



# Credit Insights - by KPMG Cyprus Credit Institute

Bringing the Corporate and the  
Financial communities together

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# A roadmap to mend damaged relationships between businesses and banks

## What are the stakes?

Small and medium-sized enterprises (SMEs) are rightly considered as the heart of the Cypriot economy. The statistics are irrefutable: a contribution of 55% to the added value of the local economy and 62% to the total employment of the local economy (see infographics below).

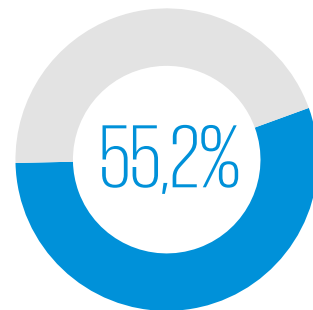
SMEs account for 99,9% of all companies registered in Cyprus. It would not be an exaggeration to state that the SME sector has always been the “locomotive” of the Cypriot economic ecosystem, as well as the main driver of growth, employment, and economic welfare of the country.

The pivotal role of SMEs is demonstrated through the European Commission’s initiative called “Small Business Act”: the Europe 2020 strategy and the prosperity of the European economy are based to a large extent on the development of the SME dynamics.

The flagship initiative states in a definitive manner: “In a globally changing landscape characterised by continuous structural changes and enhanced competitive pressures, the role of SMEs in our society has become even more important as providers of employment opportunities and key players for the wellbeing of local and regional communities. Vibrant SMEs will make Europe more robust to stand against the uncertainty thrown up in the globalised world of today”.

Source: CYSTAT, EUROSTAT, European Commission, KPMG Analysis

## The largest value - added contributor to the economy

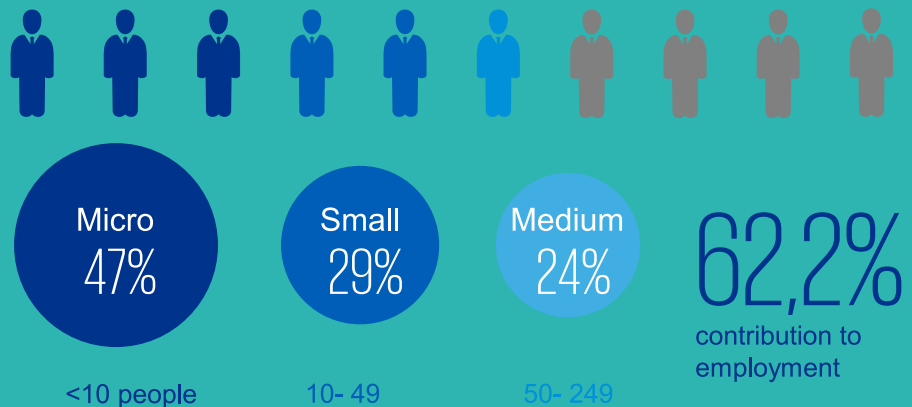


## Prevalent in the local business - set



## The biggest employer in the economy

Small and medium-sized enterprises (SMEs) are rightly considered as the heart of the Cypriot economy.

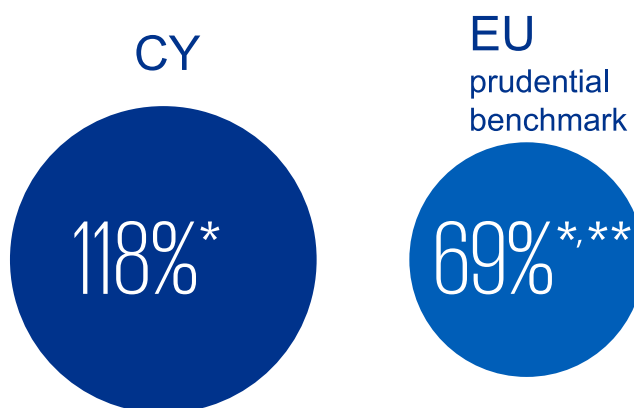


### The survival of the private business sector is in danger:

Despite its vital role in the local economy, the SMEs sector has probably been the greatest victim of the recent economic crisis as:

