Corporate viability assessments in the context of NPL resolution

** Presenter views do not necessarily reflect those of the ECB.*

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The concept of corporate viability

- In principle, viable firm if NPV (going concern) > liquidation value (gone concern), yet in practice more complex
- Implies sustained future profitability and debt servicing capacity
  - Analysis of a borrower's **financial indicators** (e.g. operation profitability, debt/EBITDA, interest coverage, debt service coverage) with varying degree of sophistication in projections → data-driven part
  - Qualitative assessment of **business model, management** and **economic environment** (e.g. adaptability of management to respond to crises and adjust business models) → less data-driven part, also requiring qualitative input
- **Spectrum** in practice, more in-depth analysis needed for "semi-viable" borrowers

Why is viability relevant?

(i) Banks: additional lending decisions and possible loan restructuring offers

(ii) Public policy: design of targeted support measures (e.g. COVID-19 related)

(iii) Financial stability: corporate zombification risks and impact on banking sector

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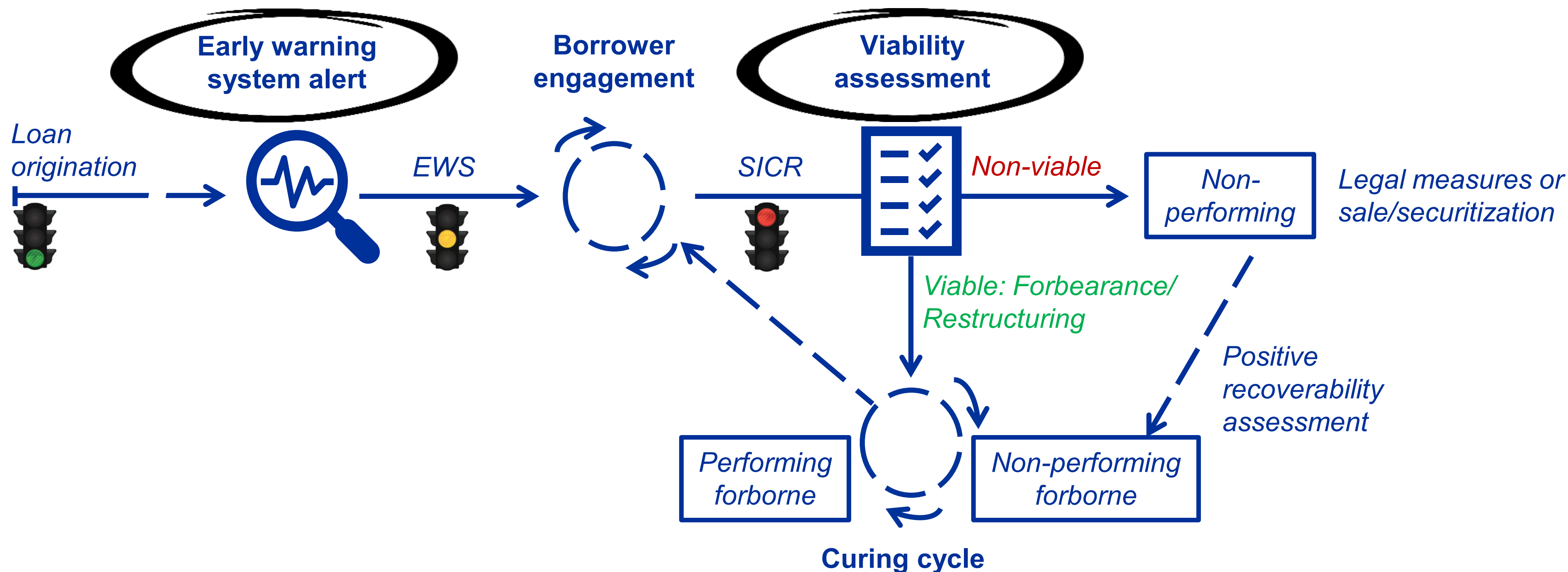
Corporate viability and the credit risk cycle

*Borrower viability assessments are closely linked to **forbearance activities and UTP assessments**, yet banks should already pay attention to potential changes in viability in the **detection of early signs of borrowers' financial difficulties**.*



Source: Author.
Note: Simplified illustration.

