Management of distressed assets in banks

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Introduction

In recent years, as a result of the increase in the ratio of non-performing loans ("NPL") in Turkey, banks and some other market players have been taking various actions, along with the Banking Regulation and Supervision Agency (BRSA) to adopt some fast-response measures. In this regard, BRSA's recent press release dated September 17, 2019 announced that the amount of loans that must be watched under follow-up accounts, has reached 46 billion TRY, and that the banks are required to make necessary changes in loan classifications and to set aside the expected loan loss provisions by the end of 2019. In addition, establishment of a common asset management company by banks has recently become one of the options considered in dealing with the non-performing loans.

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Non-performing Loans in Turkey

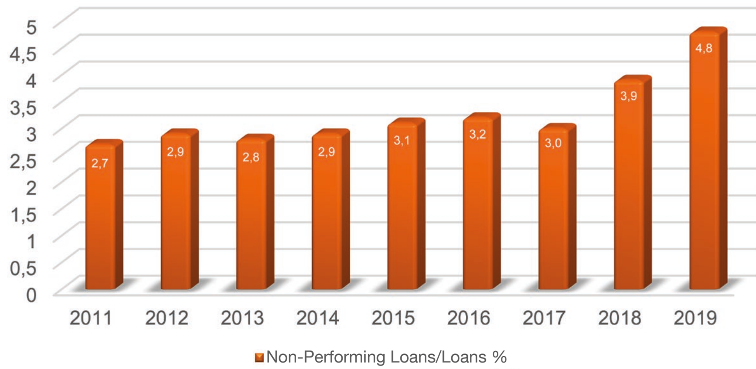
Finding appropriate solutions to NPLs is one of the most important issues on the agendas of the Turkish banks. The BRSA's recent actions seem to aim for reopening the tap to facilitate the lendings.

A receivable that is not paid on the date due does not immediately qualify as an NPL. Whether and when a receivable is defined as an NPL is determined under each country's local legislation or accounting standards. Although not directly defined under Turkish legislation, in practice, "NPL" mainly refers to loans that fall in the scope of (i) third group loans (Loans with Limited Collectability), (ii) fourth group loans (Doubtful Loans) and (iii) fifth group loans (Loans Classified as Loss), as regulated under the Banking Regulation and Supervision Agency's ("BRSA") Regulation on Procedures and Principles for Classification of Loans and Provisions to be Set Aside, dated 22 June 2016 ("Regulation on Provisions").

As bank equity carries weight in protecting the rights and interests of account owners and evaluating the solvency of banks, banks are subject to strict rules to protect equity, such as provisions to be reserved and standard ratios to be met. NPLs play an important role in calculating bank liabilities related to equity requirements, capital adequacy ratio, liquidity coverage, liquidity adequacy ratios, etc., since the loans extended by a bank and the bank's receivables represent that bank's assets on the balance sheet and in the financial structure. When the ratio of NPLs to total loans extended by banks in Europe and throughout the world is examined, it appears that most countries have higher ratios than Turkey. On the other hand, especially in 2018, the ratio of NPLs to total loans seems to have decreased in Europe. The ratio of NPLs in Turkey increased with the effect of 2018 Turkish currency crisis. There was an increase in the ratio of NPLs to total loans extended in Turkey in 2018 with the impact of the economic crisis and exchange rate increases. Particularly since August 2018, the total amount of loans extended has decreased whereas the ratio of NPLs has increased.In 2018 an increase was observed, especially in the so-called second group loans in the Regulation on Provisions. It is expected that these loans will become third group loans in the upcoming period and lead to an increase in NPL ratios.

