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Legal Considerations for NPL resolution, including debt enforcement, out of court workouts and insolvency

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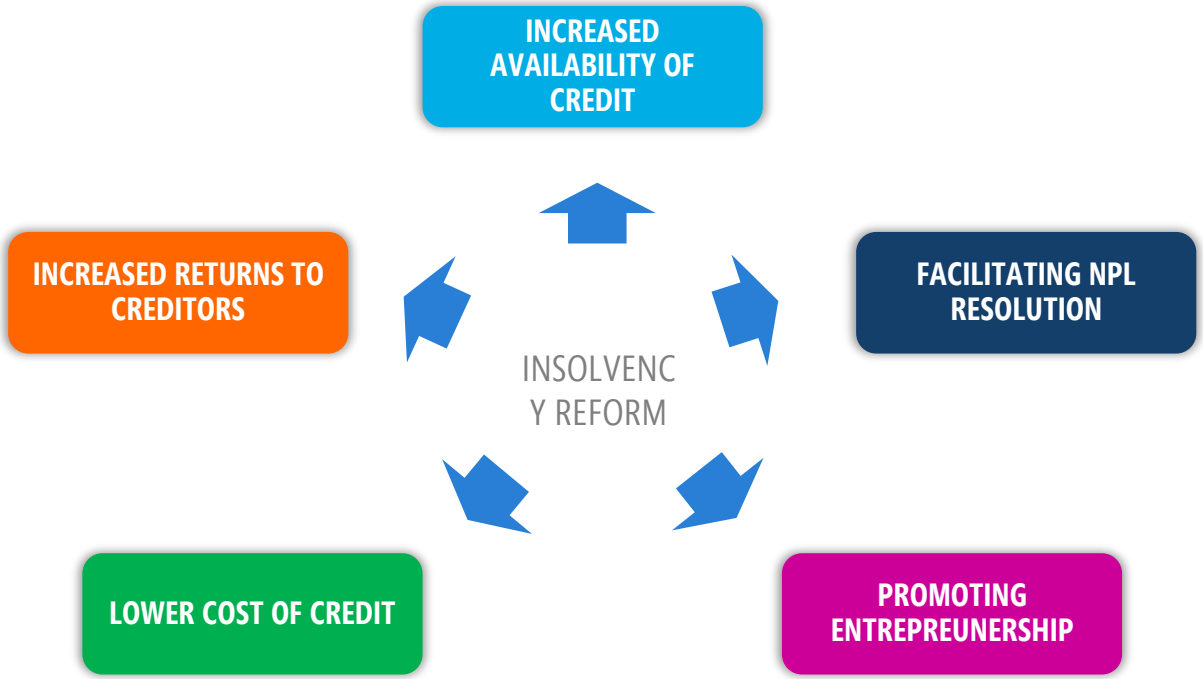
Outline

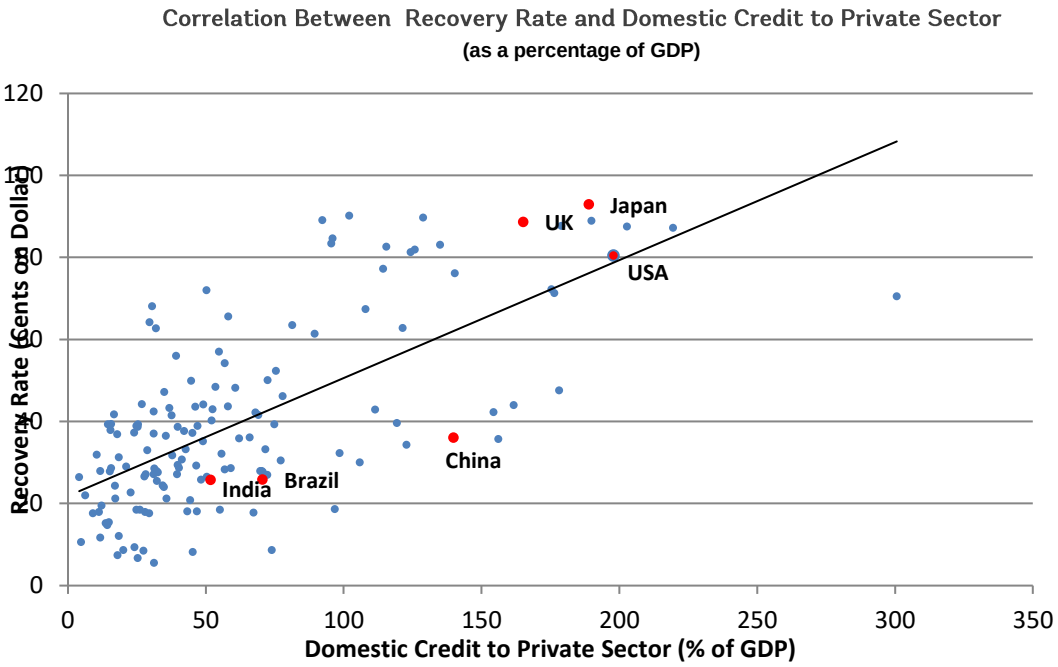
1. The importance of legal systems for NPL resolution
2. Good practices for insolvency and debt resolution
3. Out-of-court workouts (“OCW”)
4. Overview of Vietnam’s insolvency framework
5. Recommendations

