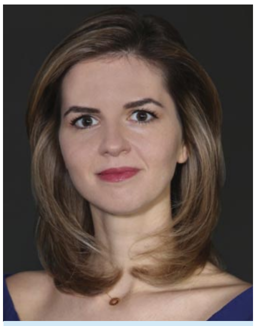
Calm before the storm: Why insolvency trends do not follow NPL trends

Irina Misca looks at trends in the insolvency and NPL market with some background history and first-hand experience



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> *The legal infrastructure is very important in the way the organic reduction of NPLs is being ran by every country*

Here are the statistics before COVID-19: 600 European companies go into liquidation every day; one in every two new companies survives less than five years.

Not surprising at all, the number of insolvencies was lower in 2020 than in 2019 and below all projections and estimations. What we are living now can be called the calm before the storm.

There are a few factors that are causing this apparent decrease of insolvent companies in almost all countries Europe wide:

The lockdown. This had a direct impact on the less digitally advanced courts and created a direct delay in officially registering new insolvencies that were already in the pipeline.

The governmental help packages. These came in order to prevent an immediate liquidity crisis for companies: tax deferrals, wage subsidies, debts or interest moratoriums.

The changes in the insolvency codes. Some countries drafted and enacted temporary changes in their insolvency codes. One of the main changes was the suspension of the obligation of the companies to file for insolvency even though conditions for these actions were normally met and the suspension of the creditor's right to place their debtors in insolvency.

Therefore, when comparing with the same figures from 2019, in the first half of 2020 there has been a general decrease in the number of new insolvencies in most countries (Western Europe the registered difference was of approx. 15%). However, short-term measures can only have a short-term impact. What will happen next?

NPL investors will have a massive market available to them in 2021. The challenge will come in assessing the viability of all opportunities in the new landscape that is covered with uncertainty. There are different estimations, some say that the number of global corporate insolvencies will increase by 25% this year (2021), while others estimate that the increase will exceed 35%. The one certain thing is that the volume of Non-performing loans will follow an upward trend.

The link between insolvency trends and NPL trends

There is no direct connection between the volume of NPLs and the number of insolvencies because of the obvious explanation that the volume of NPLs and the actual number of insolvencies are always related to the legal system of each country. Even though an economy may be extremely affected by a crisis, which will of course lead to the appearance of over-leverage borrowers and a high level of NPLs, that does not always translate into a high number of insolvencies as well.

A very good example in this respect is the situation of Greece. Even before the Covid-19 situation, Greece was holding the largest volume of NPL in Europe (more than 41%) but Greece is also the only country with a cumulative decrease in insolvencies in the last years.

The legal infrastructure is very important in the way the organic reduction of NPLs is being ran by every country:

- The insolvency and restructuring professionals play a key role in the insolvency process.
- Crisis managers can maximise the recovery rate.
- The specialised courts are an extremely important part of a healthy insolvency system.
- The involvement of the courts in the process, which can expedite or slow down the process.
- Protection for the debtor, incentive for creditors, new financing, use of electronic means.

When these elements are missing from a country's system, the insolvency proceedings cannot stand as a proper tool for recovery. And distressed companies and creditors are in the position to find alternative ways of recovery, that comes with no protection for any of them, no guarantees, no formal picture.

Therefore, they are taking many risks, that at the end of the day, will lead to a really low rate of recovery and a risky market for NPL investors. This is the current situation in Cyprus.

What does the Directive for Restructuring and Insolvency bring to NPL investors?

The Directive aims at bringing more uniformity in the European NPL market, by reducing this risks and differences between the legal frameworks in insolvency in the different EU Member States. Here is what the Directive can bring to NPL investors.

Firstly, recovery rates should increase once the mechanisms to detect financial difficulties and to restructure at an early stage are in place.

Here I would like to mention a study that CITR carried out in Romania. The study was performed on a number of 150 trading companies from our portfolio of 350 companies. What we tried to understand was in how much time after the first signs of distress does a company actually decide to take restructuring measures. So we went back in history with our analysis and we realised that almost 60% of these companies waited for three years after they started having financial problems before taking recovery measures. Only 25% asked for help and approached a crisis manager in less than one year since the first signs of distress appeared. The differences between the two categories was huge:

- in the first category the turnover dropped by 50% in three years, with the problems going spiral, compared to only 5% for the companies in the second category,
- the level of debts differed – 30% vs 8% – with the first category of companies almost always started financing their activity by selling important assets at discounted prices.

In conclusion, by putting into practice the idea of early warning tools and the use of preventive restructuring measures, the overall recovery rate in the NPL market should increase.

Secondly, and not less important, by regulating the same set of principles in all insolvency frameworks across Europe, the risk of buying an NPL portfolio will be easier to assess.

Finally, the reduction of the length of procedures will increase predictability for investors.

Case study

In many cases the creditors and the debtors in distress leave aside important sources of income that would contribute to recovery.

Once appointed as liquidator of one of the former biggest insurance companies in Romania, we started assessing all sources and resources of the case and we realised that the company was sitting on a high number of unrecovered amounts (around €30 million).

Therefore, one of the first measures we took was to restructure their legal department running the recovery process. We brought in new people, we implemented clear management routines, budgets, KPIs for each person; basically we ensured a clear team leadership. As a result, compared to the year before our appointment when the company recovered only €300,000, we managed to recover €2,565,217 and we continued on this trend the next year as well.

The recovery rate is always influenced by the existence of a crisis manager who is involved in the process.

In 20 years of experience we understood that the mission of a crisis managers is to find the value in every insolvency and restructuring case and to save it or increase it where that is possible.

Sometimes that means saving a company, some other times it means saving value as we managed to find in that company: maybe the brand, maybe the product, the share market, or the core assets. All in all, it translates to a higher recovery rate and this is what counts in the end. ■

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