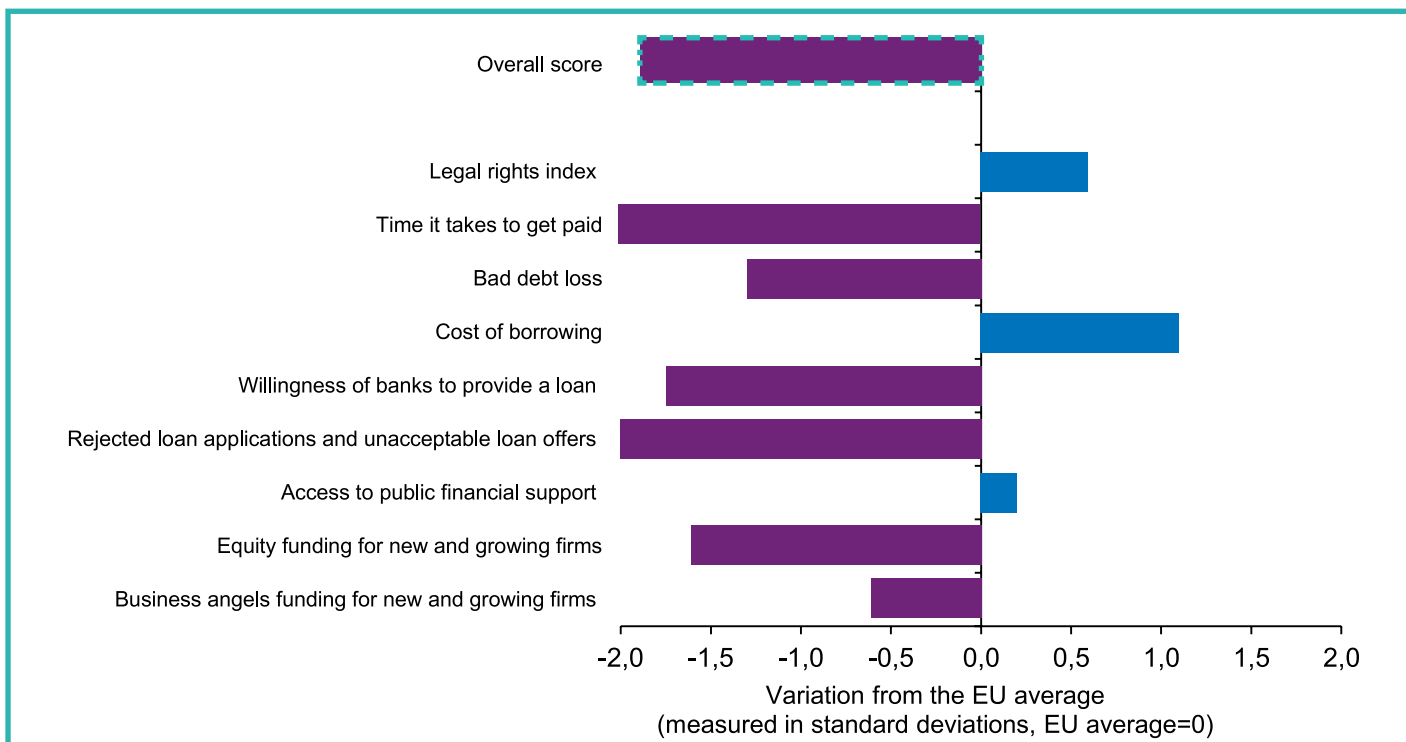
- one in two SME loans is non-performing. This has a significant indirect impact on household loans, as the SMEs sector is the “largest employer” of the Cypriot economy
- the local private business sector has one of the highest debt ratios (in relation to GDP) within the European Union (EU), amplifying the sector’s excessive leverage and over-indebtedness situation
- Cyprus displays one of the worst performances within the EU in terms of SME access to finance (see below diagram).