The Benefits of Efficient Insolvency Systems



Poor Recovery Rate Influences Credit Availability

- ✓ There is a positive correlation between domestic credit and recovery rate in economies where the creditors' rights are less sound



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The importance of legal systems for NPL resolution

Need for a legal environment supporting banks' efforts in resolving NPLs

Addressing high volumes of NPLs requires a robust legal framework

1. Contracts need to be binding and enforceable
2. Collateral should serve its ultimate purpose of guaranteeing transactions and should be easily enforceable upon default
3. The legal and regulatory system should not introduce elements that impede or significantly discourage NPL transactions
4. Tax and banking regulations should not be major impediments to write-offs and out-of-court agreements between firms in financial distress and their main creditors
5. There have to be mechanisms to quickly seize and sell any pledged collateral or (in the case of unsecured loans) enforce against property of the debtor
6. Enforcement and insolvency frameworks are also key for maintaining repayment discipline and for developing markets for portfolios of NPLs

The insolvency system should permit distressed but viable firms to be brought back to commercial viability and promote the swift liquidation of unviable borrowers

Each of these elements should be applied by a cadre of trained, efficient, and transparent institutions that encompass bailiffs, tax authorities, insolvency administrators, and, critically, courts

The importance of legal systems for NPL resolution

Impediments from legal and institutional systems for banks to resolve NPLs

In practice, most legal systems have shortcomings in one or more areas that affect NPL resolution

1. **Difficulties in enforcing debtor's assets in an extra-judicial or judicial process** (either because of weak laws or poor enforcement systems)
2. **Poor collateral legislation or dysfunctional registries** (real estate, pledges, etc.)
3. **Difficulties in restructuring a company** due to impediments in the insolvency system or in the tax legislation
4. **Poorly designed or outdated liquidation regimes**, including possible unclear repayment priorities – e.g., privileged creditors (such as government tax and employee wage claims) may have priority over secured lenders
5. **Environment unconducive to workouts**
6. **Central bank** (or supervisory) regulations that discourage distressed asset sales
7. **Regulatory challenges related to NPL portfolio purchases** (for example, requirements that the purchaser is registered as a local financial entity)
8. **Unfavorable tax treatment of NPL transactions**
9. **Requirements for the ultimate debtor's consent to transfer purchased assets**
10. **Difficulties in restructuring a company** due to the lack of capacity of key local players such as insolvency practitioners or judges
11. **Absence of priority for rescue financing or debtor-in-possession** financing to distressed companies
12. **Moral hazard** (willful defaulters) has been **particularly problematic in countries** where borrowers have ample opportunity to delay enforcement proceedings by **engaging in delay tactics** (repeated appeals, postponements), or on **account of slow, ineffective, or corrupt courts**

The importance of legal systems for NPL resolution

Preconditions for the sales of portfolios of NPLs

Several legal and regulatory preconditions need to be met to allow for the sales of portfolios of NPLs

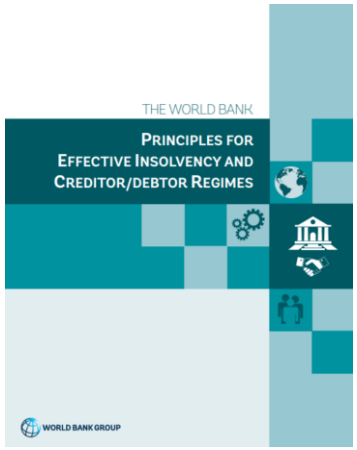
1. **The sale of NPLs requires that the legal system allows the transmission of claims on the borrowers to the investor in such assets without requiring the debtor's consent**

2. **Other potential legal obstacles for NPL sales can include:**

- Bank secrecy and data protection laws
- Requirements on the registration of security interests transferred with the NPLs
- Notification to debtors and the position of guarantors of NPLs
- Preemption rights of borrowers

