MONTENEGRO

FINANCIAL SECTOR ASSESSMENT PROGRAM

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TECHNICAL NOTE

FRAMEWORK FOR NONPERFORMING LOANS WORKOUT AND INSOLVENCY AND CREDITOR RIGHTS

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This Technical Note was prepared in the context of a joint IMF-World Bank Financial Sector Assessment Program (FSAP) mission in Montenegro during September 2015 led by Peter Lohmus, IMF and Alexander Pankov, World Bank, and overseen by the Monetary and Capital Markets Department, IMF, and the Finance and Markets Global Practice, World Bank. The note contains the technical analysis and detailed information underpinning the FSAP assessment's findings and recommendations. Further information on the FSAP program can be found at http://www.imf.org/external/np/fsap/fssa.aspx.

CONTENTS

GLOSSARY

CBM	Central Bank of Montenegro
DPD	Days Past Due
EU	European Union
FSAP	Financial Sector Assessment Program
LCB	Law on Consumer Bankruptcy
LCP	Law on Civil Procedure
LESC	Law on Enforcement and Securing of Claims
LoB	Law on Bankruptcy
LoC	Law on Courts
LoM	Law on Mediation
LoN	Law on Notaries
LoO	Law on Obligations
LPEO	Law on Public Enforcement Officers
LOR	Law on Ownership Rights
LSSCIP	Law on State Surveying and Cadastre of Immovable Property
LST	Law on Secured Transactions
LVR	Law on Voluntary Restructuring of Debts towards Financial Institutions
MoF	Ministry of Finance
MoJ	Ministry of Justice
NPL	Nonperforming Loan
PEO	Public Enforcement Officer
READ	Real Estate Administration Department
TN	Technical Note

EXECUTIVE SUMMARY

A. Key Findings

1. Nonperforming loans (NPLs) remain a difficult legacy, reflecting the local and regional boom-bust cycle as well as lax pre-crisis lending standards. If not reduced, NPLs will continue to burden banks' balance sheets, undermine profits and capital, serve a distraction to management and the board, and suppress banks' interest in new lending. According to CBM data, the system-wide NPL ratio stood at 16.5 percent at end-June 2015, albeit with significant variations among banks.[1] As the bulk of NPLs are backed by real estate collateral, the state of the real estate market is one key impediment for reducing NPLs. A second key impediment is some banks' inability and unwillingness to absorb losses. The absence of sound estimates for the shortfall in provisions relative to actual losses that would be incurred in more rapid NPL resolution impedes effective policy formulation.

2. Recently strengthened supervisory requirements should be complemented by reversing the loosening of regulatory standards observed over the last several years. In 2013, the CBM introduced a requirement for banks to prepare a multi-year NPL resolution strategy, including annual operational targets and quarterly reporting against those targets. While enhanced supervision and monitoring are expected to positively impact banks' NPL management practices, it is essential that the CBM also strengthens regulatory standards and enforcement to ensure accurate and timely reporting of nonperforming exposures, and the establishment of loss provisions that better reflect expected losses.

3. Where appropriate, banks should be required to raise additional capital. This would support the establishment of needed provisions and create headroom to absorb the losses that would be associated with future NPL workouts and write-offs.

4. The CBM should consider establishing a specialized NPL team within the Supervision Department. This team of experts would be distinct from staff who are responsible for individual bank relationship management and for supervising the credit risk management function generally. The expert team would serve as a resource to the relationship managers and their teams, support the supervision of NPL management practices in all banks, and advise on policy formulation. It would promote best NPL resolution practices and help ensure compliance with tightened regulatory standards.

5. In order to analyze, regulate, and monitor the NPL problem in its entirety, it is recommended to bring nonbank credit institutions and asset management vehicles under CBM oversight. In addition to the EUR 397 million NPLs on banks' books, about EUR 720 million has been sold, predominantly to parent banks and affiliated asset management (so-called

[1] Excluding the NPLs held by special purpose vehicles that are established and owned by the parents of some foreign-owned banks in Montenegro.

"factoring") companies. Reporting these exposures to the credit registry should be made mandatory to comprehensively monitor NPL dynamics, which will likely require some form of CBM oversight of such institutions.

