



# REPUBLIC OF SAN MARINO

## SELECTED ISSUES

May 2016

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# REPUBLIC OF SAN MARINO

## SELECTED ISSUES

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**The European and  
Legal Departments**

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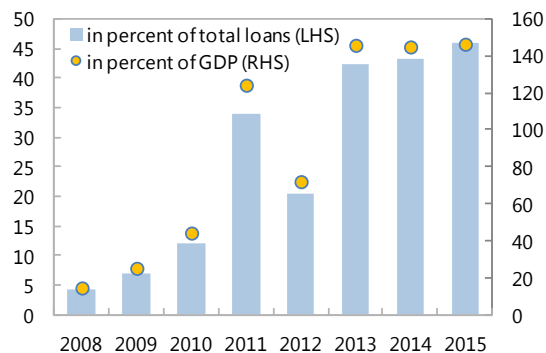
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# NONPERFORMING LOAN MANAGEMENT AND RESOLUTION

## A. Introduction

**1. Resolving the sheer level of banks’ nonperforming loans (NPLs) is one of the hardest challenges that San Marino is facing.** Since the outbreak of the financial crisis in 2009, NPLs have been on a brisk upward trend. As of September 2015, NPLs amounted to 46 percent of Sammarinese banks’ total loans, including inter-bank loans. If one considers only banks’ loans to customers (i.e., excludes interbank loans), more than half of the total portfolio (52 percent) was impaired. Given the magnitude of the Sammarinese banking sector, the current stock of NPLs is equivalent to almost one-and-a-half time the output of San Marino (about 140 percent of GDP).

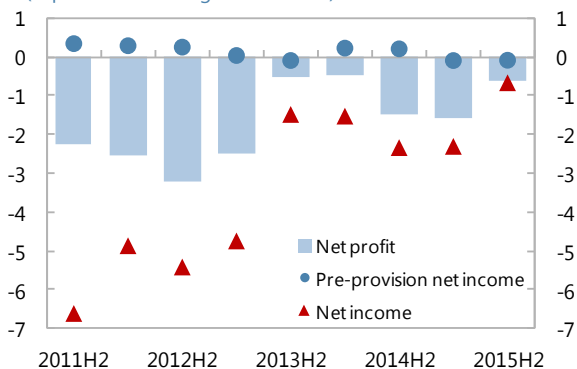
San Marino: Banking Sector’s Non-Performing Loans



Sources: CBSM; IFS; WEO; and IMF staff calculations.

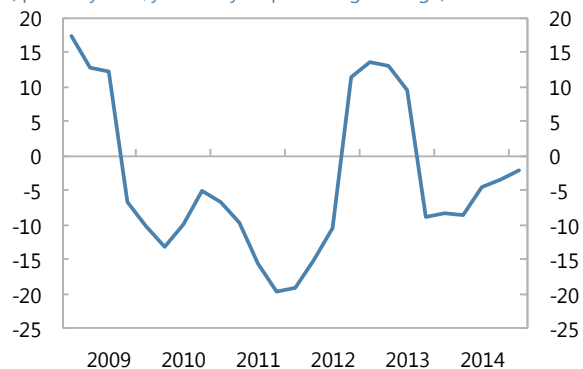
**2. The burden of legacy assets represents a threat to the stability of the banking sector and to the nascent economic recovery.** In general, a high level of NPLs reduces banks’ profitability since a lower amount of remunerating assets depresses operating income, whereas operating expenses tend to increase reflecting the accumulation of loan loss provisions and higher borrowing costs. Banks’ lower capacity to generate new capital organically through profits weakens their financial soundness and resilience to shocks. At the same time, banks are likely to become more risk adverse thus reducing lending, which in turn weighs down on economic activity.

San Marino: Banking Sector’s Profitability (in percent of average total assets)



Sources: CBSM and IMF staff calculations.

San Marino: Loans to Households and Other Resident Sectors (quarterly data; year-on-year percentage change)

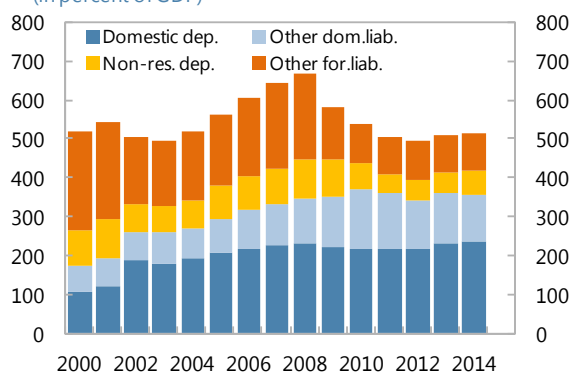


**3. The aim of this paper is to offer elements of a possible strategy to deal with San Marino's NPLs.** The paper is structured as follows: Section B provides a brief overview of the reasons behind the accumulation of impaired assets by Sammarinese banks. Section C presents some stylized facts regarding the nature and composition of San Marino's problem loans. Section D summarizes the experience of other small economies (namely, Iceland, Ireland, and Cyprus) in dealing with weak banks and NPLs, with a view to drawing policy lessons. Section E discusses recent measures implemented by the Sammarinese authorities to address weak financial institutions and their problem assets. Section F examines the main impediments to deal with NPLs in San Marino's legal and tax framework. Section G concludes and offers some policy recommendations.

## B. What Caused San Marino's Current Problems?

**4. For many years, the Sammarinese banking sector benefited from San Marino's tax haven and bank secrecy status.**<sup>1</sup> Reflecting a strict bank secrecy regime, favorable taxation, light regulatory burden, and free movement of capital, banks were able to attract substantial funds from nonresidents (mainly Italian residents) looking for confidentiality. The system's total assets were boosted to more than 600 percent of GDP by end-2008. A few Sammarinese banks entered directly into foreign markets, mainly Cassa di Risparmio della Repubblica di San Marino (CRSM)—San Marino's oldest and largest bank—which established a subsidiary in Italy (Delta Financial Group) and bought a Croatian lender (Banka Kovanica). Although Sammarinese banks balanced much of their nonresident deposits with liquid Italian securities, cross-border lending (mainly to Italy) also expanded rapidly. The easy and profitable carry-trade, together with weak supervisory oversight, contributed to weakening banks' lending standards.

**San Marino: Funding of Banks' Total Assets**  
(in percent of GDP)



Sources: IFS; WEO; and IMF staff calculations.

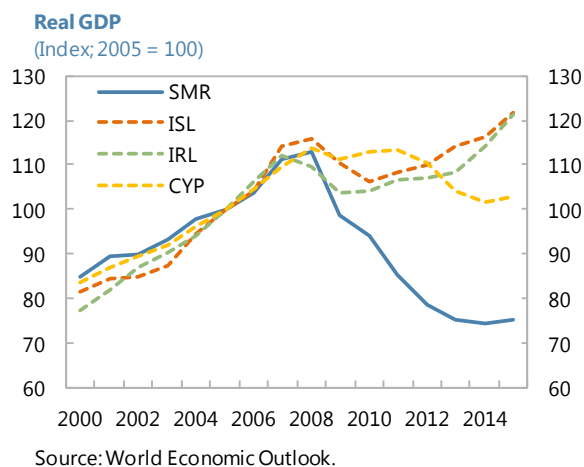
**5. This offshore business model collapsed with the outbreak of the financial crisis leading to a deep recession.** The international community started putting pressure on tax havens in order to embrace more transparency even before the outbreak of the global crisis. In 2008, San Marino received a critical AML/CFT assessment by MONEYVAL.<sup>2</sup> In April 2009, the OECD put San Marino on the "gray list" of tax haven countries. Italy added additional pressure by launching a tax amnesty in

<sup>1</sup> For more detailed information on San Marino's financial sector, see IMF (2010) and Pratt (2011).

<sup>2</sup> In the first compliance report, San Marino was rated noncompliant on 19 recommendations and partially compliant on 22 recommendations, including several core ones (see, [https://www.coe.int/t/dghl/monitoring/moneyval/Countries/San%20Marino\\_en.asp](https://www.coe.int/t/dghl/monitoring/moneyval/Countries/San%20Marino_en.asp)).

September 2009, and, in July 2010, extending the impact of San Marino’s inclusion on a “black list”.<sup>3</sup> The resulting deposit outflow was massive, and a number of Sammarinese companies moved their operations in Italy. These developments, coupled with weak external demand due to the economic and financial crisis gripping Europe, triggered a deep and prolonged recession, which has been more severe than in most other countries hit by a banking crisis, and that only now seems to have bottomed out.

**6. Furthermore, San Marino’s financial sector was shaken by the Delta-CSRSM judicial investigation.** In 2008–09, two major investigations conducted by the Italian judicial authorities led to the arrest of the top management of two Sammarinese banks—including CRSM—on various criminal charges, including money laundry. The arrests were later revoked, but criminal investigations continued. Subsequently, the Bank of Italy revoked the authorization granted to the CRSM as shareholder of the Delta Financial Group based in Italy, and placed Delta under special administration in 2009. The losses for CRSM were substantial and a heavy burden of NPLs was transferred directly onto its balance sheet. Since then, CSRSM has needed four recapitalizations (equivalent to 16 percent of San Marino’s GDP) in order to comply with minimum capital requirements.