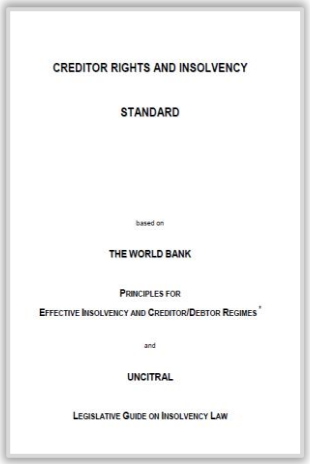
International Standard Setter

- ✓ Key International Instruments that Guide and Effective Insolvency Regimes



ICR Principles

UNCITRAL Legislative Guide



Unified Standard for ICR

Good Practices: World Bank ICR Principles

1. Credit, information, and enforcement systems need to be compatible
2. Collateral should serve its ultimate purpose of guaranteeing transactions and should be easily enforceable upon default
3. A modern, credit-based economy requires predictable, transparent, and affordable enforcement of both unsecured and secured credit claims
4. Informal corporate workouts are necessary to a functioning restructuring process
5. The integrity of the insolvency system is the linchpin for its success
6. Transparency and corporate governance are especially important in emerging markets, which are more sensitive to volatility from external factors
7. The enforcement process must generate predictable outcomes

ICR Principles for Micro and Small Enterprises (MSEs) Insolvency: a summary

MSE insolvency brings about specific challenges

1. Complex and expensive proceedings may deter MSEs from tackling financial distress
2. Creditors have few incentives to deal with MSE debtors ("creditor passivity")
3. Limited information about MSE debtors hinders creditor trust in MSE debtors
4. MSEs are commonly financed with a mixture of business and personal debt
5. MSEs are frequently operated by sole proprietors

Effective MSE insolvency systems should aim to:

1. Lower the barriers to access and encourage early resort to out-of-court restructuring procedures, hybrid procedures, and in-court simplified insolvency proceedings
2. Implement a streamlined regime
3. Establish favorable conditions and adequate safeguards for debt discharge and a fresh start for natural-person entrepreneurs
4. Reduce the stigma associated with insolvency
5. Promote entrepreneurship and growth increasing access to credit
6. Maintain basic safeguards for protecting the rights of creditors, debtors and all parties affected by MSE insolvency proceedings.
7. Implement an effective regime to prevent and sanction abuse of MSE insolvency proceedings.
8. Establish mechanisms of assisting MSEs to provide early signals of financial distress

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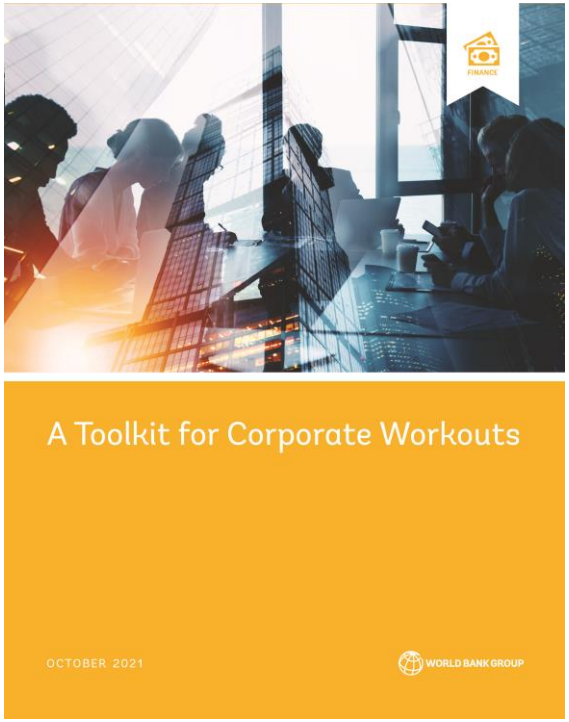
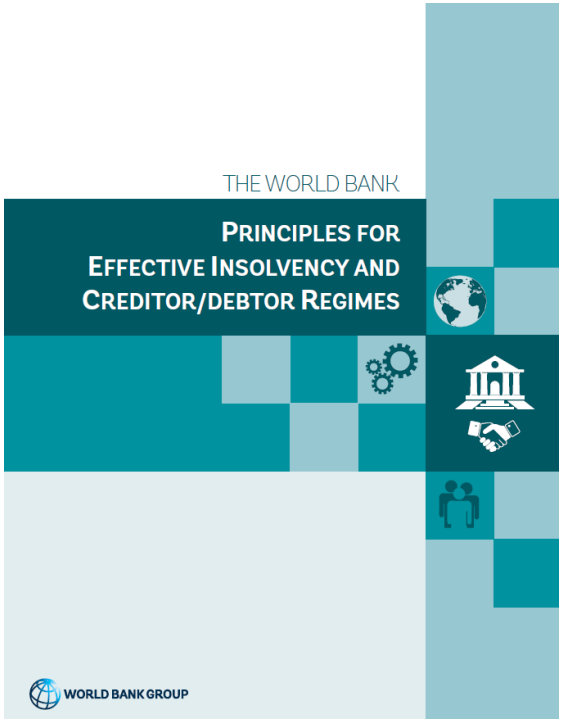
Recent Publications – WBG Insolvency