6. In recent years, Montenegro has undertaken a number of legal and institutional reforms, seeking to improve the framework for NPL enforcement, but certain gaps remain. Both secured and most unsecured claims can now be enforced using out-of-court procedures before the Public Enforcement Officers (PEOs). Nonetheless, there remains substantial variability in the speed and quality of enforcing some legal provisions by the courts. The legal framework governing bankruptcy is comprehensive and security rights are adequately protected in liquidation. The business rescue culture is not developed. Reorganization is not extensively used and most bankruptcy cases end up in liquidation. Out-of-court reorganization ('workouts') is not a common practice. Land titling and cadastral information has been improving, but gaps remain, especially in rural areas. Finally, the Secured Transaction Register is not interconnected with other databases that are related to movable property (notably, the Registry of Vehicles).

7. The recently enacted Law on Voluntary Restructuring of Debts should be complemented by additional legal measures. This law (aka the 'Podgorica Approach') establishes a framework to facilitate out-of-court negotiations and debt restructuring between a debtor and a plurality of creditors, providing tax and loan-provisioning incentives. Eligibility for using such mechanism, however, is restricted to creditors holding claims classified as B and C exclusively, which could prevent the adoption of a reorganization plan that encompasses all claims, as it is usually needed in cases of serious financial distress or insolvency. Also, the out-of-court debt- restructuring mechanism needs to be complemented by a fast-track procedure to confirm workout plans that were previously approved by a legally defined majority of creditors ('prepackaged plans'), making such plans obligatory with respect to all creditors. This would encourage creditors to participate in out-of-court negotiations and limit threatening attitudes from minority creditors ('hold-outs').

8. At the same time, the recent Law on Consumer Bankruptcy could negatively affect both the collection of existing NPLs and the issuance of retail and SME loans secured with mortgages. This new law establishes a radical exemption in favor of a bankrupt debtor's house, which cannot be sold in bankruptcy (not even to satisfy security rights created over such immovable assets), provided that this is "commensurate with the basic housing needs of the consumer." If such a provision is applied to loans secured with a mortgage created before the entering into force of the Law on Consumer Bankruptcy, most of such loans would be considered unsecured and its collection prospects could be significantly reduced. As for the future, individual loans secured with mortgages will likely disappear from the market if the mentioned prohibition of enforcement of a consumer's house in bankruptcy remains in force, and no adequate safeguards are provided to protect the rights of secured creditors. The impact on financial inclusion, credit access, and cost (in particular, for households and SMEs) should therefore be carefully considered.

B. Summary of Recommendations

Recommendations and Authority Responsible for Implementation	Time*
NPL Resolution	
Tighten the bank regulatory and supervisory framework for accurate reporting of nonperforming exposures, and for asset classification and loss-provisioning standards to accurately reflect expected losses. (CBM)	I
Require banks to raise additional capital to accommodate more accurate loss provisioning and to create headroom to absorb the losses incurred in more rapid NPL resolution. (CBM)	I
Make special purpose vehicles that are involved in the purchase of NPLs subject to the CBM's supervision and introduce mandatory reporting to the credit registry to allow for comprehensive NPL monitoring. (CBM)	I
Create a special unit dedicated exclusively to NPLs. (CBM)	I
Require banks to establish specialized workout subsidiaries into which to transfer certain of their NPLs. (CBM)	NT
Insolvency and Credit Rights	
Specify detailed provisions in the Law on Ownership Rights to expedite the eviction of foreclosed residential properties. (MoJ)	NT
Ensure the effective collaboration of the officers in charge of implementing evictions and the repossession of movable assets subject to secured transactions. (MoJ)	I
Provide adequate funding to the Real Estate Administration to complete cadastral information and titling of all Montenegro territory. (MoF)	NT
Interconnect the Registry of Vehicles and the Secured Transactions Register. (MoI & Commercial Court)	MT
Put into operation the software that will allow electronic filing of secured tractions at the register. (Commercial Court)	NT
Introduce uniform standards for appraisers and appraisals in order to ensure greater consistency of valuations across the banking system and to increase transparency and disclosure through the establishment of a centralized website for real estate auctions. (MoF)	NT
Amend the Law on Bankruptcy to: (1) allow secured creditors to be members of the creditors' committees; and (2) concentrate under a single judge (bankruptcy judge) the competence over all disputes that may arise in the course of bankruptcy proceedings. (MoF)	NT
Clarify—by regulation or amending the Law on Consumer Bankruptcy—(1) that the debtor's house exemption from being sold in bankruptcy shall not apply with respect to security rights created before such law entered into force; and (2) enable liquidation of a debtor's house in bankruptcy in presence of a valid mortgage agreement, unless adequate safeguards specified by the law allow the mortgage creditor to recover at least the foreclosure value of the property. (MoF)	I
Improve the out-of-court debt restructuring framework by: (1) extending the Law on Voluntary Restructuring eligibility to all creditors' claims; (2) creating further tax incentives to out-of-court debt restructuring, whether or not the Law on Voluntary Restructuring mechanism is used in a particular case; (3) introducing in the Law on Bankruptcy a fast-track court procedure for debt restructuring ('prepacks'); and (4) strengthening the capacity of all stakeholders and disseminating the potential benefits of using the new legislation. (MoF and CBM)	I
The institutional framework for NPLs enforcement and bankruptcy proceedings should be enhanced by: (1) improving the capacity and skills of Public Enforcement Officers through mandatory continued training and periodic evaluation of their performance; and (2) establishing that insolvency administrators should also receive mandatory continued education and must revalidate their license periodically. (MoJ)	MT