As a matter of fact, in the press release issued by the BRSA in

Table - 1: The Ratio of Non-Performing Loans to Total Loans in Turkey[1]



• 2019 data covers the period from January to August

Source: BRSA Monthly Banking Sector Data

September 2019, it was announced that the NPL ratio increased from 4,6 percent to 6,3 percent based on the impact analysis conducted on the July 2019 financial statements of the banks. At the same time, banks are notified to set aside the expected loan loss provisions by the end of 2019 regarding the loans reaching a total amount of 46 billion Turkish Liras, mad available for mainly construction and energy sectors. This has been the one of the most dramatic and effective steps taken by the regulatory authority so far toward recovering the damages caused on the bank balance sheets by the companies that have recently failed to make payments after the 2018 exchange rate crisis. This decision of the BRSA, may require the banks to restructure, sell and possibly strengthen their capital by the end of the year, however, it is believed to be likely that methods other than debt restructuring will be implemented at this stage, especially for the NPL's. As things stand such attempt of the BRSA aims to reopen the tap to facilitate lending and accelerate the recovery in the Turkish economy.

1-The data in the table is for the month of January of the following year, and provides information on the figures of the previous year.

Management of Non-Performing Loans

Banks with high NPL ratios should have strong strategies, internal systems and policies, in order to decrease those ratios. For the collection of NPLs, banks operate an internal follow-up process for loans in which they may grant a delay or provide convenience to the borrower and, if necessary, encash the collateral and initiate legal proceedings. However, in practice, the first choice of banks is not a legal follow-up proceeding due to its difficulties, the cost of proceedings and, more importantly, the possibility that other creditors of the borrower with more senior receivables will apply the same process and override the bank's receivables. In order to reduce the NPL ratio and risks by avoiding these drawbacks, banks usually restructure these debts during the internal follow-up process.

Alternative ways to decrease NPL ratios:
- Restructuring
- Sale by Securitization,
- Debt for Equity Swap and Share Sale

In addition to these conventional methods, banks in the international market have recently implemented the securitization method, or a method called "debt for equity swap," in which the debt is removed from the balance sheet of banks in return for the borrower's shares and then, ideally, the shares are transferred to a fund established by a portfolio management companies which have expertise on turn-arounds (financial restructurings) to be managed.

1 Debt Restructuring

Debt restructuring provides both banks and borrowers with an easy means of finding the most appropriate solution in line with the interests of both parties regarding debts for which the borrower has difficulties making payment, and may increase the possibility of collecting the receivables.

In debt restructuring, which is usually implemented after the receivables are overdue and in the internal follow-up process, different measures can be taken, such as providing additional financing to borrowers, amending the terms of the existing loan, discounting the interest or principal, extending the maturity periods of loans and, sometimes, making debt-equity swaps in return for the debt. In some cases where the borrower is a company, unlike in debt restructuring the financial failure of the company that prevents it from paying its debts is ruled out by means of measures related to organization, capital structure or management, to strengthen the financial structure of the borrower.

Management of Non-Performing Loans

Developments on Financial Restructuing in Turkey

In various regions, regulations regarding restructuring have been introduced, especially at times when the financial structure of a country is adversely affected as a result of the increase in the indebtedness of the real sector to financial institutions. In parallel with the London Approach, which is the most common approach globally, the 2002 regulation regarding the Istanbul Approach, and subsequently the 2006 regulation regarding the Anatolian Approach, was adopted in Turkey. Finally the Regulation on the Restructuring of Debts Owed to the Financial Sector ("Financial Restructuring Regulation"), dated 15 August 2018, set out a regulatory framework for financial restructuring which banks and borrowers can agree upon. In the context of this new regulation, banks wishing to restructure their commercial loan debts will be able to undertake financial restructuring by signing a Framework Agreement specifying basic conditions among themselves, and then signing a Financial Restructuring Agreement, which determines the restructuring conditions, with the corporate borrowers that meet certain conditions.

The Financial Restructuring issue has been regulated under the Turkish Banking Law since 19 July 2019, and as of October 2019 the Framework Agreement has been revised bringing a dual approach that covers both small and large-scale firms depending on their debt amounts.

Latest regulatory amendments on financial restructuring

Since September 2018, several draft laws were prepared to provide the basis for the Financial Restructuring Regulation. The long-awaited law has now been enacted by the parliament, entered into force on 19 July 2019, for the primary purpose of addressing the concerns of banks. The new law brings certain amendments and tax exemptions, along with clarification regarding exemption from the scope of embezzlement, in relation to financial restructurings under the Financial Restructuring Regulation and the Framework Agreement, by means of a new provisional article inserted in the current Banking Law and by amendments to Article 53 thereof. Subsequently the languages of Financial Restructuring Regulation and the Framework Agreement have been aligned with the new law and the Framework Agreement is redrafted in a dual structure according to size of the borrower firms in October 2019.