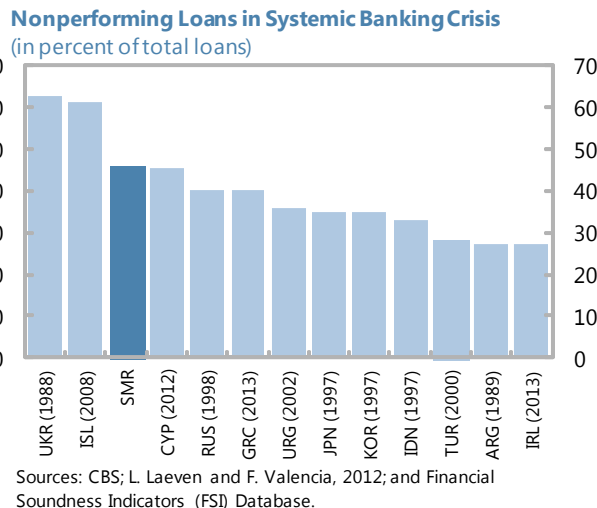
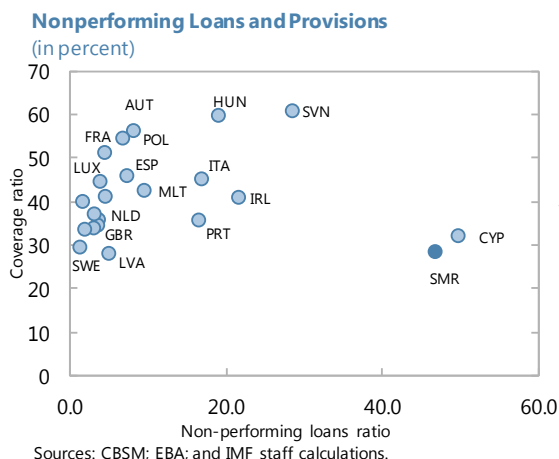


## C. Where Does San Marino Stand?

**7. The asset quality and the loan-loss provision levels of Sammarinese banks compare unfavorably with other European countries.** The burden of NPLs is second only to the one of Cypriot banks, while their loan-loss-provision coverage is one of the lowest among European banks.<sup>4</sup> The situation of the Sammarinese banks also looks troublesome when the current level of NPLs is compared with those reached at the peak of recent systemic banking crises in other countries.

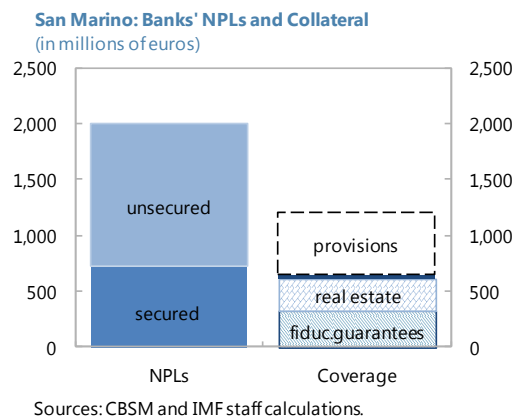
<sup>3</sup> Italian firms doing business with Sammarinese companies were subject to enhanced scrutiny from the Italian authorities and were more likely to be inspected.

<sup>4</sup> The data for the European countries are drawn from the transparency exercise recently carried out by the European Banking Authority ([http://tools.eba.europa.eu/interactive-tools/2015/transparency\\_exercise/atlas.html](http://tools.eba.europa.eu/interactive-tools/2015/transparency_exercise/atlas.html)).



**8. More-than-half of NPLs is vis-à-vis nonresidents.** Impaired problem loans vis-à-vis nonresidents accounted for more than three-quarters of NPLs of the system as a whole, although the amount of total lending is more evenly distributed (Figures 1 and 2). This large share of nonresident NPLs reflects the substantial amount of Delta-group impaired assets on CRSM’s balance sheet. Excluding CRSM, the share of NPLs vis-à-vis nonresidents remains slightly above 50 percent.

**9. Slightly more than one-third of NPLs is secured** (36 percent of the total). Banks report that the total value of the collateral would cover about 40 percent of total secured loans, thus raising the total coverage ratio (provision plus value of the collateral) to 127 percent for those loans.<sup>5</sup> About half of the value of the collateral is represented by guarantees, 46 percent by real estate—24 percent of which is located abroad—and the remaining by cash deposits and other financial instruments.

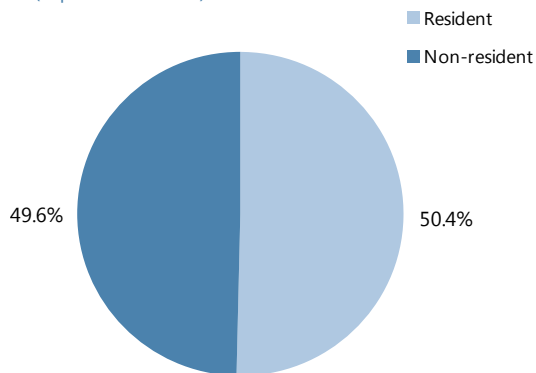


**10. Impaired loans are also relatively concentrated.** On average, a bank’s five largest exposures represent about 70 percent of total NPLs. If CRSM is excluded, the share declines to about 41 percent of total problem loans. This implies that a targeted approach aimed at resolving those large exposures would already mitigate the problem substantially.

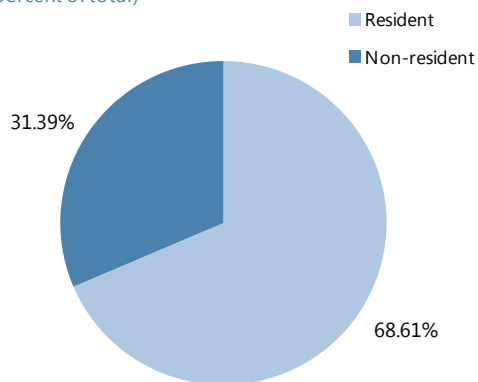
<sup>5</sup> The corresponding coverage of total NPLs would therefore be equal to 61 percent.

**Figure 1. San Marino: Banks' Gross Loans Breakdown by Residency and Sector, end-2015**

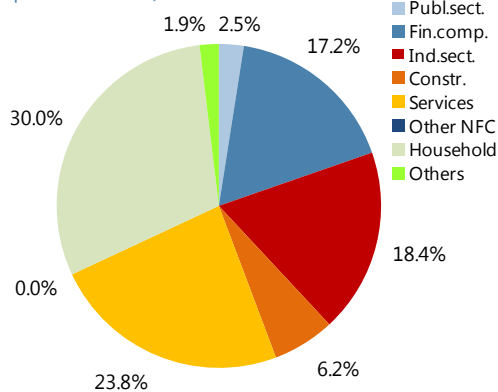
**Total Loans - Breakdown by Residence**  
(in percent of total)



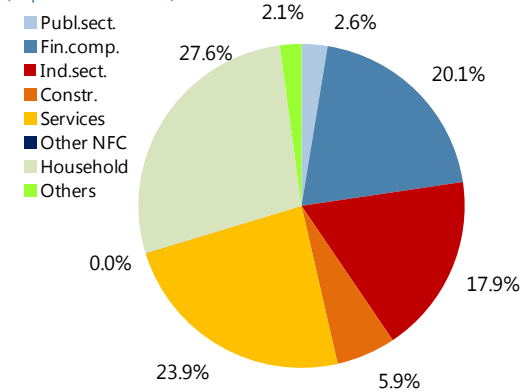
**Total Loans excl. CRSM - Breakdown by Residence**  
(in percent of total)



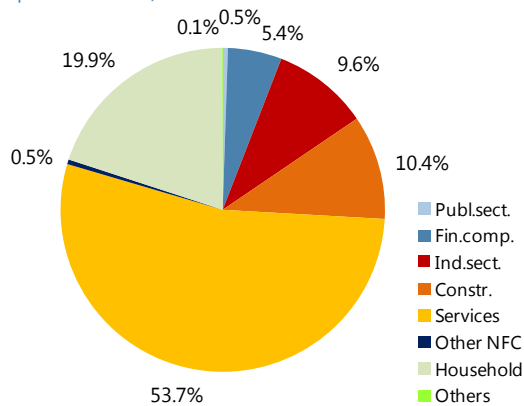
**Total Loans to Residents - Breakdown by Sector**  
(in percent of total)



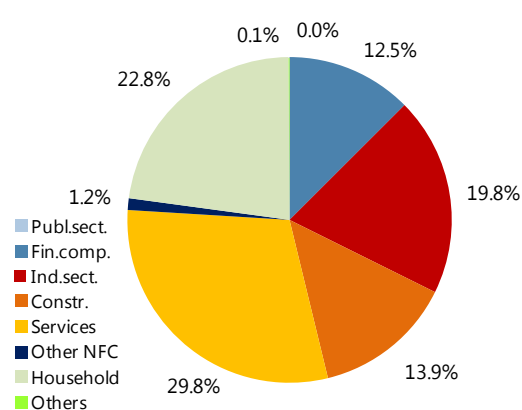
**Total Loans to Residents excl. CRSM - Breakdown by Sector**  
(in percent of total)



**Total Loans to Non-Residents - Breakdown by Sector**  
(in percent of total)



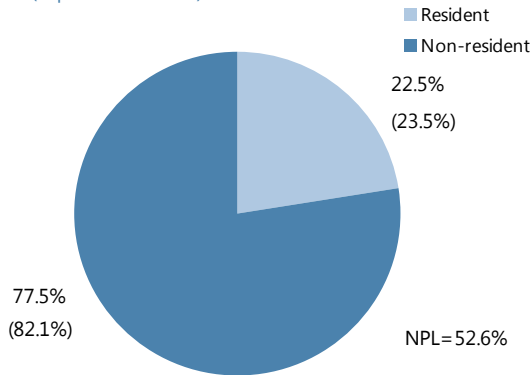
**Total Loans to Non-Residents excl. CRSM - Breakdown by Sector**  
(in percent of total)



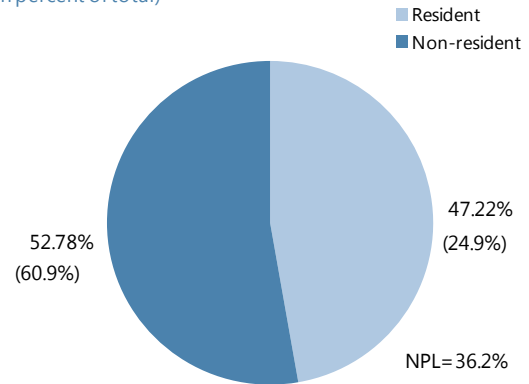
Sources: CBSM and IMF staff calculations.