* I-Immediate" is within one year; "NT-near-term" is 1–3 years; "MT-medium-term" is 3–5 years

INTRODUCTION

9. This Technical Note (TN) examines the current state of NPLs in Montenegro, assesses the regulatory and supervisory framework as well as the insolvency and creditor rights regime, and makes recommendations for strengthening the framework. The analysis was carried out as part of the 2015 Financial Sector Assessment Program (FSAP), and was based on the legal and regulatory framework in place, the supervisory practices employed, and other conditions as they existed as of September 2015. The TN evaluates the legal, regulatory, and supervisory regimes in four key areas: (i) creditor rights and enforcement systems (for secured and unsecured credit); (ii) debt recovery and informal enterprise workout practices; (iii) formal insolvency system (liquidation and reorganization proceedings); and (iv) effectiveness of the relevant institutional, regulatory and supervisory frameworks in implementing laws, regulations, and supervisory requirements in this area. In addition, the TN assesses recent efforts at NPL resolution, including the implementation of a newly enacted law on voluntary out-of-court restructuring, and the role of special purpose vehicles.

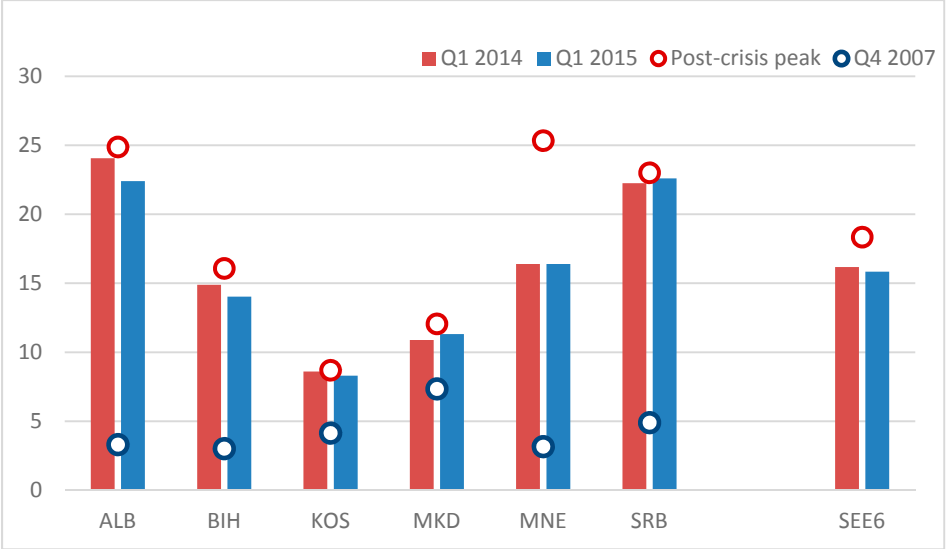
STATUS OF NONPERFORMING LOANS IN MONTENEGRO

