a systemic crisis. Therefore, simple and easily applied economic indicators, such as whether the SME's going-concern value exceeds its liquidation value, should be developed to assess SME viability. Financial or other support to micro and small SMEs should be automated and standardized (for example, maturity extensions, principal reductions) once identified as viable/feasible.
- *Stay/standstill.* Contractual standstills are preferred and could be put in place by using boilerplate contracts; however, such standstills are not as effective as a court-imposed stay since they only bind consenting creditors. To the extent a court-imposed stay is needed, this could be established by a simple notification to the court rather than a formal court approval to simplify the process for an already overburdened court system.
- *Backstop.* Due to constitutional concerns (right to property and due process), majority voting by creditors without court involvement should be avoided, unless agreed to in advance by all creditors. Therefore, the mechanism should be backstopped with a pre-pack in-court approval process with a cram-down to bind minority dissenting creditors.

CONCLUSION

41. **Debt-distressed SMEs in Europe face a number of challenges in restructuring.** Their large numbers, small size, and weak balance sheets increase the fixed costs and risks to banks of restructuring. Despite recent reforms, insolvency systems and out-of-court workout frameworks in Europe are still ill-suited to the particular needs of SMEs, limiting their usefulness. Difficulties in foreclosure have also slowed the pace of loan resolution, contributing to the backlog of NPLs and

corporate debt overhang. If left unaddressed, SMEs' high levels of indebtedness and bad loans will remain a drag on the recovery and financial stability.

42. **Resolving the SME loan problem in Europe would benefit from a comprehensive strategy covering a broad spectrum of reforms to accelerate restructuring and resolution.**

Such a strategy should feature tighter regulation of banks' NPL management, insolvency reforms to improve the efficiency of SME restructuring, a greater push for out-of-court workouts, and supportive macro and financial policies. The focus should be to provide a wide range of cost-effective and efficient tools and to strengthen the incentives for restructuring and resolution. International experience with SMEs also has highlighted the need to guard against the risk of moral hazard and propping up weak SMEs by maintaining the policy focus on exiting nonviable firms, while supporting viable but distressed SMEs.

Annex. International Experience with SME Debt Restructuring

1. This annex summarizes experiences with SME debt restructuring in crisis context in Indonesia, Japan, Korea, Malaysia, Thailand, and Turkey.

Indonesia

2. **In 1998, the Indonesian authorities established a new governmental agency, the Jakarta Initiative TASK Force, which provided a one-stop forum to facilitate out-of-court workouts for corporates.** Using simplified templates, the Jakarta Initiative TASK Force also targeted SMEs.

However, few SME cases were resolved through the Jakarta Initiative TASK Force due to the government's priority to resolving large corporates and the sheer number of distressed SMEs (IMF 2000a; IMF 2004).

3. **More than 100,000 SME NPLs were transferred to the Indonesian Bank Restructuring Agency, an asset management company.** The Indonesian Bank Restructuring Agency adopted an across-the-board approach to SME debt restructuring. SME loans were either targeted for resolution through cash settlement (with interest and principal discounts) or sold through an open tender auction to other financial restructuring agencies.

Japan

4. **In 2000, the Civil Rehabilitation Act—which, albeit not explicitly applicable to SMEs, aims at providing simplified, expedited, and prepackaged procedures for distressed SMEs—came into force.** Both debtors and creditors may initiate the procedure under the Civil Rehabilitation Act. The court needs to ascertain whether the debtor is experiencing actual or potential balance sheet insolvency. Any application proposing an infeasible plan or suggesting bad faith by the debtor needs to be rejected by the court (Anderson 2001). Key features of the Civil Rehabilitation Act include the following: (1) no rights of secured creditors may be changed without their consent; (2) rights of unsecured creditors may be impaired by a simple majority of creditors holding more than half the total amount of unsecured claims; (3) there is no automatic stay, but temporary stays imposed by a court enable a time period to negotiate; (4) consent of shareholders is not required to dispose of the business or reduce capital; (5) post-petition financing has first priority in a class together with administrative expenses; and (6) the debtor remains in possession during the restructuring, is subject to the duty to act honestly and fairly, and requires court permission to undertake certain actions (for example, liquidate assets, acquire new loans, settle or pursue lawsuits, and hand over collateral). The court confirms a plan unless it violates the law, is a product of fraud, has no possibility of success, or is against the general interests of the creditors (Pomerleano 2005; Bufford and Yanagida 2006; IMF 2009a).