**Figure 2. San Marino: Banks' Nonperforming Loans Breakdown by Residency and Sector, end-2015**

**Total NPLs - Breakdown by Residence**  
(in percent of total)

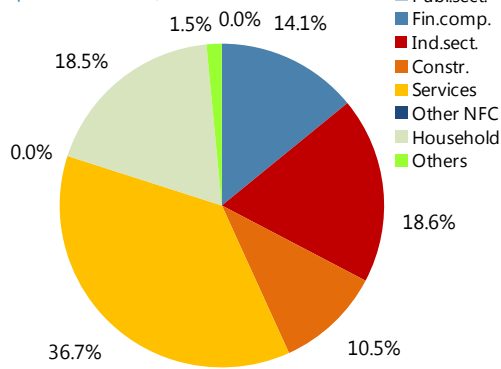


**Total NPLs excl. CRSM - Breakdown by Residence**  
(in percent of total)

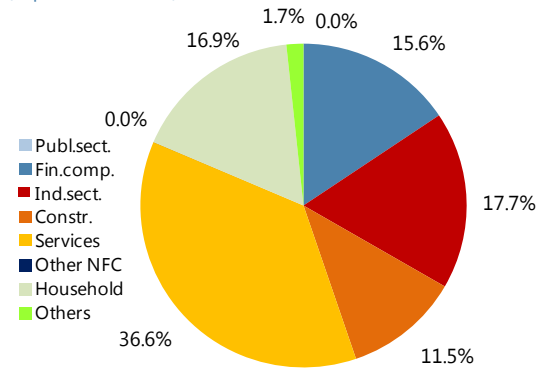


Sources: CBSM and IMF staff calculations.

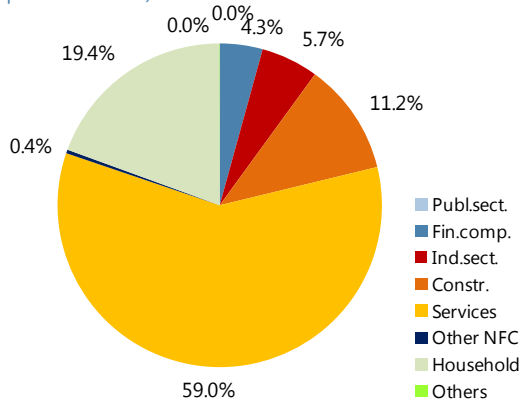
**Total NPLs to Residents - Breakdown by Sector**  
(in percent of total)



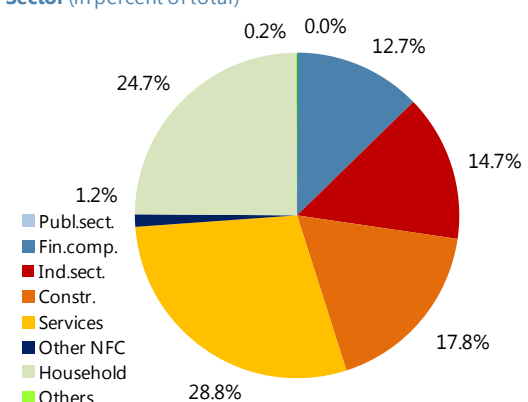
**Total NPLs to Residents excl. CRSM - Breakdown by Sector**  
(in percent of total)



**Total NPLs to Non-Residents - Breakdown by Sector**  
(in percent of total)



**Total NPLs to Non-Residents excl. CRSM - Breakdown by Sector**  
(in percent of total)



Sources: CBSM and IMF staff calculations.



## D. What Lessons Can Be Drawn from Other Small Country Crisis Cases?

**11. In some aspects, San Marino's situation can be compared with that of other crisis-case small countries such as Iceland, Ireland, and Cyprus.** These countries share some common features. They are relatively small economies, although not quite as small as San Marino. Like San Marino, the banking sector of these countries expanded disproportionately in the run up to the financial crisis, well exceeding the fiscal capacity of the host economy to support the sector. Weaknesses in prudential regulation and supervision, both domestically and cross-border, together with liquid capital markets mispricing potential risks, prompted an unprecedented borrowing and lending spree by the banks in these countries, fuelling a domestic real estate boom. Iceland, Ireland, and Cyprus all experienced banking crises of systemic proportions, which led to significant downsizing of their domestic banking sector and to a massive deterioration of asset quality.<sup>6</sup> Nonetheless, it is important to bear in mind a crucial difference between San Marino and this group of countries: San Marino lacks the backup of a lender-of-last resort facility, which in crisis times plays a crucial role in stemming deposit runs and bank contagion. Despite some similarities, Iceland, Ireland, and Cyprus followed different approaches to deal with ailing banks and problem loans.

**Table 1. Crisis Countries Examples: Iceland, Ireland, and Cyprus**

Country	Exchange rate	Crisis trigger	Main portfolio affected	Main approach applied
Iceland	Flexible	Freeze of wholesale capital markets	Commercial real estate/property developers, mortgages, small-medium enterprises (*)	"Domestic/foreign" bank approach, internal work-out
Ireland	Euro	Burst of the real estate bubble	Commercial real estate/property developers, mortgages, small-medium enterprises	Asset Management Company, internal work-out, outright sale of NPLs
Cyprus	Euro	Burst of the real estate bubble and losses on Greek sovereign bond holdings	Retail, small-medium enterprise, corporates, commercial real estate/property developers	Internal work-out

(\*) It refers only to the domestic portfolio.

<sup>6</sup> To deal with the financial crisis and its economic consequences, Iceland, Ireland, and Cyprus received financial support from the International Monetary Fund and in the case of the last two countries from the European Union as well.

## Iceland

**12. Iceland protected domestic depositors and taxpayer money by splitting its failed banks along domestic/foreign lines.**<sup>7</sup> When the financial crisis struck, wholesale capital markets froze and abruptly re-priced counterparty risk, and the overextended banking system collapsed. The government did not have the means to save the banks (too big-to-be-rescued). Therefore, there was no choice but to let the banks default. Since the international funding and lending were sufficiently separable from the rest of the banks' activities, Icelandic deposits and assets were carved out of the failing banks and transferred to new state-owned banks, while most of the foreign-owned assets and liabilities were allocated to the "old" banks, which were declared insolvent and placed into the winding-up proceedings.<sup>8</sup> Capital controls were imposed to contain further depreciation of the currency.

**13. This strategy had some shortcomings but also crucial benefits.** The appraisal of the assets transferred from the failed to the new banks proved extremely difficult, time-consuming, and contentious, thus delaying the recapitalization of the new banks. In addition, the new banks continued holding a large amount of NPL (45 percent of total loans in late 2008). However, this approach, protected domestic deposits and taxpayers, preserved the functioning of domestic payment system, achieved an immediate downsizing of the banking sector, as the new institutions were largely funded by deposits.

**14. The sizeable markdown of the assets transferred to the new banks secured significant private sector involvement and provided room for private debt workout.** To limit the costs to the public sector, creditors of the new domestic banks were offered the option of converting their claims into equity holdings. Given the protracted negotiations over the "fair value" of the defaulted banks' assets, creditors of the old banks agreed to a debt-to-equity swap operation (de facto bailing them in), thus ensuring their stake in potential upside from economic recovery.<sup>9,10</sup> Banks retained and managed problem loans on their own. However, high capitalization and initial conservative asset valuation allowed banks to agree with the government and the business federation on a comprehensive debt-relief program for firms and families.<sup>11</sup> Thanks to this program, firms that

<sup>7</sup> For a more detailed analysis of the causes that led to the crisis and the international rescue package, see IMF (2012).

<sup>8</sup> In October 2008, new banks were created (Arion Bank, Islandsbanki, and Landsbankinn) by transferring the domestic assets (written down by 50–60 percent) and deposits of the three major failed banks (Kaupthing, Glitnir, and Landsbanki), which were placed into receivership under the control of Resolution Committees.

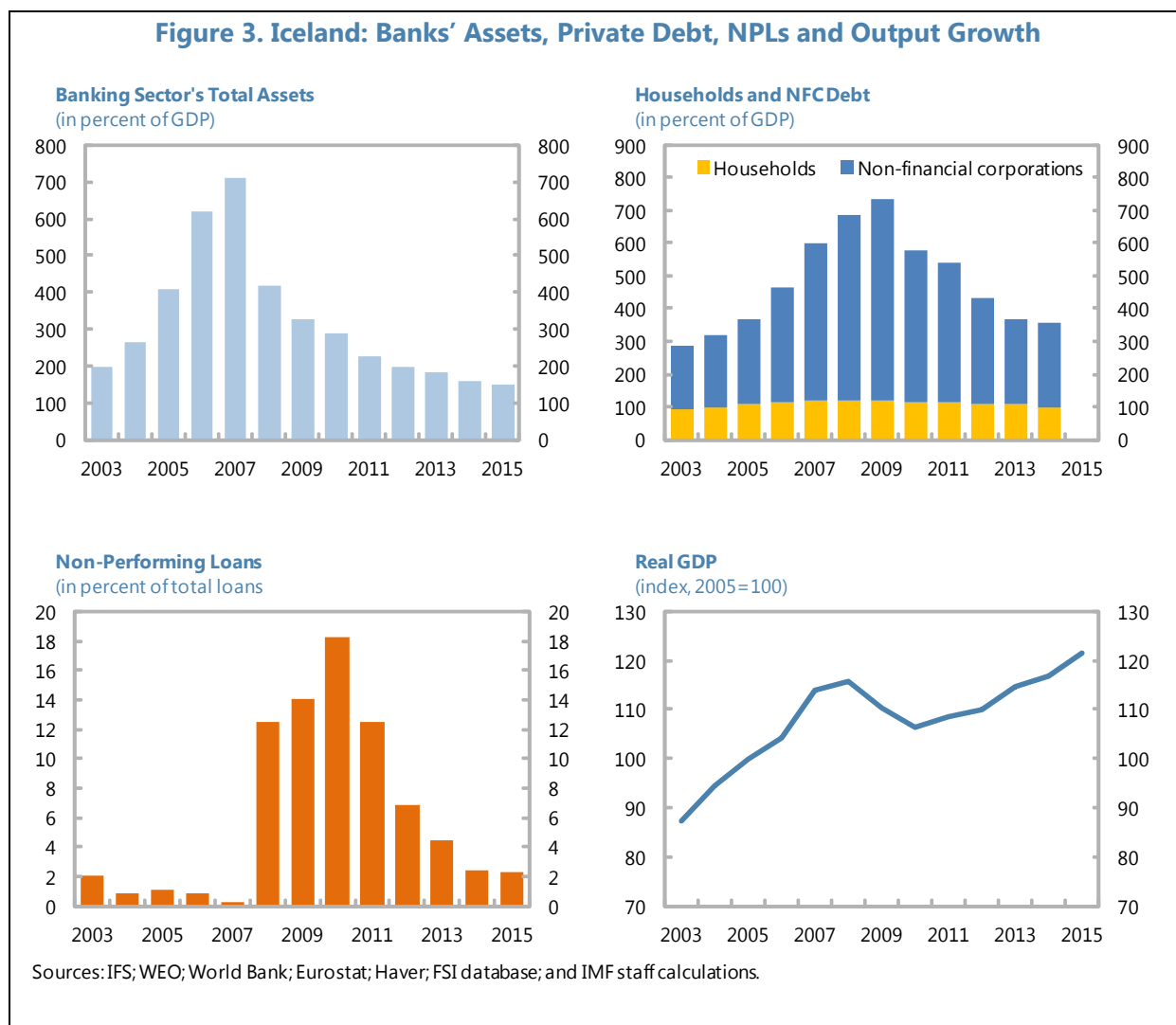
<sup>9</sup> In this way, two banks were privatized while the third one remained state-owned.