A. Regional Context

10. Across the region, the sizeable rise in NPLs following the financial crisis has yet to be addressed. By July 2015, NPLs in the Western Balkans stood on average at 15.8 percent of total loans—over three times higher than they were in pre-crisis times (Figure 1). Albania and Serbia still have the highest NPLs in the region at over 20 percent, each is either near or at its historical peak. Montenegro also posted a high level of NPLs, but, contrary to Albania and Serbia, it saw a decline from the peak of 25 percent in early 2011 to 16.5 percent in mid-2015.[2] If unresolved, NPLs will continue burdening bank balance sheets, undermining profits and capital, distracting management and board attention from new and ongoing banking business, and suppressing banks' consideration of new lending and, more broadly, banks' ability to boost economic activity and growth.

[2] The decline came largely as a result of "bulk sales" of bad loans.

Figure 1. Montenegro: Nonperforming Loans to Total Loans 1/
(In percent)



Sources: Central banks.

1/ Notes: Latest data for Albania and Bosnia and Herzegovina are Q4 2014. Data on Montenegro does not include the portfolios of bad assets offloaded to special purpose vehicles and parent banks.

B. History, Trends, and Status of Nonperforming Loans in Montenegro

Cause of NPLs

11. The local and regional boom-bust cycle has left a legacy of high NPLs in Montenegro. In the years since 2000, the banking sector in Montenegro has undergone significant financial deepening characterized by a period of sustained expansion of bank credit. The pre-crisis credit boom was concentrated in the real estate sector and financed mainly by foreign parent banks. As in many booms, real estate collateral valuations were often inflated upon loan origination and loan documentation was incomplete in some cases. Large capital inflows, peaking in 2008 at about 46 percent of GDP, and rapid increase in government expenditures fuelled the economic boom. The financial crisis and resulting burst of the local asset bubble gave rise to a sharp increase in NPLs and deteriorating bank profitability.

Trends

12. NPLs in Montenegro have remained persistently high, with variations between banks and relatively low provisioning levels. The share of NPLs remains at a relatively high level of 16.5 percent by mid-2015 (see Figure 2). Similar to other financial soundness indicators, important variations of NPL ratios are observed within the banking sector, with ratios exceeding 30 percent in two banks. NPL levels for domestic banks are slightly higher at 18.8 percent, compared to 16.2 percent for foreign-owned banks. The provision coverage ratio, as a share of NPLs, was at

72.6 percent at end-June 2016. More than half of NPLs have been, however, 100 percent provisioned for (in category 'E').

Figure 2. Montenegro: NPLs to Gross Loans (In percent)

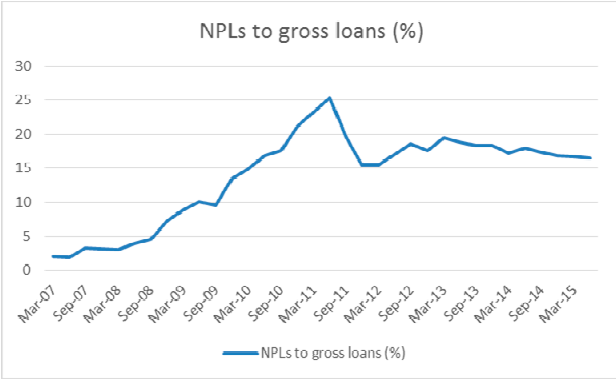
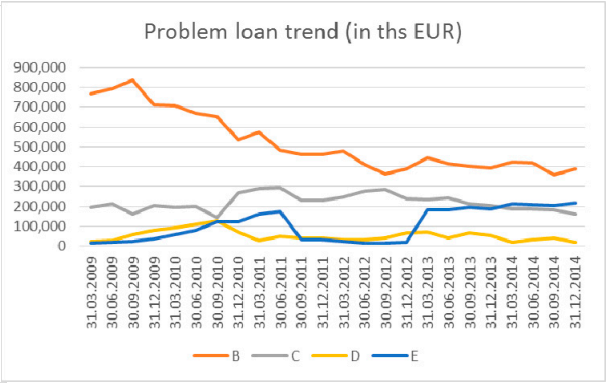