Financial Restructuring should aim to preserve and increase the value of an enterprise. Therefore, banks need to work together with the portfolio managers who have sectoral expertise and an investor/client network to address for.

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In some European countries, NPLs are managed by transferring the loans to specific workout units formed solely for this purpose. This method is sometimes carried out by transferring receivables of the parent company bank to a subsidiary to be established for this purpose only. However, this is mostly applied by financially strong banks, where the internal workout units are often managed by the parent company bank.

In models in which the NPLs are followed in the internal systems of banks, the related receivables continue to remain in the banks' balance sheets. Therefore, the bank continues to bear the cost of these receivables.

Lately, banks in Turkey seem not to be in hurry to sell the troubled assets they have to the investors; instead, they are known to be working on restructuring them. In fact, restructuring should aim to preserve and increase the value of the enterprise, and include sustainable changes in the management of the borrower, rather than purely collecting bank receivables. On the other hand, banks whose main activity is providing banking services are not expected to have sufficient expertise about the different sectors of their customers. This requires banks to work with portfolio managers and partners of the relevant business that have both human resources with sectoral expertise and an investor/customer base. Only in this way will banks be able to achieve their growth targets, refocus on their existing and new customers, minimize the risk in new financing and utilize their risk management competencies at the highest level, and thus will ensure effective control in terms of NPLs. However, it is also a fact that in our country, the portfolio managers specialized in this field and equipped with the necessary knowledge are not sophisticated enough in terms of quality and quantity.

2 Sale to Asset Management Companies

Removing bank NPLs from the balance sheet will strengthen a bank and cause it to renew its focus on its core business. One of the most preferred means of taking NPLs off the balance sheet is to sell them to AMCs whose legal basis is the "assignment of receivables" under Article 183 of the Code of Obligations. NPLs can be brought back into the economy with a regulated, professional approach by AMCs authorized by the BRSA to buy, collect, restructure and sell NPLs according to their ability to be collected. On the other hand, banks may be forced to hold "fire sales" when transferring receivables to maintain their liquidity ratios.

Asset management companies, which have usually emerged around the world following a period of serious economic problems in a particular country, were regulated in Turkey by the BRSA, following the 2001 crisis, with Law on Restructuring the Financial Sector Debt Amending Certain Laws, dated 30 January 2002 and numbered 4743. As of 1 November 2006, AMCs are regulated by the Regulation on the Establishment and Operational Principles of Asset Management Companies (the "AMC Regulation").

AMCs, their operations and documents drafted regarding their operations including establishment, are exempt from stamp duty, fees, Banking and Insurance Transactions Tax and deductions for the Resource Utilization Support Fund in the calendar year of their establishment and the following five calendar years.