<sup>10</sup> "...[T]he key characteristics of crisis management and resolution in Iceland were that shareholders lost their equity, unsecured bond holders were bailed in, vital infrastructure elements of the domestic banking system were preserved, and (*domestic—editor's note*) deposits were given preference over other unsecured claims." (Guðmundsson, 2015.)

<sup>11</sup> The main components were (i) a write-off of the household sector debt in excess of 110 per cent of the fair value of each property; (ii) a government temporary subsidy to low-income, asset-poor households with high-interest mortgage payments; and (iii) a debt-relief for small- and medium-sized firms, if they could credibly document

(continued)

continued operating were again in a position to invest and support employment, while less-financially distressed households were able to resume consumption.<sup>12</sup> Sound policies and favorable external developments—together with capital controls, which helped ensure stability—paved the way to a broad-based economic recovery. This, combined with deleveraging efforts by households and corporates, reduced private sector leverage and banks' NPLs.



positive cash flow from future activities. The firm had to be willing to re-engineer its operation to make best use of its assets. More details on the household debt relief program can be found at <https://eng.forsaetisraduneyti.is/debt-relief/>.

<sup>12</sup> Matthiasson and Kirby (2013).

## Ireland

**15. As part of a comprehensive strategy aimed at restructuring its failed domestic banking sector, Ireland created the National Asset Management Company (NAMA).**<sup>13</sup> After the bursting of the property bubble, fuelled by domestic and cross-border banking credit, the Irish banks faced very large losses on their property portfolios. To stabilize the ailing banking sector, the Irish government first granted a blanket guarantee to stem the liquidity drain<sup>14</sup> and injected new capital to restore solvency. To prevent further losses, the Irish government reshaped the banking sector through mergers and nationalization.<sup>15</sup> Banks' managers were replaced, shareholders wiped out, and subordinated-debt holders suffered large losses, while senior-debt holders were protected to avoid risk of contagion.<sup>16</sup> Stress tests were carried out to gauge capital shortfalls. With the specific aim of dealing with the large amount of legacy assets, which overburdened banks' balance sheets, the Irish government created NAMA in late 2009, which was approved by the European Commission in February 2010. The Irish banks were allowed to transfer property-related loans (in excess to €20 millions) at a discount to a special purpose vehicle, the capital of which was underwritten by NAMA and Irish institutional investors, in exchange for NAMA bonds (Table 1).<sup>17</sup> Although NAMA contributed to stabilize the Irish banking sector, slow progress in private sector debt restructuring has left Irish banks to deal with a still large amount of NPLs (Figure 4). At the same time, the Irish central bank took a number of initiatives, including setting quarterly targets for the resolution of mortgage loans (2013–14) as well as nonpublic bank-specific targets for the resolution of distressed SMEs loans, while issuing guidelines on mortgage arrears resolution, provisioning, and valuation process. In 2015, the central bank replaced the quarterly targets with intensive and intrusive bank-by-bank supervision.<sup>18</sup> To help dealing with highly indebted household, in late 2012, Ireland implemented a major overhaul of the personal insolvency regime.<sup>19</sup>

<sup>13</sup> Although Ireland's banking system had assets close to nine times of GDP in 2008, the locally controlled banks accounted for about 44 percent of the total.

<sup>14</sup> The blanket guarantee lasted two years. It was succeeded by the Eligibility Liability Guarantee, with narrower coverage in terms of liabilities and banks, which ended in March 2013.

<sup>15</sup> Anglo Irish Bank (Anglo) was nationalized in January 2009 and Irish Nationwide Building Society (INBS) in August 2010. Anglo deposits were transferred to Allied Irish Banks, and INBS deposits to Irish Life Permanent. Anglo and INBS were subsequently merged into the Irish Bank Resolution Corporation, which was put in special liquidation in February 2013.

<sup>16</sup> Schoenmaker (2015).

<sup>17</sup> 95 percent of these bonds were guaranteed by the state, while the remaining 5 percent was in the form of subordinated debt, the service of which depends on the financial performance of NAMA.

<sup>18</sup> For more details, see IMF (2015).

<sup>19</sup> The Personal Insolvency Act was enacted in December 2012. The Act reformed personal insolvency law and introduced three new non-judicial debt resolution processes, namely (i) Debt Relief Notice ("DRN") to allow for the write-off of qualifying debt up to €20,000 subject to a three-year supervision period; (ii) Debt Settlement Arrangement ("DSA") for the agreed settlement of unsecured debt; and (iii) Personal Insolvency Arrangement ("PIA") for the agreed settlement of secured debt up to €3million and unsecured debt. The Act also continued the reform of Personal Bankruptcy law in Ireland, including the introduction of automatic discharge from Bankruptcy, subject to

(continued)

**16. A centralized asset management company like NAMA, aims to achieve three general objectives:**

- Free banks from the burden of managing and trying to recover the problem loans, thereby allowing them to focus on their core business; that is, identifying and lending to healthy customers.
- Replace problem loans of uncertain value with sound, marketable assets that can be used to mobilize liquidity to resume lending. In addition, this makes the value of the remaining banks easier to assess since there is less uncertainty about its potential future losses. Reduced uncertainty should lead to more interest in the banks from investors and creditors.
- Unlock value by dedicating specialized staff to the management of impaired assets, while achieving economies of scale.

**Table 2. Ireland: Summary of Loan Acquisitions by NAMA**

	Allied Irish Banks	Anglo Irish Bank	Bank of Ireland	Educational Building Society	Irish Nationwide Building Society	Total
Loan balances transferred	20.4	34.1	9.9	0.9	8.7	74.0
Transfer value	9.0	13.4	5.6	0.4	3.4	31.8
Discount	56%	61%	43%	57%	61%	57%
Realized loss	11.4	20.7	4.3	0.5	5.3	42.2

Source: NAMA (<https://www.nama.ie/financial/key-financial-figures/>).

**17. These benefits need to be weighed against a number of challenges:**

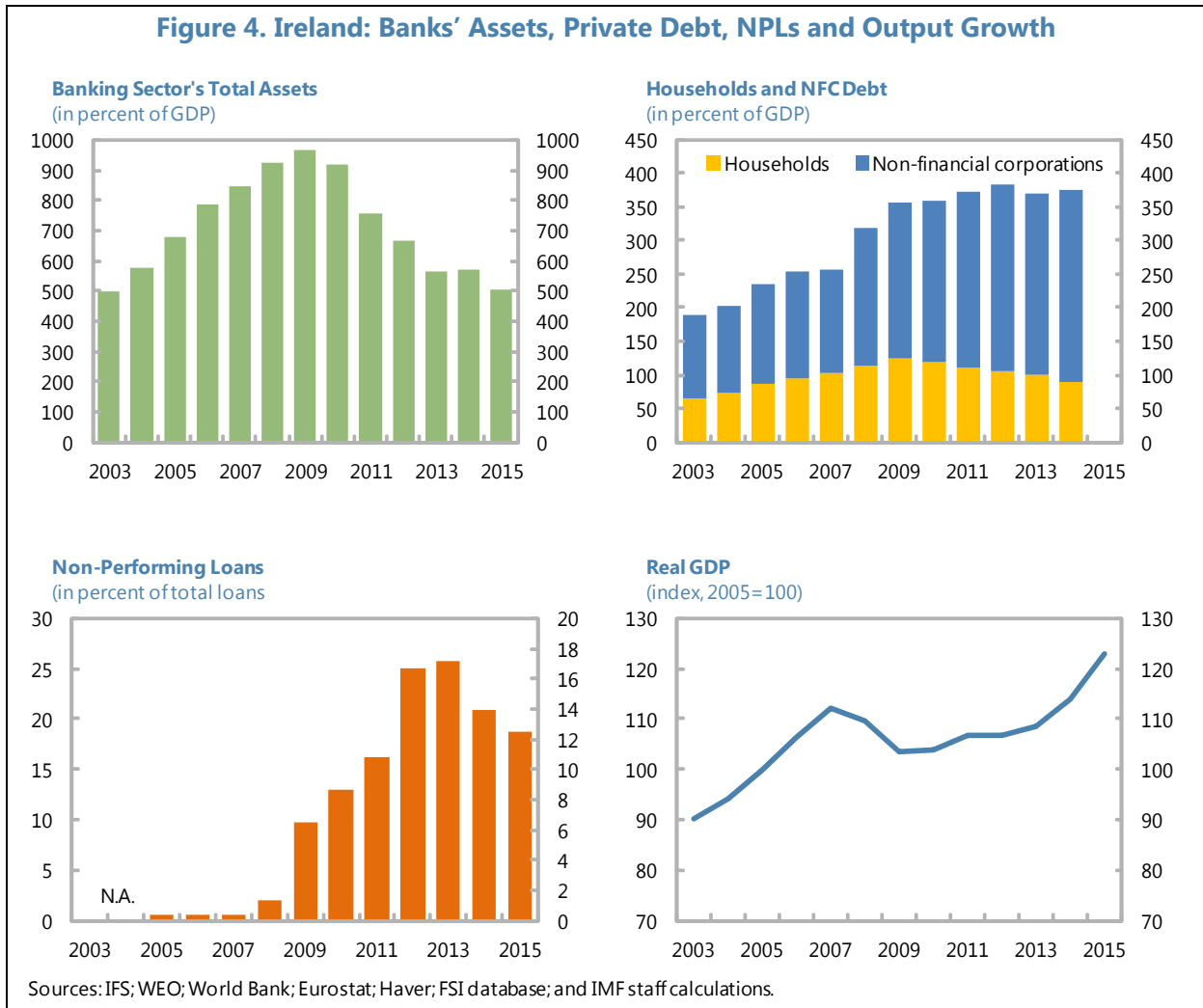
- The most difficult challenge is to establish a correct transfer price for the assets in order to avoid an unwarranted windfall to shareholders and other unguaranteed providers of capital to the transferring banks. In the case of NAMA, following the EC practice, the assets were transferred at their real (or “long-term”) economic value (REV).<sup>20</sup>