Figure 3. Montenegro: Problem Loan Trend (In thousands of euros)

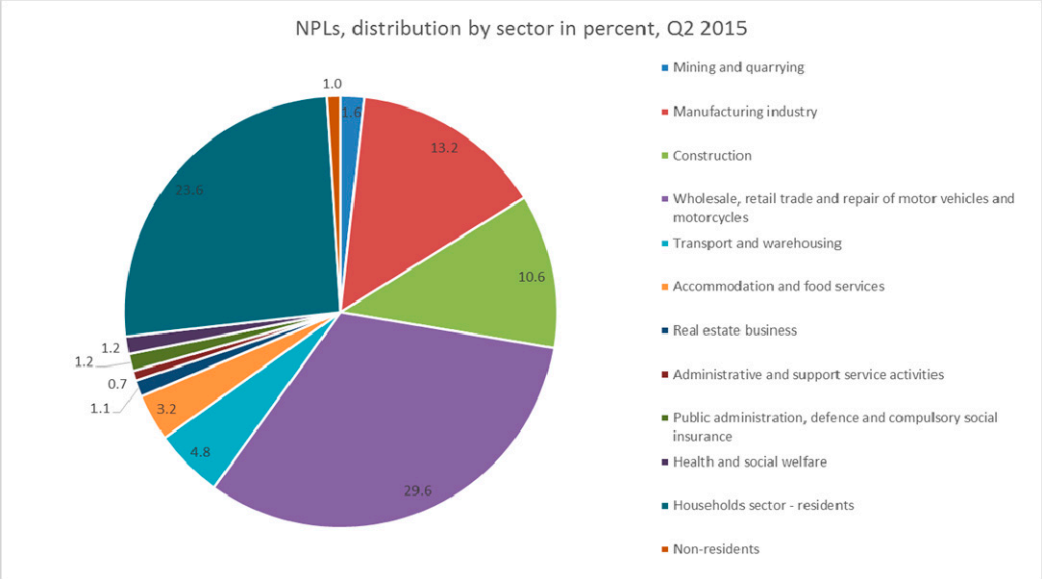


Source: CBM. Due to implementation of IAS 39 in 2013, the definition of loans has changed thereby impacting data comparability.

13. NPLs are concentrated in the corporate loan portfolio, amounting to around two-thirds of the overall portfolio. Banks' loan portfolio reached 2.4 billion EUR in mid-2015, 42.7 percent being loans to legal persons, with the largest shares recorded in trade (37.1 percent), and construction (11.6 percent), 38.4 percent accounting for loans to natural persons and 17.9 percent being loans to nonresidents. NPLs are concentrated in the corporate sector with more than half of the overall portfolio accounting for three sectors: trade (29.6 percent), manufacturing (13.2 percent) and construction (10.6 percent) sectors while NPLs to households accounted for a quarter of the overall portfolio. Sectoral NPL distribution shows particularly high NPL levels in the manufacturing, construction and transport sectors (see Figure 5). As there are many enterprises which, during the economic boom, expanded their operations to non-core business activities; in particular, construction, the data on sectoral NPL distribution in Figure 4 and 5 may be somehow misleading.