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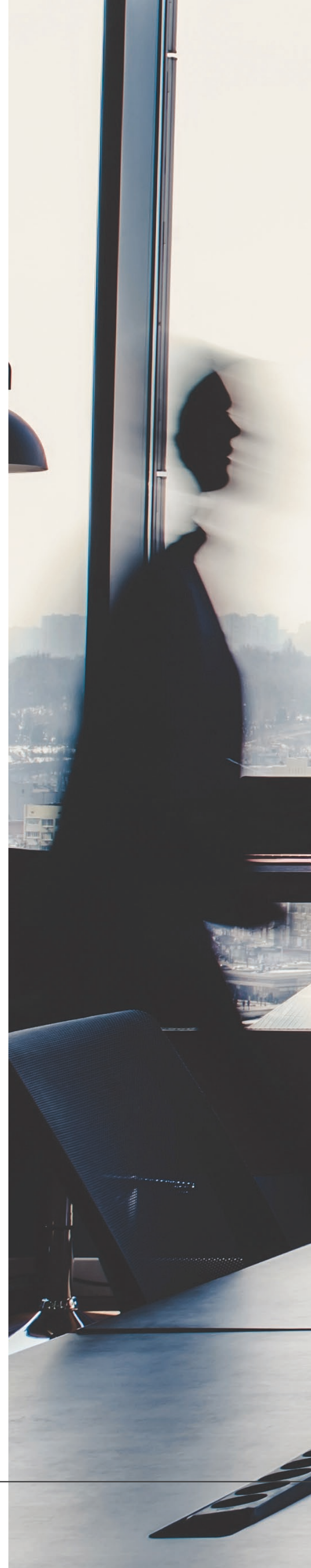
In this sense, AMCs in Turkey mostly serve to collect the receivables of individuals relating to credit cards and consumer loans. However, in order to make a permanent contribution to the national economy and to bring these NPLs back into the economy, it is clear that there is a need for structures aiming to increase the value of companies that have used these loans in the medium and long term, rather than those which take over loans deemed problematic with regard to the collection of receivables.

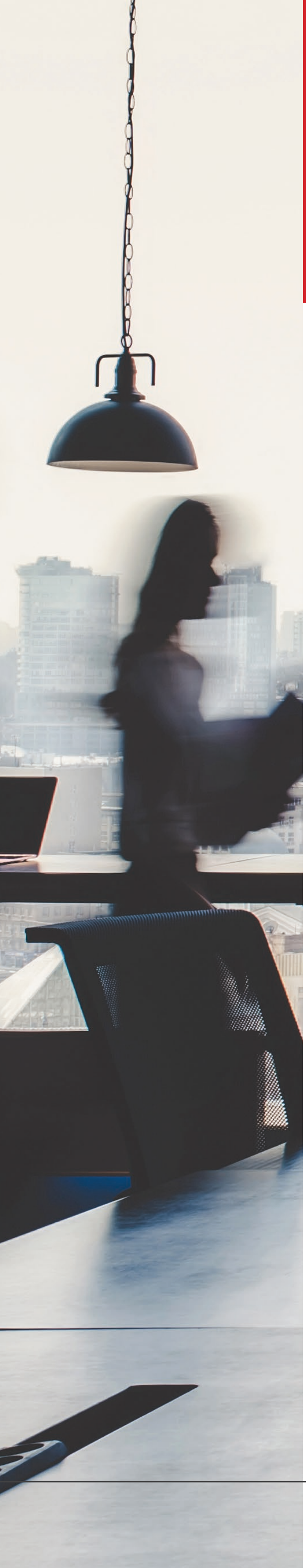
In Article 11 of the AMC Regulation, the field of activity of asset management companies is regulated in line with the provision of Article 143 of the Banking Law. Within this scope, AMCs are authorized to purchase, sell, collect or buy the receivables and other assets of related institutions; convert the assets into cash or sell them by restructuring; and operate, lease or acquire real estate or other goods, rights and assets acquired for the purpose of collecting receivables and refinancing the borrowers[2]. The AMC Regulation also enables AMCs to collect outstanding receivables of banks or to take over these receivables on a fiduciary basis and then repay the collected receivables to the banks. It is no wonder that in such a case, NPLs will remain on a bank's balance sheets.

If the transferring bank and the transferee AMC are group companies, and particularly if the AMC is the bank's subsidiary or if the bank has control over the AMC, the related receivables may continue to remain on the consolidated balance sheet after the transfer, even if they are no longer on the bank's balance sheet (solo balance sheet).

In recent years, AMCs in Europe have been established and administered directly by the state or established with state funding support. At the beginning of 2017, a structure was proposed by Andrea Enria, head of the European Banking Authority, which took a pan-European approach and could serve as the basis for a standardized blueprint for AMCs on the national level. Recently, with the increase in the ratios of the non-performing loans of the banks, whether a similar structure will be established in Turkey has been discussed in the markets. With this method, a common AMC is aimed to be established, to take over highly collectible non-performing loans by the public and private banks, as in the proposed structure of the European Union. However, issues like the strategy of such a structure, how potential conflicts of interest between the stakeholders will be prevented, projected difference of an AMC regarding the creation of the the added value beyond the competencies of the banks in regard to collection, and how it will contribute to the restructuring of the real sector, remain controversial.