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certain conditions, after three years. The Act was followed by the establishment of the Insolvency Service of Ireland (ISI) in March 2013. The ISI is an independent statutory body the aim of which is to oversee and operate the new personal insolvency system (<https://www.isi.gov.ie/en/ISI/Pages/Home>).

<sup>20</sup> In general, the REV corresponds to the net present value of the stream of expected cash flows, reflecting losses that can reasonably be expected over the remaining life of assets but ignoring market failures related, for example, to  
(continued)

- The main drawback of an AMC, whether or not centralized, is the upfront crystallization of losses for banks, if impaired assets have not been adequately provisioned.<sup>21</sup> In any event, the establishment of an AMC should be viewed in conjunction with special resolution mechanisms. Indeed, such mechanisms would allow the takeover or orderly wind down those institutions which are not able to cope with regulatory requirements after transfer of their assets at market value.



excessive product complexity, confidence crises resulting in a lack of liquidity, or excessive risk aversion. See also Communication from the Commission on the Treatment of Impaired Assets in the Community Banking Sector, 25 Feb. 2009 OJ 2009 C 72/01 ([ec.europa.eu/competition/state\\_aid/legislation/impaired\\_assets.pdf](http://ec.europa.eu/competition/state_aid/legislation/impaired_assets.pdf)) and Boudghene and Maes (2012).

<sup>21</sup> In Germany, weak financial institutions were allowed to transfer structured securities (typically ABS, CDO, CLO, RMBS, CMBS) to a special purpose vehicle established for each beneficiary at or close to book value in exchange for State-guaranteed bonds. Any future losses were to be clawed back from the transferring bank in the near future. The scheme, however, has never been used.

- The governance arrangements of an AMC need to be carefully structured to ensure a strong independent management and to avoid any sort of undue external pressure from either political entities or transferring banks. In other words, an AMC must be politically and financially independent. It must have a clear and limited mandate and operate in a transparent way, while preserving market discipline.
- The success of an AMC depends also on the development of a market for the sale of distressed assets.

## Cyprus

**18. To restore solvency of its ailing banking sector, Cyprus was the first European country to bail in uninsured depositors.**<sup>22</sup> Before the crisis, Cypriot banks attracted large foreign deposits thanks to low taxation and relatively high deposit rates. This funding fuelled a rapid expansion of banks' domestic lending, which led to a boom in the domestic property market, as well as investment abroad, notably in Greece. As the domestic real estate bubble busted and growth came to halt, Cypriot banks' asset quality deteriorated dramatically. The situation further worsened with the Greek debt restructuring, which substantially decreased the value of Greek government bonds held by the banks. With public debt already high, recapitalizing the banks with public support was unfeasible (capital needs were estimated to the tune of 60 percent of Cyprus' GDP). The authorities, therefore, intervened both Laiki Bank and Bank of Cyprus. Laiki Bank was split into a good/bad bank, with the first part transferred to Bank of Cyprus while the second one, comprising uninsured deposits and other assets, was to be wound down over time. Bank of Cyprus was recapitalized through an equity conversion of uninsured deposits, after fully diluting existing shareholders and bondholders. Given limited fiscal space, Cyprus's strategy to deal with NPLs has continued to be based on banks' internal workout. In this context, policies and practices have been guided by a sector-wide arrears management framework and code of conduct.<sup>23</sup>

## Policy Lessons

- *Reducing NPLs is a rather complex and lengthy process.* Cross-country evidence shows that, after reaching their peak, it takes between three to five years—and in some cases even longer—for NPLs to return to a downward path.
- *It requires a thorough restructuring of the banking sector.* Unless already adequately provisioned, the management and resolution of NPLs inevitably translate into bank losses and capital

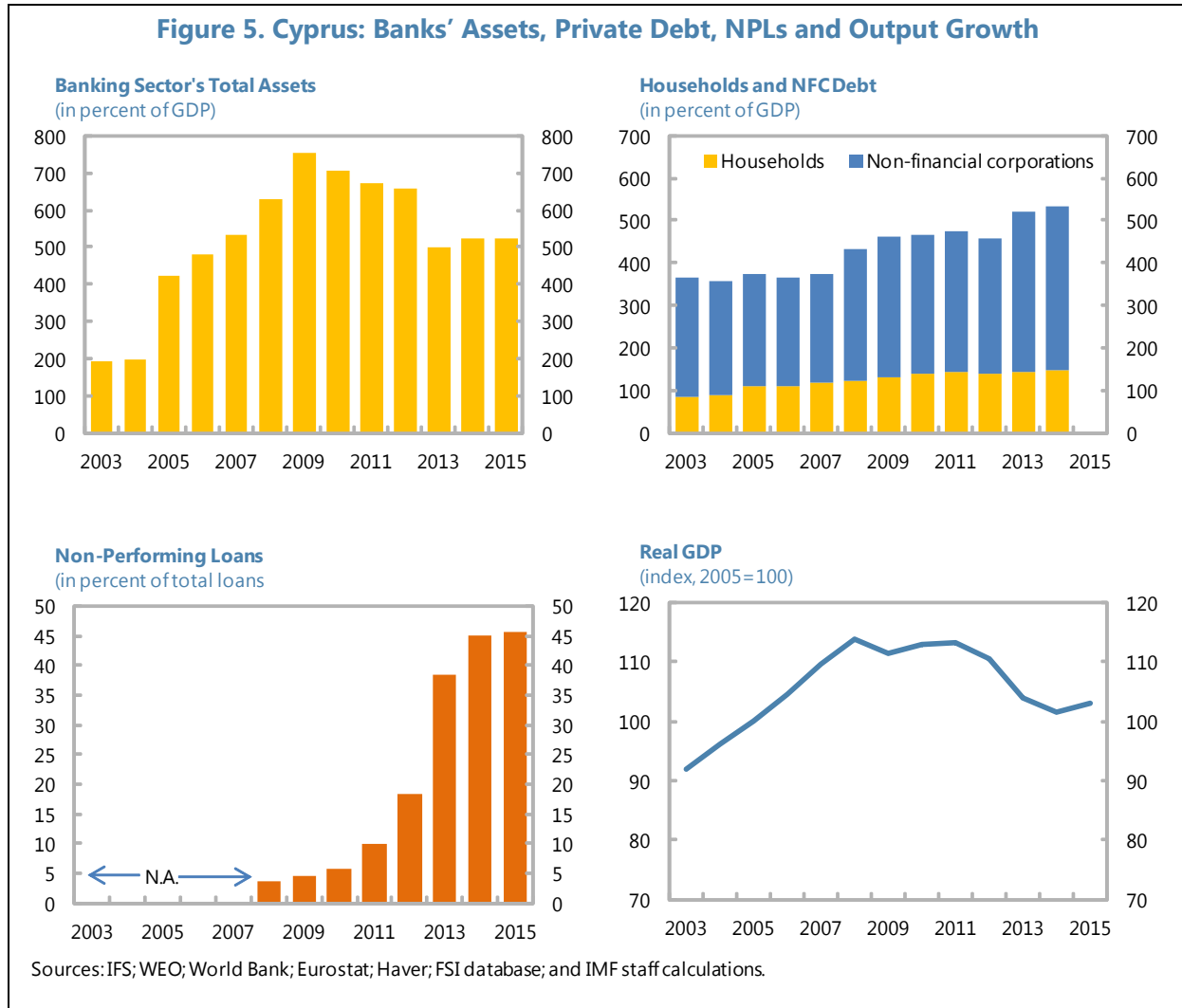
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<sup>22</sup> For more details, see IMF (2013).

<sup>23</sup> In September 2013, an Arrears Management Framework and a Code of Conduct for borrowers and creditors was issued designed to manage the increasing number of borrowers in financial difficulties and enhance the framework for private-sector-debt restructuring (see [http://www.centralbank.gov.cy/nqcontent.cfm?a\\_id=12953&lang=en](http://www.centralbank.gov.cy/nqcontent.cfm?a_id=12953&lang=en)).

shortfalls. Therefore, it is important that supervisors have all the instruments to deal with weak banks and the authorities devise a clear plan to restore banks' solvency.