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Corporate viability in early warning systems

The early identification of warning signs of financial distress should ***guide the bank's engagement with the borrower*** *with a focus on rehabilitating viable firms.*

- **EWS regulatory framework set out by [ECB guidance on NPLs 2017]** (e.g. samples of firm- and sector-specific early warning indicators) **and [EBA GL on loan origination and monitoring 2021]** (not prescriptive on early warning indicators to be used; requires banks to consider credit quality deterioration signals on 19 topics related to the firm's macroeconomic environment, financial situation, instrument-specific risks and externally sourced signals)

- **Common practical challenges:**

  - **Structural challenges** (e.g. inadequate updated financial information for SMEs, unreliable behavioural information for SMEs with multiple bank creditors)

  - **Challenges related to COVID-19 pandemic** (e.g. blurred early warning signals due to extraordinary support measures, periods of high uncertainty)

- Further improvement and development desirable in the banking sector on issues such as **early warning system automation and digitalisation** (e.g. broadening use of sector- and firm-specific data, digitalising inputs, automatizing corporate early warning systems)

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Corporate viability assessment post-SICR

In case of a significant increase in credit risk, banks need to thoroughly ***assess the distressed firm's affordability of existing debt****.*

- Requires **detailed and reliable information** on the starting point financial position and underwriting criteria
- Forward-looking **cash flow projections under base and stress conditions** based on robust and consistent assumptions, with industry-specific **hurdle rates**
- Ideally covering the **lifetime** of outstanding debt
- Special attention to **non-standard repayment schedules** that may otherwise lead to biased results (e.g. interest-only periods)

Example: Affordability assessment of a sample bank in the accommodation and food services segment

Risk metric	Hurdle	Affordability outcome
Debt Service Coverage Ratio	>110%	Pass
	100%-110%	Further investigation
	<100%	Fail
Interest Coverage Ratio	>450%	Pass
	300-450%	Further investigation
Net Debt to EBITDA	<450%	Pass
	450-650%	Further investigation
	>650%	Fail

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Viability assessment and forbearance policy

*Banks should only grant **forbearance measures to viable and cooperating firms**.*

- Adequate **forbearance processes** are key to the timely and sound management of viable distressed debtors
  - Financial difficulties of (potentially) viable firms might be either temporary or structural
  - Loan modification should be aimed at ensuring that the loan is repaid (i.e. requires affordability)
  - Cost of granting measure in terms of NPV should be lower than that of alternative measures (e.g. different type of modification, liquidation)
  - Process can be started either by the bank or the client
- Clients to which forbearance measures have been granted need to be **monitored closely**

➔ Granting sustainable forbearance measures to distressed viable firms can have important system-wide benefits for financial stability, but caution is warranted to avoid forbearance being used as a way to hide NPLs.

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Defining viability metrics and thresholds

Definition of appropriate viability metrics and thresholds ***should be based on industry expertise****, taking advantage of international best practice.*