2-The terms "asset management company" and "portfolio management company" in Turkish law often create confusion as to which corresponds to the term "asset management" in English. However, in current practices in Turkey, AMCs mainly function to collect loans. On the other hand, according to current regulations in Turkey, asset management companies are not only management platforms, but also investment platforms. Because the financial assets that it takes over are owned collectively by its investors and the manager, the assets are not separate from the assets of the AMC itself. In other words, the assets are on the balance sheet of the asset management company This situation causes them to be characterized as investment companies rather than management companies. Yet a portfolio management company that is regulated under Turkish capital markets legislation is a management company in line with foreign practices, and is not an investment company. The funds are directed by those who own the investments, but they are not owned by the investors, and the owners of the fund participation units are investors. In this respect, it is possible to suggest that Turkish PMCs are actually "asset management" companies.



Management of Non-Performing Loans

In Turkey, it is seen that the sales to AMCs mainly appear to be related to consumer loans of banks granted to individual customers. According to the PwC Turkey report, Turkish NPL Market Purchasing, published in 2018, while the ratio of loans has increased significantly, especially those extended to SMEs and corporate customers, retail loans are still ahead in terms of sales to AMCs according to data for the last decade. Banks in Turkey made 35.6 billion worth of receivables sales between 2008 and 2017, and sales of these receivables were essentially based on unsecured personal loans.

3 Sale By Securitization

Securitization, a frequently preferred method for lowering NPL ratios in international markets, is a structured financing transaction in which a bank's illiquid assets are converted into liquid securities .

Securitization can be performed in two ways: on-balance sheet and off-balance sheet. In on-balance sheet securitization, loans on the bank's balance sheet are converted to securities by the bank without being transferred to a third party, and the securities are issued as covered bonds, whereas in off-balance sheet securitization, the loan is transferred to a special-purpose entity irrevocably (using the true sale method), and the securities are issued by this entity. Internationally, either method can be used in the securitization of loans. However, while on-balance sheet securitization is a liquidity instrument, the main purpose served by off-balance sheet securitization is the collection of receivables.

3- In some international applications of the securitization, a debt for equity swap could also be performed and the management function may be carried out for companies that are likely to improve.

Off-balance sheet securitization, which can be done in Turkey by issuing asset backed securities or mortgage backed securities, is regulated under the Communiqué on Asset Backed and Mortgage Backed Securities of the Capital Markets Board (III-58.1). Within the scope of the communiqué, it is possible to include receivables from banks and financing companies arising from both consumer loans and commercial loans in the asset financing fund portfolio. However, according to the communiqué, in order to be included in the fund portfolio, bank loans must fall under first group loans as specified in the Regulation on Provisions. Yet, NPLs are inherently associated with the third, fourth or fifth groups, and thus cannot be subjected to asset or mortgage backed securitization according to current capital market legislation. Therefore, problems such as high cost and interest risk may arise in terms of NPLs that can be securitized by issuance abroad. For this reason, securitization of NPLs appears not to be feasible or preferable in Turkey by banks.

Sale by Securitization for NPLs does not seem to be an appropriate method for the banks in Turkey, due to the current regulatory restrictions of CMB.

Management of Non-Performing Loans

4 Debt for Equity Swap and Sale of Shares

In its simplest form, a debt for equity swap converts debt into equity by means of a bank cancelling debt in exchange for shares of the borrower company, which has defaulted on loan repayment. The borrower company undertakes to give the bank company shares in proportion to all or some of its debt, and the bank undertakes to waive the right to claim such amount of the receivable.

In international cases, the primary exit method after a debt for equity swap is selling the acquired shares directly to investors. The public offering method or resale of the shares to the borrower company are relatively seldom-used options. Due to the risks involved, investors who invest in such financial assets are more likely to be venture capital funds and institutional investors.