### But heavily over - leveraged



\*Non financial corporation debt to GDP (excluding SPEs)  
 \*\* represents the threshold "over which a banking crisis is more probable"

### And structural difficulties in accessing SME finance



Source: CYSTAT, EUROSTAT, European Commission, KPMG Analysis

Arguably, the local SMEs sector is facing notable structural problems that may potentially endanger not only its future growth but also its very survival. This, at a time when the economy is showing strong growth trajectory, with the 'birth' and 'death' rates of businesses showing good signs of recovery (see adjacent diagram) . Thus, the resilience of the SME sector has profound repercussions on the local economy and society.

### The fundamental relationship between the business and the financial sectors

A sound and efficient debt market is the trademark of a functioning economy and is fundamental for business expansion and economic growth, especially in Cyprus, where the funding of productive investments is almost exclusively carried out through the financial/banking sector.

Equally fundamental is the capital (re)structuring of businesses, since over-leverage has led, to a large extent, to the problems of our business and financial sectors. Consequently, the right balance has to be struck between prudent and viable financing of productive investments to fuel sustainable growth on the one hand, and tight management of the levels of debt of the corporate sector, on the other hand. Excessive indebtedness gives rise to grave vulnerabilities especially in the event of a subsequent economic downturn, reduces the level of productive investment in the economy, and affects the capacity and appetite of financing banks to fund such investments.

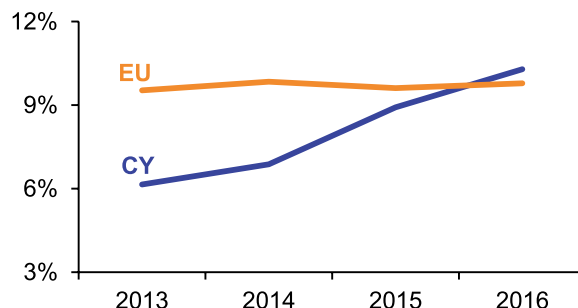
The interests of the private business sector and the financial sectors are inextricably interlinked. The former is almost exclusively dependent on the latter due to its financing needs; the latter's resilience and prosperity are reliant on the health and growth of the country's corporate world. And the health of both sectors contributes to sound economic performance for the country.

It is evident, nevertheless, that in recent years communication channels and bridges of cooperation between the business world and the banking world have deteriorated, at a time when a key deciding factor for the sustainability of our economic model is the productive and constructive cooperation between the two sectors.

In a volatile world characterised by increasing complexity coupled with unprecedented and multilevel technological, competitive and regulatory changes, there is no room for inertia and complacency. Restoring balance and trust between businesses and banks is an absolute pre-requisite for safeguarding our economy's resilience and healthy growth.

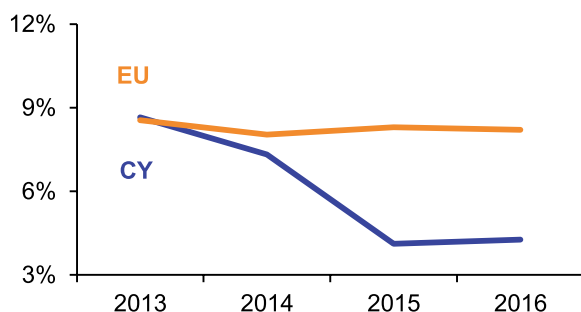
## Confidence returning in business demographics

### Enterprises' "birth rate"



Birth rate: number of enterprise births in the reference period (t) divided by the number of enterprises active in t - percentage

### Enterprises' "death rate"



Death rate: number of enterprise deaths in the reference period (t) divided by the number of enterprises active in t - percentage

Source: CYSTAT, EUROSTAT, European Commission, KPMG Analysis

### **A new model is required to propel the economy forward**

We urgently need to shift to a radically different culture and business paradigm that will redefine the relationships between businesses and banks. There is no alternative but to base this paradigm shift on constructive dialogue and consultation, cooperation and mutual trust.