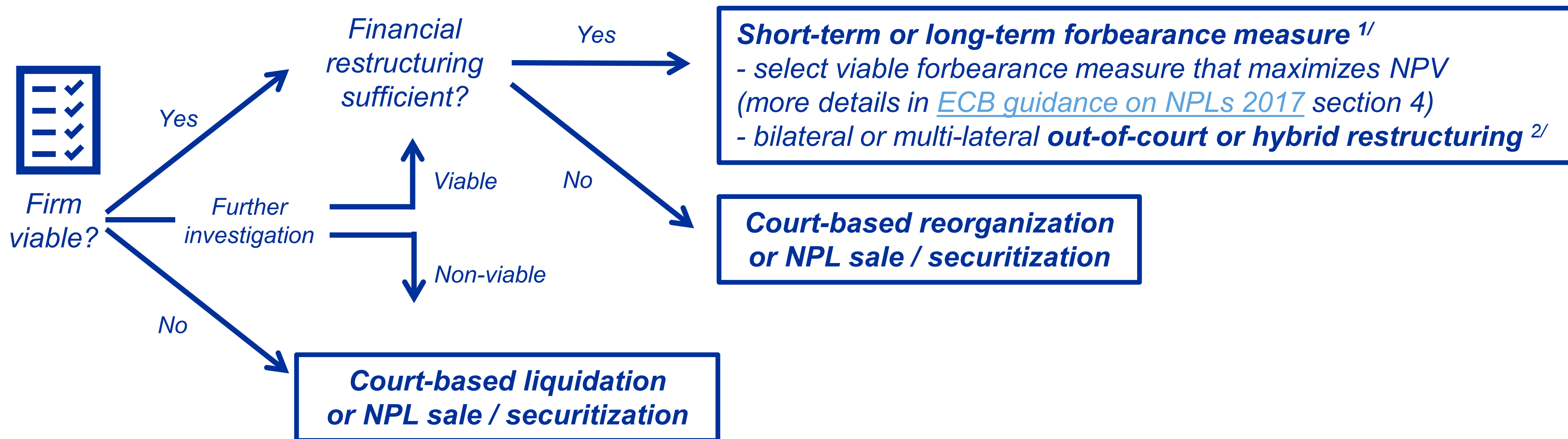
- Primary responsibility of **private financial creditors** to perform viability assessments of distressed firms in the NPL resolution context (in-house or with outside assistance)
- Caution in setting **different hurdle rates across industries** (pros and cons, risk of biased results, e.g. firms with debt service coverage ratio <1 should always be deemed non-viable)
- Some indications on thresholds for non-viable firms given in the European Commission guidelines for large firms' access to loan guarantee schemes (2014) …
  - Debt-to-equity ratio > 7.5 and EBITDA interest coverage ratio > 1 for the two most recent reporting years (Art. 2 para. 18)
- … or in ECB AQR Phase 2 manual (2014 version)
  - High debt to EBITDA multiple ≥ 6 as one indication of financial difficulties of corporates (excl. project finance, CRE, shipping and aviation)[1/]

Risk metric	Hurdle	Outcome
Debt Service Coverage Ratio	>a	Pass
	b-c	Further investigation
	<d	Fail
Net Debt to EBITDA	>a	Pass
	b-c	Further investigation
…	…	…
	…	…

1/ Debt to EBTIDA < 6 should not be understood as indicating firm viability.

Viability should inform the NPL resolution approach

Only debt of over-indebted but fundamentally viable firms should be restructured, while ***non-viable firms should be liquidated****. In some cases, court-based reorganization could be an alternative for potentially viable firms that require financial and operational restructuring.*



Source: Author.
Note: Simplified illustration partly based on Bauer et al. 2021, Flattening the insolvency curve: Promoting corporate restructuring in Asia and the Pacific in the Post-C19 recovery, IMF WP/21/16.
1/ Short-term forbearance measures include interest only, reduced payments, grace periods and arrears/interest capitalisation. Long-term forbearance measures include interest rate reduction, extension of maturity/term, additional security, rescheduled payments, partial or total debt forgiveness, etc. 2/ Potentially with simplified procedures for micro and small firms.

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Viability assessments during the COVID-19 pandemic

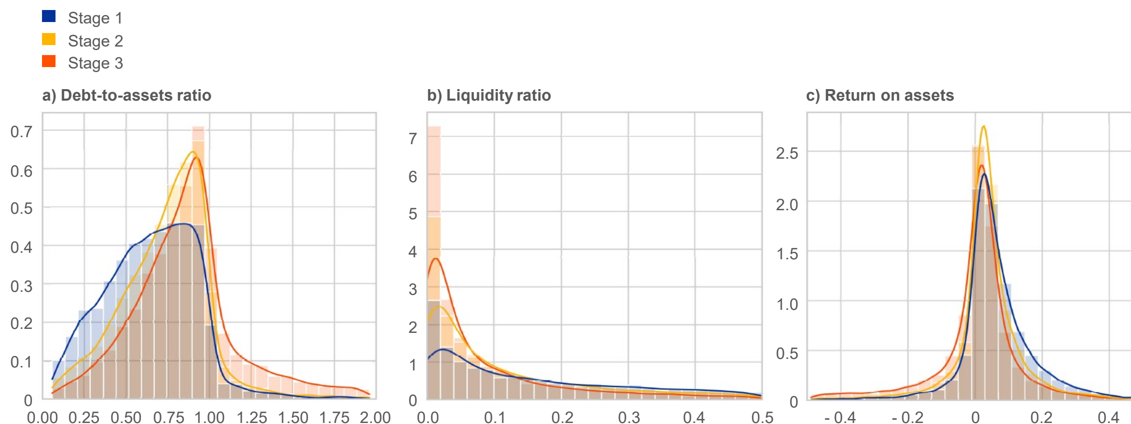
*"Significant institutions should use well-structured and sound creditworthiness assessment procedures so they can **differentiate, in a timely and effective manner and on a case-by-case basis where appropriate, viable from non-viable debtors**. This process should also take into account the expiry of public support measures currently in place."* (ECB Banking Supervision, Dear CEO letter, Dec. 2020, emphasis added)