- *Regardless of the strategy, an adequate legal framework is crucial to facilitate loan workouts. A well-functioning judicial system, insolvency regime, and debt enforcement procedures are essential for the management of NPLs. In a context of debt overhang, an efficient debt-restructuring framework, encompassing potential debt relief, would allow viable borrowers to resume investment and consumption, thereby supporting economic recovery.<sup>24</sup>*



<sup>24</sup> For a broad overview of NPL resolution in Europe, see Aiyar and others (2015).



## E. What Has San Marino Done So Far?

**19. A process of consolidation has reshaped the banking sector landscape.** The Central Bank of San Marino (CBSM) has played a key role in preserving financial stability, notably by quickly and effectively intervening some small institutions in difficulty. As a result, between 2009 and 2015, the number of credit institutions has declined from 12 to 7, one of which de facto operates as “bad bank” for another credit institution, while the number of financial and fiduciary companies dropped from 48 to 8 over the same period.

**20. So far, banks have managed NPLs internally, but three closed funds have been established to deal with the impaired assets of weak banks absorbed by other Sammarinese credit institutions.** In 2013, the government adopted some urgent measures to safeguard financial stability in dealing with weak banks (DL, June 27, 2013, n.72). In particular, in order to facilitate the transfer of assets and liabilities of significantly under-capitalized banks to healthy ones, this law allowed the State to provide a tax credit (deferred tax asset—DTA) to compensate for the difference between the value of the assets and liabilities at the time of the transfer. The recipient bank can use the DTA over a period of eight years (up to 15 percent per annum in the first six years and 5 percent per year in the remaining period) against the payment of the corporate income tax or other payments to the State. The amount of DTA may vary over time to offset: (i) losses incurred following the settlement of the transferred assets; (ii) additional loan loss provisions that the recipient bank—in agreement with the supervisory authority—needs to make within 12 months from the transfer date; and (iii) changes in the market value of the fund’s share (i.e., its net asset value).

**21. However, this approach has some shortcomings.**

- *It allows some arbitrage for the calculation of the risk-weighted assets of transferring banks.* While NPLs carry a risk-weight of 150 percent, the investment in closed funds is weighted at 100 percent, although the risk profile of transferring banks has not changed since they are the sole owners of those funds. Since the transfer does not imply full derecognition of the bad assets, if accounts were fully consolidated, no capital release would ensue. Nevertheless, spinning-off problem loans in a different entity has some advantages: it allows the transferring bank to focus on its core business while the special vehicle carries out the workout activities; it allows to better track the performance of the recovery activity and, in this specific case, the amount of DTA that the State has to provide.
- *The inclusion of the DTA in regulatory capital overstates banks’ financial soundness.* The benefits associated with the DTA can be realized only when banks earn taxable income, so when banks experience tax losses—like Sammarinese banks nowadays—the DTA loses value. Since the DTA capital loses value precisely when the bank needs capital to offset losses, it represents a potentially fragile buffer.<sup>25</sup> The inclusion of DTA in the regulatory capital calculation has been

<sup>25</sup> For an analysis of DTA and bank stability in the US, see Gallemore (2012).

indeed revised in the Basel III/EU Capital Directive framework.<sup>26</sup> In addition, DTA reduces the amount of (potentially) income-earning assets thereby reducing future profitability.

**22. The three largest banks are in the process of setting-up a joint AMC.** However, given the difficulty in agreeing on common valuation criteria for transferred assets, the AMC is expected to comprise separate a fund for each of the banks. A more effective pooling of the NPL portfolios would help achieving larger economies of scale, consolidate debtor positions, and could attract potential foreign investors. However, as discussed above, any capital release for transferring banks should be avoided, since they retain full ownership of the funds.

## F. What Are the Main Impediments to Deal with NPLs Effectively in San Marino?

### Debt Collection and Enforcement

**23. Market participants generally assess San Marino’s judicial and enforcement processes as efficient and speedy.** San Marino allows out-of-court mortgage and pledge enforcement. Judicial enforcement provides for two options: summary and ordinary proceedings. The summary proceedings are short and streamlined proceedings that allow enforcement measures and generally take a few months to complete. However, the initiation of summary proceedings is subject to a number of documentary requirements and is associated with higher costs due to notarization requirements, public registry taxes<sup>27</sup> and other court fees. Ordinary judicial enforcement allows additional flexibility in documentary requirements but involves lengthy court proceedings and is rarely used.

**24. Since 2012, San Marino’s court system has experienced a sizeable increase in the number of judicial enforcement cases.**<sup>28</sup> Despite a large increase in the number of enforcement cases, San Marino’s court system has been able to cope with the surge in the case load and no significant delays in the judicial processes have been reported. Some of the private sector

<sup>26</sup> Basel III treats DTAs differently depending on how much they can be relied upon when needed to help a bank to absorb losses. Where their value is less certain to be realized, they must be deducted from capital. However, Basel has subsequently clarified that DTAs that are transformed on a mandatory and automatic basis into a claim on the State when an institution makes a loss would be one of the forms of DTAs for which deduction would not be warranted. The EU Capital Requirement Directive implements the above Basel rules.

<sup>27</sup> Some banks reported registry taxes as most burdensome because they applied proportionally to the value of the contract, thereby discouraging the use of summary proceedings in cases of enforcement on large outstanding debt claims. While the existing regulation seems to allow avoiding the registry taxes by providing that the court fee absorbs the registry fee payable where the bank statements are used as the proof of debt—the practice of application of the norms is reportedly inconsistent.

<sup>28</sup> The Court (Tribunale Unico) reported that the number of summary proceedings filed by the banks increased from the average of 45 cases annually in period of 2007–2011 and to an average of 240 cases annually in the period of 2012–2015.

stakeholders reported, however, an excessively bureaucratic and paper-based nature of court and administrative filings. Measures to streamline judicial and administrative processes—such as replacing paper documents submission with electronic ones—could be warranted.

**25. Cross-border debt recovery presents particular challenges to the NPL resolution.** The large stock of NPLs with a cross-border element gives rise to additional challenges with regard to debt enforcement. Particular difficulties seem to arise from enforcement on debt to residents secured by the collateral located outside of San Marino (predominantly in Italy). Such cases often require coordination of legal actions both domestically and abroad, triggering processes related to recognition and implementation of foreign court decisions and, as a result, are generally associated with longer resolution time, higher costs, and lower recovery rates. The treaty between San Marino and Italy on judicial cooperation dates back to 1939 and does not reflect more recent developments in the legal systems of the two countries.

**26. San Marino's stagnant real estate market impedes effective value recovery through asset sales.** A public auctions mechanism for mortgage sale applies to out-of-court foreclosure as well as to judicial sales, both of which are fully controlled by creditors. Auction sales rules appear to allow sufficient flexibility with respect to timing and pricing. However, in light of weak real estate market conditions, auction sales are viewed as a poor instrument for value maximization. Challenges in realizing collateral are often the main reason for long delays in recovery on debt enforcement both through out-of-court and in-court enforcement venues. The lack of potential buyers and banks' unwillingness to sell assets at large discounts significantly slow down the resolution process.

**27. In expectation of a real estate market to rebound, banks have started leasing repossessed properties.** Difficulties in selling collateral push banks to accept property title transfer in exchange for debt settlement. Real estate management and leasing has reportedly been profitable for some Sammarinese banks. Current regulation limits the time allowed for banks to hold foreclosed real estate on their books (36 months for occupied and 24 months for unoccupied properties; extensions of these limits are subject to CBSM approval). Acknowledging the difficult situation of the real estate market, the CBSM recently suspended those time limits until the end of 2016 to provide banks with additional time to effectively dispose foreclosed properties.

**28. Incentivizing recovery of viable debtors, including via enhancements of the insolvency regime, could help to speed up the resolution process.** Rehabilitating of viable debtors could provide creditors with better chances for recovery than straight asset liquidation. Effective legal instruments allowing rehabilitation of viable firms are crucial for value preservation at the time of widespread distress. To help unwind the private sector debt overhang, the Sammarinese insolvency system could be enhanced with tools facilitating debt restructuring.

## Insolvency Regime

**29. San Marino's insolvency regime contains several critical weaknesses.** San Marino's insolvency statute dates back to 1917 and lacks a number of key features of the modern insolvency system. Certain issues seemingly unregulated by the law have been solved via judicial precedents,

which take an important role in San Marino’s legal system. The law applies equally to companies and individuals<sup>29</sup> and does not draw a distinction between them. The regime does not provide for a fresh start for individuals and entrepreneurs, who cannot obtain a debt relief without the consent of creditors, even under the court-imposed restructuring plan. Thus, even after exiting the insolvency process the individual debtor could continue to carry the pre-insolvency debt for an unlimited time until full repayment to all creditors.<sup>30</sup>

**30. The insolvency regime is largely a forum for court-supervised asset liquidations.** The liquidations regime is relatively simple and in many cases expedient. The insolvency statute provides for rather short deadlines for different stages of the procedure. However, the duration of a single procedure can be significantly extended because disputes relating to creditors’ claims are resolved through ordinary court procedure. Furthermore, certain categories of public creditors (e.g., tax authorities) continue to retain their super-priority status, ensuring they are satisfied in full ahead of secured creditors.

**31. The lack of instruments for pre-insolvency settlements and insolvency-protected reorganizations significantly undermines the ability of the system to rescue viable businesses.** Although restructuring agreements initiated by debtors (“*concordato*”) are allowed, they are very rare and often envisage liquidation plans.<sup>31</sup> Creditors cannot file or propose restructuring plans. Secured and privileged creditors (e.g., tax creditors) are excluded<sup>32</sup> from the approval process of *concordato* plan, which is voted on only by unsecured creditors. However, the plan can only be approved under the condition of full repayment of all special priority and secured creditors. A *concordato* plan cannot provide for debt rescheduling or haircuts of secured creditors’ debt without such creditors’ consent. Moreover, for the purpose of *concordato* approval, the secured creditors’ claims are considered secured for the full amount of outstanding debt rather than up to the underlying value of collateral. Such strict requirements limit the effectiveness of *concordato* and undermine its potential as a restructuring mechanism. As a result, the system discourages

<sup>29</sup> Personal debt eligible for restructuring under the law includes both business and consumer debt.