To this end, bold steps are required from all key stakeholders:

#### **On the one hand, company owners, directors and business managers:**

- must undertake immediate measures to ensure the viability, resilience and further growth of their businesses
- have the primary responsibility, but also the legal obligation, for the survival of their companies and for the preparation of effective plans for the sustainable restructuring of their operations and debt obligations. The legal duties of directors will be the subject of the second article of this issue of Credit Insights
- have to re-establish communication and trust with banks on the basis of transparent corporate governance, reliable and timely information, and prudent business practices.

#### **Banks on the other hand:**

- must act immediately upon the first signs of financial difficulties on the part of their borrowers. Early warning tools need to be firmly in place while sufficient numbers of capable personnel must be committed for direct involvement with borrowers
- in view of the large number of non-performing borrowers and the often complex nature of these loans, considerable effort, time and resources need to be devoted to construct truly sustainable, long-term and fair restructuring plans
- must demonstrate perseverance, tolerance and objectivity to all borrowers who are cooperating in a transparent and constructive manner. Even terminated accounts (court judgment issued or legal action filed or pending), are conducive to sustainable restructuring, under certain circumstances
- must fulfill their key economic role, which is the responsible and prudent financing of productive investments, projects and business ventures.

#### **The third essential component of the puzzle is the State, which has a number of fundamental and encompassing roles, namely to:**

- facilitate the efficient interaction between the corporate and the financial worlds by “ironing out” any deficiencies which have transpired from the four years of operation of the insolvency framework
- create, through further improvements to the insolvency regime, the appropriate balance of incentives and disincentives to borrowers and lenders alike to engage in fruitful negotiation to avoid insolvency

- act to improve the present state of the judiciary insofar as the efficiency, timeliness and specialisation of the court system is concerned, alongside the expansion of alternative dispute resolution methods. Cyprus has consistently been a laggard in these respects within the EU
- adopt a planned course of actions to accommodate the efficient and timely liquidation of non-viable entities, to ensure the release of resources back to the productive economy
- institute a level-playing field by involving all state creditors in the restructuring process, by removing super-priority creditor powers of the tax department, and by issuing appropriate instruction to the district lands offices to follow a uniform and consistent approach when it comes to restructuring-related cases
- explore the possibility of initiating a proactive and comprehensive ‘national private sector debt strategy’ – which will cover, inter alia, all the above, through the establishment of a multi-disciplinary team of experts to be directed and monitored and by a non-politicised Board of Governors which will own, and be accountable for, this significant project
- take action to develop a fully-fledged credit bureau which will, among other things, reinforce responsible lending and will go a long way in changing the payment culture and discipline of borrowers.

#### **The Financial Expert**

All stages of the proposed roadmap should be supported and reinforced by the expertise of specialised financial advisors, who will bring the stakeholders to the dialogue table and will provide credibility, technocratic expertise and robustness to the process.

The difficult role of the independent financial expert is to re-connect the alienated stakeholders, to converge their divergent goals and to provide an objective view which will balance the stakeholders’ needs and wants.

#### **KPMG Cyprus Credit Institute (‘CCI’)**

The timing for a quantum leap in our economy is now mature for a major transformation of the present mind-set to embrace a new model of stakeholder collaboration.

The newly-formed KPMG CCI is committed to playing a pivotal role in the reshaping of the prevailing culture and business paradigm, by creating a professional point-of-reference hub which will promote thought leadership and will encourage the key stakeholders of our economy to ‘work together’ in a cooperative, constructive way, in search of economic prosperity and sustainability.

# Company Directors' overriding role and responsibility in corporate rescue

## Introduction

It is an indisputable fact that company directors are critical to the management of companies, and this becomes even more pronounced when companies are facing financial difficulties. The powers endowed upon directors to manage the affairs of the company, inevitably bring obligations and responsibilities upon them.

As described earlier in this edition of Credit Insights, one in two SMEs, the backbone of the local economy, are still in non-performing status, six years following the onset of the Cypriot crisis.