5. **In 2000, the Japanese Ministry of Economy Trade and Industry established 47 support centers to facilitate consultations with SMEs and help formulate restructuring plans.** Over 17,000 SMEs used the support centers and more than 2,000 restructuring plans were formulated. The

Ministry of Economy and Trade also established 17 SME restructuring funds, which raised 51.5 billion yen, which were underutilized.

6. **In 2009, the Japanese government enacted the “Act Concerning Temporary Actions to Facilitate Financing of SMEs” (the “SME Act”) in response to the financial crisis, which was extended twice and expired in 2013 (IMF 2012b).** The SME Act formed part of a concerted effort to assist SMEs through various special support programs, including credit guarantees and public loans. The SME Act obliged banks to use best efforts to amend the terms and conditions of distressed loans at the request of SMEs. To incentivize banks to process applications, the supervisory guidelines for banks were relaxed, and restructured SME loans were no longer required to be treated as NPLs.

Korea

7. **In 1999, Korea separated the distressed corporate sector into three segments: large, medium, and SME (IMF 2000b).** For the latter, the government instructed banks to evaluate the financial soundness of SMEs and identify targets for workouts, and set up individual workout departments in banks to review the restructuring plans. Banks evaluated the status of about 22,000 SMEs and classified 40 percent as viable. Restructuring options included rolling over SME loans, providing grace periods for repayment, reducing interest rates, and, for larger and stronger banks, injecting liquidity by providing fresh money. The government also played a role in establishing government-sponsored credit guarantee funds to provide loan guarantees to SMEs to enhance the availability of credit to the sector, and setting up Corporate Restructuring Funds to provide liquidity to SMEs through both debt and equity investment (IMF 2006; IMF 2010).

8. **The level of state support provided to SMEs suggests that SME over-indebtedness was delayed or inhibited rather than resolved.** The state guarantees were available to SMEs with ties to the larger corporates. Bank lending was concentrated around firms that could secure these guarantees, which skewed incentives in favor of existing firms, as the guarantees were constantly rolled over, creating a barrier for entry. For microenterprises, support to SMEs has meant support to the household sector (IMF 2010).

9. **In 2004, the government started a creditor-led restructuring program for SMEs under a revised version of the Corporate Restructuring Promotion Act (“Corporate Act”).** The revised Corporate Act stipulates shorter deadlines, allows debtor in possession, and permits shareholders to repurchase converted equity. About 7,300 SMEs underwent this program, and half were restructured and one-quarter were liquidated. Assessments by the Bank of Korea suggest that banks’ implementation of the program was too lenient and thus only moderately successful to resolve the debt overhang since, in some instances, nonviable SMEs also received debt restructurings (IMF 2010).

Malaysia

10. **In 1999, Malaysia offered SMEs (with debts up to RM 50 million) bridge financing from the loan monitoring unit of the central bank while the SMEs pursued debt restructuring** (Claesens 2005).

Thailand

11. **In 1999, Thailand promoted several mechanisms targeted at SMEs:** (1) the Corporate Debt Restructuring Advisory Committee, formed within the Bank of Thailand, introduced a simplified version of its inter-creditor and debtor-creditor agreements for SMEs; (2) the Bank of Thailand set monthly targets for financial institutions to resolve SMEs cases; and (3) the Bank of Thailand led a consortium to purchase promissory notes issued by creditworthy SMEs at a discount. The facility was priced at below the average cost of funds to the banks in order to encourage its use (Claessens 2005; IMF 2000c).

Turkey

12. **In 2006, Turkey established the “Anatolia Approach” targeted at SMEs.** The “Law for the Restructuring of Debts Owed by Small and Medium Sized Enterprises to the Financial Sector” (the “SME Law”) aimed at rehabilitating 70,000 Turkish SMEs with debts in excess of YTL 1.7 billion, thus preserving jobs. Under the SME Law, the regulation concerning the general conditions for agreements was developed by the Banking Regulation and Supervision Board. Framework agreements prepared by the Turkish Bankers’ Association consistent with the regulation were approved by the Banking Regulation and Supervision Board for a two-year term and were signed by 21 commercial banks. Under these framework agreements, NPLs could be restructured in a variety of ways, including through extending maturities, rolling over loans, providing fresh loans, decreasing principal/interest rate/default interest rate, and debt-to-equity swaps. Success was limited since by 2008, only 97 restructuring agreements had been signed, mainly because of limited interest and participation by the 21 commercial banks.

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