A Toolkit for Corporate Workouts (2021)



WBG Principles for Effective Insolvency and Creditor / Debtor Regimes (2021)

Legal framework for insolvency

Effective insolvency systems should aim to:

1. Integrate with a country's broader legal and commercial systems
2. Maximize the value of a firm's assets and recoveries by creditors
3. Provide for the efficient liquidation of both nonviable businesses and those where liquidation is likely to produce a greater return to creditors and the reorganization of viable businesses.
4. Strike a careful balance between liquidation and reorganization
5. Provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors.
6. Provide for timely, efficient, and impartial resolution of insolvencies
7. Prevent the improper use of the insolvency system
8. Prevent the premature dismemberment of a debtor's assets by individual creditors seeking quick judgments
9. Provide a transparent procedure
10. Recognize existing creditor rights and respect the priority of claims with a predictable and established process

Legal framework for MSE insolvency

The law should establish simplified insolvency proceedings for reorganization and liquidation of MSEs, which should have the following key features:

1. Eligibility
2. Commencement criteria
3. Conversion of proceedings
4. Procedural formalities and deadlines
5. Management in simplified reorganization and liquidation proceedings
6. Reorganization plans
7. Personal guarantees
8. Mechanisms for covering the costs of proceedings

Out-of-court workouts ("OCW")

An OCW is a privately negotiated restructuring. They have the following characteristics:

- Typically, no administrative authority has introduced any restructuring-specific guidelines.
- Any administered guidelines may not be binding on workout participants or workout participants may agree purely voluntarily to be bound by them.
- There is no provision for the court to play a role.

Enhanced workouts are restructurings in which participants are bound by law, regulation, or contract to follow restructuring-specific standards introduced by an administrative authority such as a central bank, in accordance with an expectation or requirement set out by that authority, but where no provision is made for the court to play a role.

Example: Indonesia

Hybrid workouts involve private negotiations of restructuring terms pursuant to a procedure that provides for the court to play a role, where this role falls short of supervision of the full procedure. A hybrid workout procedure benefits from advantageous features of both OCW procedures and reorganization procedures: it is typically a relatively inexpensive process that can make a restructuring binding on stakeholders — parties, other than the debtor, that are or may be affected by the restructuring — that do not consent to it.

Example: France

Vietnam's insolvency system: current framework

Insolvency proceedings in Vietnam are currently regulated by the Law on Bankruptcy which entered into force in 2015. The new Law overhauled the outdated previous regime and introduced a number of good international practices, such as:

- Improved reorganization procedure
- Stronger creditors' rights during insolvency
- Rules on avoidance of preferential transactions
- Management of insolvency proceedings by professional insolvency office-holders.

2020-2021 Assessment of Vietnam's Legal Framework:

- Slow liquidation proceedings remain the most likely method of recovery for secured creditors
- The average time to recover is 5 years
- It will take 2 years to formally initiate insolvency proceedings
- An insolvency case costs around 15% of the value of the estate
- Secured creditors are expected to receive on average 21.3 cents for every dollar loaned

Vietnam's insolvency system: successes and shortcomings of the 2015 Law

Successes

1. More streamlined provisions related to rehabilitation of viable companies
2. Clearer standard for the commencement of insolvency proceedings
3. Creditors are no longer required to demand payment from the debtor before commencing insolvency proceedings
4. Extension of the suspect period for preferential and undervalued transactions from 3 to 6 months prior to commencement of insolvency proceedings

Shortcomings

1. No OCW provisions
2. Requirement to exhaust reorganization procedure prior to commencement of liquidation
3. Liquidation by piecemeal sale of the debtor's assets remains common
4. Cumbersome reorganization procedure

Barriers to NPL Foreign Investment

1. **Currently, NPL foreign investors are not allowed to take security over immovables**

2. **Recommendation: remove the restriction**

Recommendations going forward

1. Introduce an OCW framework
2. Introduce efficient insolvency procedures tailored specifically towards SMEs
3. Improve the regulations for insolvency practitioners

Thank you!