The fact that 50% of SME loans (sitting on the balance sheets of banks and credit acquiring companies) are still in non-performing status is ample indication that something is fundamentally wrong. The factors behind this may be manifold, probably a combination of most or all of the following:

- Company owners and directors (collectively described as directors) have not faced up to reality and have not taken those measures needed to restructure and rescue their companies
- Lenders have not come to grips (e.g. negotiated with a view to resolving) yet with the mountainous load of NPL cases
- There is still a huge deficit of communication, understanding and trust between directors and lenders, which indeed leads to varied expectation gaps and a lack of consensus (as described in the previous article)
- A number of companies is evidently non-viable and should move swiftly through a liquidation procedure.

Whatever the reason might be, directors are always at the driving wheel when it comes to steering their companies out of trouble. It cannot be otherwise. They are the ones running the companies; they are the ones who will need to work on credible restructuring plans, communicate with lenders, restore communication and trust, seek and obtain expert help.

## EU Directive on preventive restructuring frameworks and directors' duties and liability

The European Commission (EC) has taken a decision to shift the focus away from liquidation towards encouraging viable businesses to restructure at an early stage in order to avoid insolvency. The key to success for preventive rescue is directors' pro-activeness and timing. As per the EC's recent directive on preventive restructuring, Member States must have in place the necessary legislative provisions to ensure that directors fulfill their duties and obligations (with related punitive actions and liabilities if they do not).

Thus, where an enterprise is experiencing financial difficulties, directors have a duty to take immediate steps to minimise losses and to avoid insolvency. Examples of these steps are as follows:

- seek professional advice
- use early warning tools
- protect business assets and avoid loss of key assets
- examine the company's viability and reduce expenditure
- hold negotiations with creditors
- seek to enter into preventive restructuring procedures.

In addition, the directive highlights the importance of protecting the legitimate interests of creditors, workers and other stakeholders and of taking immediate steps, where a debtor is in the vicinity of insolvency.

This European directive comes on the back of an increasing international trend to shift directors' duties from being shareholder-oriented to being more creditor-oriented in the situation where their company is in the vicinity of insolvency.

In fact, many case-law-based jurisdictions have incorporated provisions for 'wrongful trading', which occurs when the directors of a company have continued to trade a company past the point when they knew, or ought to have concluded, that there was no reasonable prospect of avoiding insolvent liquidation and they did not take every step with a view to minimising the potential loss to the company's creditors.

## **Conclusion**

Legislators are increasingly taking the view that when a company is in the vicinity of insolvency, creditors' interests should have clear prevalence compared to the interests of other stakeholders. This shift will have profound implications on company directors, as it will expose them to an increased risk of incurring personal liability if they allow their company to continue to trade while insolvent.

The message for company directors is simple and clear. They have to size up to their legal duties and obligations. They have to take full responsibility and accountability for the well-being of the companies they are running:

**by being on top of the company's business and financial affairs**

**by having reliable monitoring and reporting mechanisms (including up to date audited financial statements)**

**by instituting and sustaining an open-ended communication and dialogue with lenders and other stakeholders**

**by obtaining reliable expert advice to restore and preserve company health and value.**



# KPMG Debt Advisory and Debt Management services

01

## New project financing

- Feasibility studies
- Investment appraisals
- Business and asset valuations
- Business plan reviews and assistance
- Financial forecast reviews
- Model review and assistance



## Borrower and lender financial restructuring assistance

- Independent Business Reviews
- Financial restructuring plans (liabilities rationalisation)
- Refinancing assistance
- Stakeholders negotiation assistance
- Restructuring options identification, assessment and monetisation



02

03

## Crisis Management & Turnaround

- Cash crisis management and cash flow stabilisation
- Operational restructurings (assets, profit and loss and cash flow optimisation)
- Corporate turnaround assistance
- Turnaround executive/chief restructuring officer appointments



## Asset and Debt management services

- End-to-end Debt for asset transaction implementation (strategy, negotiation, execution)
- Real estate asset due diligence (financial, technical, zoning, tax)
- Valuations reviews
- Asset management planning, portfolio optimisation and exit strategies
- Loans servicing insourcing and outsourcing
- End-to-end foreclosure procedure insourcing and outsourcing



04

05

## Corporate Recoveries

- Receiver/Manager appointments
- Liquidation appointments
- Act as Court appointed officers
- Independent expert reports
- Insolvency expert witness reports



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