<sup>30</sup> Cross-country experience suggests that providing a fresh start through discharge of financially responsible individuals from the liabilities at the end of insolvency proceedings (typically after 2–5 years) is among key features of economically efficient personal insolvency regimes. European Commission recommends reducing the discharge time and debt settlement for honest entrepreneurs to a maximum of three years. See European Commission recommendations on a new approach to business failure and insolvency ([http://ec.europa.eu/justice/civil/files/c\\_2014\\_1500\\_en.pdf](http://ec.europa.eu/justice/civil/files/c_2014_1500_en.pdf)).

<sup>31</sup> In the period of 2006–2015, the courts reported only 13 requests for opening of restructuring (“*concordato*”) proceedings with subsequently only 9 restructuring agreements (“*concordato*”) concluded (the other 5 cases proceeded into liquidation). Only three out of the nine restructuring agreements envisaged debtor’s continuation of business activity, while the other cases ended in liquidations and/or sales of business/assets to third parties.

<sup>32</sup> Note that while San Marino’s insolvency regime, in principal, allows secured and privileged creditors to participate in *concordato* voting—such participation extinguishes their priority rights, e.g., a secured creditor voting on *concordato* become unsecured—and thus, is generally of no interest to secured/privileged creditors.

early insolvency filing by debtors, for which entering into insolvency commonly implies cessation of business activity.

**32. Recent changes enhancing the special moratorium regime for businesses in financial distress constitute a positive development, but their potential to significantly impact NPL resolution is limited.** In 2006, San Marino introduced a special moratorium regime,<sup>33</sup> which allows companies, upon court approval, to request a stay on all creditors' actions and, in turn, places the company under the supervision of a court-appointed trustee safeguarding creditors' interests. The objective of the moratorium is to provide companies with additional time (up to a maximum of two years) to find a negotiated workout with creditors or prepare for a pre-packed sale. The moratorium law was amended in 2015 to grant a priority protection to new financing granted during the moratorium, but this priority does not trump the traditional priority of privileged creditors such as tax authorities and the social security agency. In addition, the lack of a comprehensive framework for the treatment of contracts (i.e., allowing termination or continuation of business relationships) during the moratorium is reported as an important obstacle to preservation of the business continuity.

**33. In response to the gaps in the formal insolvency system, Sammarinese banks have recently adopted a contractual debt workout mechanism** (Box 1). In July 2015, the banks signed a Code of Conduct prepared under the umbrella of the Sammarinese Banking Association. The Code of Conduct is designed to promote voluntary workouts and guide multi-creditors negotiations for distressed debtors (both corporate and individuals) with financial debt exceeding €1 million. In line with international best practices (INSOL/London Approach), the Code sets the basic principles guiding financial negotiation while allowing general flexibility of the processes and a temporary stay on enforcement of creditor banks' claims.

**34. To facilitate voluntary workouts, San Marino should introduce legal tools allowing the cram down of dissenting creditors.** The out-of-court mechanisms are generally most effective when instituted in the context of an effectively functioning insolvency system. Experience shows that an out-of-court mechanism can be a useful complement to the formal system since it helps avoid the costs and delays that are typically associated with the court-administered system. As San Marino's legal system currently lacks legal instruments that would allow binding the dissenting creditors to the terms of the restructuring agreement achieved within voluntary negotiations and

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<sup>33</sup> Since the introduction of moratorium law in 2006, only three cases of moratorium have been registered. Note: the special moratorium regime for *business entities* is distinct from the moratorium, which can be granted under the provisions of insolvency law to *all legal entities* (including public companies and charities). The moratorium instituted under the insolvency law can only be granted to the debtors whose assets exceed liabilities and which "due to extraordinary events" are incapable of paying debts as they fall due. These very strict requirements for eligibility for the insolvency law moratorium (even as compared to the special moratorium for businesses), and the uncertainty about debtor-in-possession financing provided during such moratorium significantly limit its use.

approved by the majority of creditors, such deficiency may limit the capacity of the Code of Conduct to become an effective mechanism for debt workout.

**35. San Marino’s insolvency system would benefit from pre-insolvency/pre-packed procedures.** Legal mechanisms that allow binding the dissenting creditors, including secured and other privileged creditors,—subject to adequate safeguards of creditors' rights—to the terms of the restructuring agreement could improve the efficiency of debt restructuring in San Marino. Rules for out-of-court negotiated agreements submitted for court approval as well as improving post-filing restructuring tools appear equally warranted for expanding San Marino’s debt restructuring toolkit. Creditors should be allowed to file insolvency cases with a purpose of debt restructuring and propose restructuring plans.

**36. Further flexibility should be accorded to the existing *concordato* instrument to make its use more attractive.** To enhance the chances of success of debtors’ rehabilitation, additional measures should be considered, including (i) expanding the scope of protection of new financing (both in pre- and post-filing period) to ensure priority, including over public creditors; (ii) providing for the participation of all creditors, including secured and public creditors (such as tax authorities) in debt restructuring; (iii) allowing creditor-proposed restructuring plans and flexibility of their terms (e.g., pre-packed sales, debt-to-equity swaps); (iv) ensuring that, for the purposes of formation of creditors’ classes and voting on the plan, the secured creditor’ claim is limited to the market value of underlying collateral with the remaining amount of debt, if any, being treated as unsecured claim; and (v) introducing measures targeted at ensuring preservation of business value in cases of attempted rehabilitation (e.g., improving the rules on treatment of contracts in pre-insolvency and insolvency period, including to allow prioritization of certain key contractual relationship and protection from the claw-back action in pre-insolvency period).

**37. Traditional super-priority status for tax authorities in insolvency should be revisited.** San Marino historically privileges tax authorities within insolvency providing for (i) their super-priority ranking (i.e., ahead of secured creditors) in liquidation; and (ii) full repayment on tax claims as a condition for *concordato*, should be revisited. Instead, consideration should be given to providing explicit legal basis for the tax administration to participate in debt restructuring and insolvency processes subject to clear and predictable guidance.

**38. International best practices and the experience of recent insolvency reforms in Europe could provide useful guidance to San Marino’s reforms.** Reforms introducing new pre-insolvency mechanisms and enhancing existing restructuring tools, although with some different features, have been introduced recently in Italy, Germany, Greece, and Slovenia, among others (see Box 2). With regard to the special priorities of tax authorities the UNCITRAL Legislative Guide on Insolvency Law (UNCITRAL, 2005) recommends that priorities be “minimized”, especially, “priorities over secured

claims.”<sup>34</sup> The World Bank’s Principles for Effective Insolvency and Creditor Rights Systems (2005) state that “public interests generally should not be given precedence over private rights”.<sup>35</sup>

**39. Design of the reforms should be tailored to San Marino specific needs and avoid encouraging protracted liquidations.** The predictability of liquidation and efficiency of judicial processes should be preserved while consideration should be given to specific issues San Marino may face as a microstate. These include institutional and capacity constraints, as well as the specific structure of its corporate sector, almost exclusively comprising SMEs. It would therefore be important to avoid burdening the system with overly complex and costly procedures. In this context, and considering a high concentration of the NPLs with a few large debtors and the recently adopted voluntary framework for financial debt workouts (i.e., the Code of Conduct), the introduction of pre-insolvency/pre-pack mechanisms into the insolvency system seems particularly appropriate in facilitating restructuring of the private debt overhang.

### Tax Disincentives

**40. San Marino’s tax system includes a number of features that can create disincentives for adequate provisioning and loan write-off, as well as debt restructuring.**

- *Tax deductibility of the loan loss provisions is subject to an annual cap of 5 percent.* The law limits the tax deductibility of loan loss provisions to 5 percent of the total outstanding loan portfolio at the end of the fiscal year. The rule discourages provisioning and puts a clear limitation on the banks’ ability to timely discount losses and clean their balance sheets. Given the large stock of NPLs with relatively low provisioning, the limit is likely binding for many banks.
- *Tax deductibility of loan loss write-offs is subject to strict limitations.* Sammarinese tax legislation subjects tax deduction for losses on bad or impaired debts to strict conditions requiring evidence of “certain and clear loss” (e.g., enforcement, insolvency procedures or legal opinion).<sup>36</sup> Furthermore, in cases of a debtor’s insolvency, the losses associated with the write-offs can be deducted only over a limited period of time (before the end of the year subsequent to the year in which the insolvency was initiated) from the moment of opening of the insolvency case. Such rules—combined with the cap on tax deduction of loan loss provisions—do not allow banks sufficient flexibility in properly reflecting their losses. Relaxation of the conditions on the tax deductibility of write-offs for the banks should therefore be considered to facilitate and encourage expedient resolution of the NPL stock. The current legal requirements on

<sup>34</sup> See Recommendation 188 of the UNCITRAL Legislative Guide on Insolvency Law [www.uncitral.org/pdf/english/texts/insolven/05-80722\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf).

<sup>35</sup> See Principle 12A of the World Bank’s Principles for Effective Insolvency and Creditor Rights Systems [www.worldbank.org/ifa/IPG-Revised-Pples-FINAL-\[21-Dec-2005\].pdf](http://www.worldbank.org/ifa/IPG-Revised-Pples-FINAL-[21-Dec-2005].pdf).

<sup>36</sup> Losses incurred on loans of €2,500 or less, which are deductible six months after reaching maturity.



conditions for write-offs could be replaced with supervisory guidance on conditions and timing of the write-offs.