IMF criteria for Debt for Equity Swap

The criteria for a successful debt for equity swap are outlined in a report prepared by the IMF for China as: (i) the use of a debt for equity swap where it is truly advantageous and bank ownership of equity is limited in scope and time; (ii) strict solvency and viability criteria for corporates (i.e., excluding so-called zombie companies from the scope), (iii) the investors who will take over the shares having information or a say about management, (iv) robust regulatory treatment of equity holdings for banks, and (v) conversion is at fair value and losses are recognized.

Debt for Equity Swap in Turkey

Few examples of debt for equity swap have been observed in Turkey. The most well-known case is the OTAS-Turk Telekom case where OTAS used its shares in Turk Telekom as collateral for the loan. Reference to this method was made in the Regulation on Restructuring of Debts Owed to the Financial Sector, dated 15 August 2019, and finally another reference has taken place under the Banking Law by means of recent amendments therein[4].

However, in both Turkish banking regulations and international law, in accordance with BASEL rules, there are restrictions on banks holding equities and having subsidiaries. Pursuant to Article 56 of the Banking Law, banks' shares in a company (other than credit institutions and financial institutions) shall not exceed 15% of their own equity, and the total amount of the shares banks hold in these companies shall not exceed 60% of their own equity. In addition, any equity acquired by a Turkish bank is considered to be a loan, and as such will be subject to credit limitations.

Debt for Equity Swap method should be considered as the preliminary stage of the disposition of converted company shares

Due to disadvantages of banks such as equity restrictions, capital adequacy requirements, and limited expertise in the management of the companies, equities of which they are taking over, equities must be entrusted to portfolio managers having the expertise and necessary resources to sustainably increase the business value of the borrower company.

4 - One of the measures that can be resorted to within the scope of financial restructuring pursuant to the Financial Restructuring Regulation, Banking Law and the Framework Agreement, is converting the receivables (either principal, interest or dividend) arising from the loan to equities, partially or completely.

Management of Non-Performing Loans

Private equity houses play a major role in the rehabilitation of companies by taking over management, as a result of their expertise, advanced management techniques and experience with private equity investments.

> **To this end, banks should act in cooperation with companies such as private equity houses, which are experienced in private equity investments. The main objective in this method is to prevent the negative effects banks will be exposed to when selling loans directly, for example, by putting the acquired shares into private equity investment funds, managing companies with the support of a portfolio manager and making profitable exits from companies.**

Therefore, the debt for equity swap method should mainly be considered as the preliminary stage of the disposal of converted shares. Otherwise, the NPLs will continue to remain on the bank's balance sheet until sold to potential investors, creating additional obligations such as provisioning.

On the other hand, investing in companies with NPLs does carry high risks. Therefore, the professional managers who will manage an asset should have expertise in the sector, such as company restructuring and accurate assessment of whether a problematic company can become profitable. At this point, it is important that a portfolio manager's income from management mostly be linked to their performance.

Management of the shares by portfolio managers

In addition, since they are not publicly traded like investment companies, private equity houses have advantages in NPL management, such as the private equity funds ("PEIF") which are controlled by private equity houses and are subject to more flexible regulations, including not having public disclosure obligations or liquidity or capital adequacy requirements.

PEIFs are regulated by Communiqué III-52.4 on the Principles of Private Equity Investment Funds by the Capital Markets Board, which is based on Articles 52 and 54 of Capital Markets Law No. 6362. PEIFs can be defined as collective investment schemes which do not have legal entity status and that are established and managed by portfolio management companies for a period of time, the shares of which can only be sold to qualified investors. PEIFs invest in assets that have higher risks and higher potential returns, and have flexible legal arrangements. Investors are solely responsible for their commitments and are required to provide capital to these funds as per an investors' agreement, in which the important issues regarding PEIFs are regulated.

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Depending on its strategies, a PEIF can be established for many different purposes and structuring a PEIF to invest in companies suffering from financial debt (“distressed debt funds”) is possible and occurs often in international practice. Distressed debt funds, which have been the focus of investor interest in the rapid rise of NPLs in the United States and then in the European markets since the beginning of 2010, are in demand because they have higher returns if the receivables are managed properly, compared to other types of investments.