- Migration to Stage 2 and 3 was broadly kept in check by **extensive fiscal and other support measures to firms** (e.g. fiscal transfers, loan guarantees)

- Case for swift viability assessments and advanced triage for SMEs **evolved during the COVID-19 pandemic**
  - Revised insolvency expectations
  - Accelerated structural transformation (digitalisation, greening, etc.)
  - Corporate debt overhang issues in some sectors as medium-term vulnerability

Distribution of borrowers' financial ratios by IFRS 9 stage classification (end-2020)

(x-axis: multiples; bars: histogram; lines: kernel density)



Sources: ECB (supervisory data, AnaCredit), Bureau van Dijk (Orbis) and ECB calculations.
Notes: Sample covers 1,500,000 firms with an active lending relationship classified as Stage 1 at the end of 2019 that remained active at the end of 2020 and for which financial ratios are available in Orbis. The panels show the distribution of three financial ratios for firms whose lending relationships remained in Stage 1 (blue), migrated to Stage 2 (yellow) or migrated to Stage 3 (red) during 2020. Firms with multiple credit relationships classified in different IFRS 9 stages are assigned to the stage corresponding to the worst credit quality. The liquidity ratio is defined as the ratio of cash and cash equivalents to current liabilities.

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Practical challenges in assessing corporate viability in the COVID-19 environment

Challenges

- Episodes of elevated uncertainty (recovery path, government actions, end-state visibility)
- Exacerbated information asymmetry, in particular lack of timely financial information for unlisted SMEs, in some countries also related to lack of external auditors or requirements for small businesses to prepare financial statements
- Creditor coordination needs due to large corporate and SME focus
- Capacity and expertise constraints to perform a high number of SME viability assessments in a short period of time
- Combining private sector lead with possible need for higher standardisation and simplification to achieve timely assessments for a possibly large number for SMEs in most affected sectors

Policy options

- Information requirements and facilitated exchange of firm-related information in hybrid or out-of-court workout mechanisms
- Creditor cooperation through pooling of resources, cooperation with credit bureaus
- Mechanisms to support market-based indications of firm viability
- Systematic classification of distressed companies into buckets with corresponding standardized restructuring solutions (e.g. Miller-Stiglitz 1999)
- Supervisory targets and expectations on viability assessments?

Note: Partly based on FSB 2022, Approaches to Debt Overhang Issues of Non-financial Corporates: Discussion Paper

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How to encourage SME viability assessments?

- **Support and incentives for SME viability assessments and advanced triage**
  - Facilitate the availability of common information sets by major creditors for viability assessments (e.g. through out-of-court workout frameworks in the transposition of the 2019 EU Directive on preventive restructuring frameworks)
  - Standardise viability assessments in systemic crisis situations and support their conduct through central platforms or pooling solutions (e.g. Icelandic *beina brautin* scheme in 2010)
  - Incentivise private-sector led viability assessments by conditioning targeted public support measures on debt restructuring and/or equity raising from private sources, which imply a positive assessment of viability by market participants (e.g. Blanchard et al. 2020)
- **Enabling frameworks for SME debt restructuring**
  - Introduce hybrid or out-of-court debt restructuring schemes (see FSB thematic review results, forthcoming), possibly with simplified and cost-effective procedures for MSEs, while minimizing potential for strategic behaviour
  - Ensure efficient insolvency procedures as precondition and benchmark for restructuring
  - Study innovative approaches: e.g. US small business restructuring (“simplified Chapter 11”), public administration cram-down in Italy

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