- *Tax authorities appear to have very limited scope for participating in debt restructuring.* The Sammarinese tax office can grant restructuring of tax claims to debtors (both corporate and individuals) in financial distress. However, the scope of such restructuring is limited to extension of maturities and does not allow tax debt forgiveness. Rescheduling of tax debt maturities is also subject to provision of guarantees/collateral. Early application for tax debt restructuring (before the liability is matured) allows preventing tax penalties. Additional flexibility for tax authorities to participate in debt restructuring could be explored as a temporary measure to allow tax authorities to agree to partial debt relief (at least as far as penalties and interests are concerned) in insolvency proceedings and out-of-court debt restructuring arrangements with debtors in financial distress.
- *The tax on transfers of NPLs constitutes an additional obstacle to NPLs resolution.* The transfer tax of 0.1 percent of the nominal debt amount applies on all transfers of NPLs, including on transfers into AMCs in which the transferring bank holds participation. The transfer tax increases the tax costs of NPLs resolution through banks' related AMCs as well as third party sales. Removal of the transfer tax should be considered.

## G. Conclusions

**41. International experience suggests that a comprehensive strategy is needed to deal effectively with the sheer amount of NPLs plaguing San Marino's banking sector.** This calls for close coordination and cooperation among different stakeholders through, for instance, a working group comprising supervisors (CBSM, in the case of San Marino), the government, the private sector (both banks' and enterprises' representatives) and the judiciary. The strategy should identify clear objectives and it should be accurately communicated to the public and transparently implemented.

**42. The strategy should address the cleanup of banks' balance sheet as well as legislative and regulatory issues.** In particular:

### Balance Sheet Repair

- A forward-looking AQR for all banks is critical to reduce uncertainty on banks' asset quality, including the adequacy of collateral evaluation and provisions. The CBSM should require banks to quickly meet any need for additional provisions in order to bring the currently relatively low NPL coverage ratios to adequate levels. Should capital shortfalls emerge, the CBSM should demand weak banks time-bound market-based recapitalization plans. Public support for systemically important banks may be needed.



## NPL Management

- San Marino's banks might benefit from the creation of a joint AMC, preferably with the participation of independent specialized investors. Participating banks would acquire shares of the AMC based on the value of the transferred assets. The transfer price should be set by an independent expert, based on the market value, and in accordance with a common methodology. The supervisor should ensure that the nonconsolidated accounting for bank's NPLs transferred to the AMC could be allowed only under the condition that no individual bank retains de jure or de facto control of the AMC, with each participating bank holding an equitable share in the profits and losses of the AMC. Where these requirements are not met the transferred assets should continue to be reflected on the bank's balance sheet.
- Where there is an intention to facilitate the distressed assets sales, securitization could be a helpful instrument to better segregate different risks exposures and target specialized investor.

## Legal Framework

- The key reform priority should include modernizing and enhancing insolvency system to provide a wider range of features for rehabilitation by (i) allowing pre-packed filing of the out-of-court restructuring agreements; (ii) enhancing the *concordato* mechanism by providing for greater flexibility of its terms, while ensuring equitable participation of all creditors in the *concordato* approval; and (iii) ensure protection of new financing provided in the context of pre-insolvency and insolvency procedures by according it priority status in subsequent insolvency procedures, including over tax and other public debt.
- In addition, the super-priority ranking of tax authorities over secured creditors for the purposes of insolvency should be reconsidered. To the extent priorities are deemed important from a policy perspective, priorities (e.g., ahead of unsecured creditors) should be limited to the tax claims within a specified period of time (e.g., last 12 or 24 months) while interest and penalties should be treated as unsecured (or subordinated) claims.
- Lastly, the need for a special framework for consumer and entrepreneur insolvency should be evaluated. This would allow for obtaining conditional debt relief (i.e., a fresh start) within a reasonable time period (e.g., three years).

## Taxation

- With respect to taxation, the tax disincentives to provisioning, write-offs and debt transfers should be reconsidered. Specifically, this applies to the 5 percent cap on deductibility of loss provisioning, the limited period for write-offs of tax deductibility in insolvency, and the 0.1 percent tax on debt transfer.
- In addition, the scope for the tax authority's to participate in restructuring schemes should be expanded. This could be done by temporary allowing them further flexibility in tax debt restructuring and write-offs, subject to predefined criteria.

## Institutional and Judicial Enforcement

- Further streamlining and electronic automatization of court submission filings should be considered. This could also apply to other administrative processes, and could be done through a centralized electronic system to save resources and facilitate processes.
- Finally, it remains important to ensure that taxes and fees related to judicial enforcement do not excessively raise costs of enforcement.

### Box 1. Code of Conduct for Management of Debt Restructuring Negotiations

**In July 2015, all seven Sammarinese banks subscribed to a voluntary Code of Conduct to facilitate debt restructuring of financially distressed borrowers.** In so doing, banks have committed to follow a common set of rules in negotiating debt restructuring of either companies or individual whose debt exceeds 1 million euro.

**The Code provides for a two-step procedure to debt restructuring negotiations** that may be initiated by the qualifying debtor or one of the creditor banks.

- The first stage is a preliminary assessment/negotiation procedure in which all financial creditors participate. Nonfinancial creditors participation is allowed subject to the consent of the debtor and the majority of participating financial creditors. This stage provides, *inter alia*, for (i) the full financial disclosure of the financial and business situation of the debtor and his relationship with each of the creditors; (ii) the suspension of any act on behalf of the debtor or creditors that may prejudice other creditors, including debt enforcement/insolvency actions; and (iii) a meeting of all financial creditors of the debtor allowing appointment of a coordinator for the negotiations. During the preliminary negotiation stage, the creditors are expected to assess the general state of debtor's distress and decide whether a restructuring of the debt is warranted.
- Based on the assessment of the debtor's financial situation, the qualified majority of creditors (representing at least 60 percent of debtor's financial debt) may agree to proceed with the debt restructuring. During this second stage, the debtor and his creditors prepare a restructuring plan intended to bring the business back to viability. The restructuring agreement can be concluded if it receives the support of the creditors holding at least 60 percent of debtor's financial debt.

**The restructuring agreement concluded under the Code is binding only upon the creditors signing such agreement.** However, the Code provides for two key principles guiding the conduct of all financial creditors with respect to the restructuring agreements:

- All creditors participating in the negotiation are expected to recognize the priority of those creditors providing new financing as part of the restructuring plan.
- Dissenting creditors are expected to enter into bilateral temporary moratorium agreements with the debtor, which take into the account the terms of the restructuring agreement, thus allowing the viability of such agreement.

## Box 2. Recent Reforms to Corporate Restructuring Techniques in Selected European Countries<sup>1</sup>

### Italy

**A series of reforms took place between 2009 and 2015, and another major reform is underconsideration.** There are multiple options that allow debt restructuring without resorting to a full insolvency process:

- Restructuring agreements, which are designed to repay the company's outstanding debt, and are supported by a limited stay of creditor actions. Restructuring agreements need to be approved by the court and by creditors representing at least 60 percent of claims. An expert gives an opinion on the feasibility of the restructuring agreement. The agreement binds the approving creditors, while dissenting creditors need to receive full payment.
- Rescue plans, whose objective is to restore the company's financial health, especially in cases of illiquidity or temporary crisis. The main purpose of this legal provision is to protect the actions undertaken in a rescue plan against potential claw-back actions in a successive insolvency process.
- Restructuring agreements with financial institutions. The 2015 reform has added a new restructuring tool: the possibility of reaching an agreement with financial creditors, when a company has more than 50% of its outstanding debts with financial institutions. If a majority of 75 percent of financial creditor agrees to such a restructuring, the remaining financial creditor are also be bound by the agreement. Non-financial creditors need to be paid in full.

**The multiplicity of the restructuring and reorganization mechanisms increased the importance of rules on post-petition or bridge financing,** taking into account the potential gaps and interruptions between procedures and ensuring the priority of the new financing and the protection of creditors against claw-back actions. Several technical amendments have addressed this point.

### Germany

**The 2012 amendments to the insolvency code introduced protective shield proceedings available only to debtors in imminent insolvency,** not in actual illiquidity or insolvency, who qualifies for debtor-in-possession status. The latter requires a debtor petition and absence of expected negative impact on creditors, which is evaluated by the court and a (preliminary) creditors' committee appointed by the court. The scheme gives eligible debtors the possibility to prepare within a maximum of three months a pre-packaged restructuring plan in the opening ("interim") stage, before formal commencement of insolvency proceedings under the monitoring and with the assistance of a mediator ("Sachwalter") and the creditors' committee. At this stage, the judge may permit the debtor to create administrative claims for a subsequent formal insolvency proceeding, e.g., by borrowing new funds. If a feasible prepackaged plan can be negotiated under the protective shield, it may be put to a vote and eventually confirmed in a subsequent formal insolvency proceeding under the general provisions for voting, cram-down, and minority protection (guarantee of liquidation value for all claimants).

### Slovenia

**The 2013 amendments to the insolvency law introduced changes to reorganization procedures** (compulsory settlement) which included (i) increased control of the proceeding by financial creditors, including the ability to initiate proceedings, to introduce a plan that takes precedence over the debtor's plan, and to take management control in certain cases; (ii) an absolute priority rule to ensure that if the value of equity is zero, debtor equity will be eliminated; (iii) corporate restructuring features, including debt/equity swaps and corporate spin-offs to facilitate viable firms continuing as a going concern; (iv) secured creditors are included in the compulsory settlement process and can pool collateral under a settlement plan; (v) the write-down of collateral to market value with a corresponding conversion of the now unsecured portions of collateralized loans into unsecured claims is permitted; and (vi) the process recognizes

**Box 2. Recent Reforms to Corporate Restructuring Techniques  
in Selected European Countries (concluded)**

the possibility that requisite majorities of creditors can agree to reduce principal on unsecured debt, and to extend maturity and/or to reduce the interest rate for both secured and unsecured debt.

<sup>1</sup>See Technical Background Notes to IMF Staff Discussion Note on “A Strategy for Resolving Europe’s Problem Loans,” September 2015. For details on Italy also see Selected Issues to the 2015 Article IV Consultation, IMF Country Report No. 15/167. For details on Slovenia see Selected Issues to the 2014 Article IV Consultation, IMF Country Report No. 15/42.

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