However, it should be underlined that assessment of the financial improvement and profitability of company in the future, whose shares will be acquired, has key importance in the acquisition of NPLs by PEIFs. This would be the key determinant for the pricing of shares. At this point, independence is extremely important in portfolio creation and management.

In addition, the main contribution of this model to the banking and the real sector becomes possible by the portfolio managers taking charge of the management of the companies that they invest thanks to their expertise, advanced management techniques and experience with the potential to play a role in the rehabilitation (turn-around) of these companies and by taking the burden that commercial banks cannot be expected to take on. On the other hand, it is obvious that in our country, the portfolio managers specialized in this field and equipped with the necessary knowledge are not sophisticated enough in terms of quality and quantity.

Conclusion

NPLs, which deteriorate bank asset quality and lead to decreased profitability, prevent banks from focusing on the main areas of activity where they can generate high profits. This is creating a significant negative effect on the national economy from a macro perspective. In countries where this problem has arisen in recent years, various practices have been implemented to reduce the increase in unpaid receivables, and new administrative and legal reforms have been planned.

In the light of the current regulations, considering the characteristics of the national economy and the needs of the private sector, some methods such as debt restructuring, sales to asset management companies, securitization and debt for equity swap have risen to prominence.

The debt restructuring method is inadequate for the bringing the borrowers back into the economy. Even if financial restructuring continues to be a frequently used method by the banks, the recent increase in the ratios of the non-performing loans as stated in the BRSA's recent press release in September 2019, reveals the need for a more substantial solution that focuses to the underlying problem. Although sales to AMCs is the most widely used method for certain types of loans today, these sales result in bank losses due to high discounts, and the method is not the most preferred one by investors because the assets subject to sale are not separated from the assets of the AMC. On the other hand, although the project to establish a common AMC by the leading commercial banks may bring a short-term relief to the sector in terms of NPLs, the strategy of such a structure, how potential conflicts of interest between stakeholders will be prevented, projected difference of an AMC in creation of an added value beyond the competencies of the banks that in regard to collection, and how it will contribute to the restructuring of the real sector, is controversial. The asset and mortgage backed securitization is only possible for first group loans, therefore NPLs cannot be subjected to this process in Turkey.

Conclusion

Banks may cooperate with portfolio managers who have the knowledge and experience to increase the value of borrower companies, to minimize NPL losses and to bring the borrowers back into the national economy and production. In this sense, the transfer of shares of borrowing companies, which may regain their financial stability in the future, to portfolio managers in order to effectively manage them by acquiring them using the debt for equity swap method, will ensure the rehabilitation of these companies.

In particular, for reasons such as the subsidiary limitation, capital adequacy requirements and the lack of sufficient expertise in the management of the companies, which they are taking over, it is important for banks to cooperate with portfolio management companies that are experts in the private equity investment sector. In addition, due to the high risk of investments in NPLs, the management of these assets should be left to professional managers. Portfolio management companies, especially, have sectoral expertise and can best provide the necessary action and organization. As a result of the debt for equity swap method, which has frequently been used abroad in recent years, profitable exits are made from companies and bank losses are minimized as a result of good management of company shares. In addition, PEIFs, which can be established and managed by portfolio management companies, are a suitable solution for the financing of the assets taken over from banks through securitization, as can be seen in examples of distressed asset funds abroad. Since the PEIF system in Turkish law is largely in line with the equivalent structures abroad (not having a legal entity status, exemption from corporate tax, management by a licensed portfolio management company, separation of fund assets, flexible structure, establishment of different funds based on asset classes, investors can have a say in the management of the fund) and the ease of investment and exit from participation units may make PEIFs a solution preferable to securitization methods abroad. The portfolio managers can undertake the burden that commercial banks cannot be expected to take on, as they have a potential to play active role in turn-around of the companies by taking over the management of the companies they invest in due to their expertise, advanced management techniques and experience. However, it is a fact that in our country the portfolio managers are not sophisticated enough, in terms of quality and quantity.

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