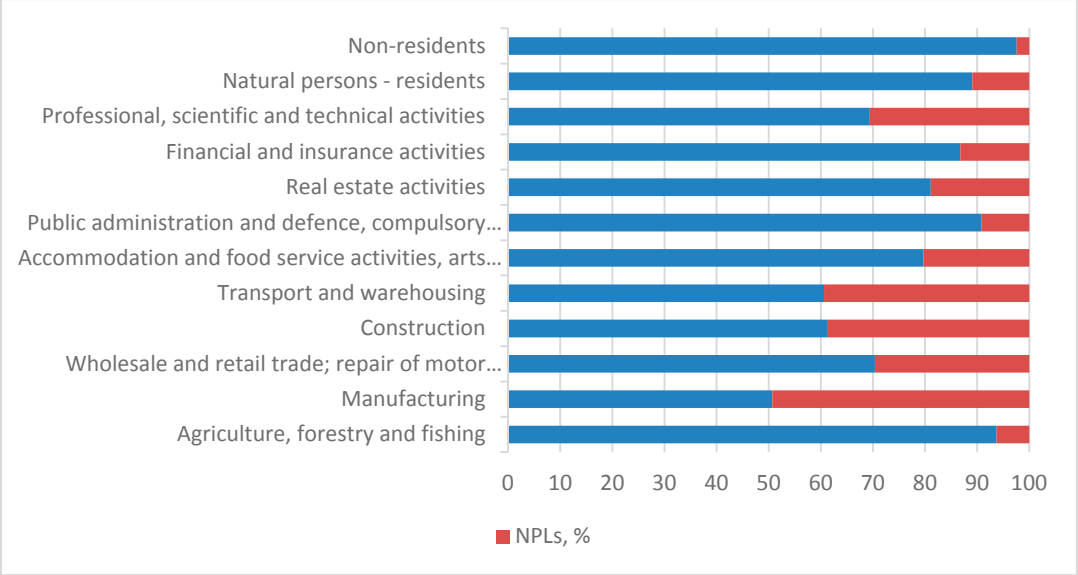
14. One strategy by some banks to resolve NPLs was to offload their worst NPLs to so-called factoring companies (see Figure 6). Over the course of 2009–2015, some EUR 720 million in NPLs were sold predominantly to affiliated group asset management companies, which are, in most cases, owned by foreign parent banks. As a result of the offloading, the overall system-wide NPL ratio declined significantly in 2011 from 25.3 percent mid-2011 to 15.5 percent at the end of the same year. The upward trend in NPLs resumed in 2012 to 19.4 percent in March 2013 and has since slightly declined again (see Figures 2 and 3).

Figure 4. Montenegro: Nonperforming Loans by Sector
(In percent of overall portfolio)



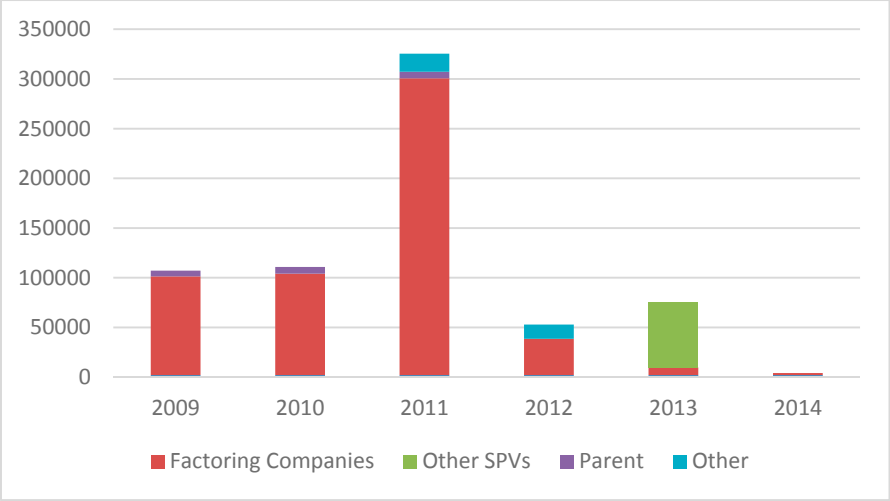
Source: CBM.

Figure 5. Montenegro: Nonperforming Loans by Sector
(In percent)



Source: CBM.

Figure 6. Montengro: Nonperforming Asset Sales Between 2009–2014
(In thousands of euros)



Source: CBM.

15. While banks have also taken measures to restructure loan portfolios, the chosen solutions appear to have had limited effect on sustainable improvement of the repayment ability of companies. Total gross restructured loans and receivables amounted to Euro 360.7 million at end-Q1 2015 or 14.9 percent of loans and receivables. Loans with extended principal or interest repayment accounted for the main share in total restructured loans in the amount of Euro 134 million or 37.2 percent. Banks' appear to be unwilling to apply more drastic restructuring measures such as debt forgiveness, albeit this may be hampered by the fact that a large share of NPLs, or respective collaterals, are related to real estate which are difficult to sell in the current market environment.

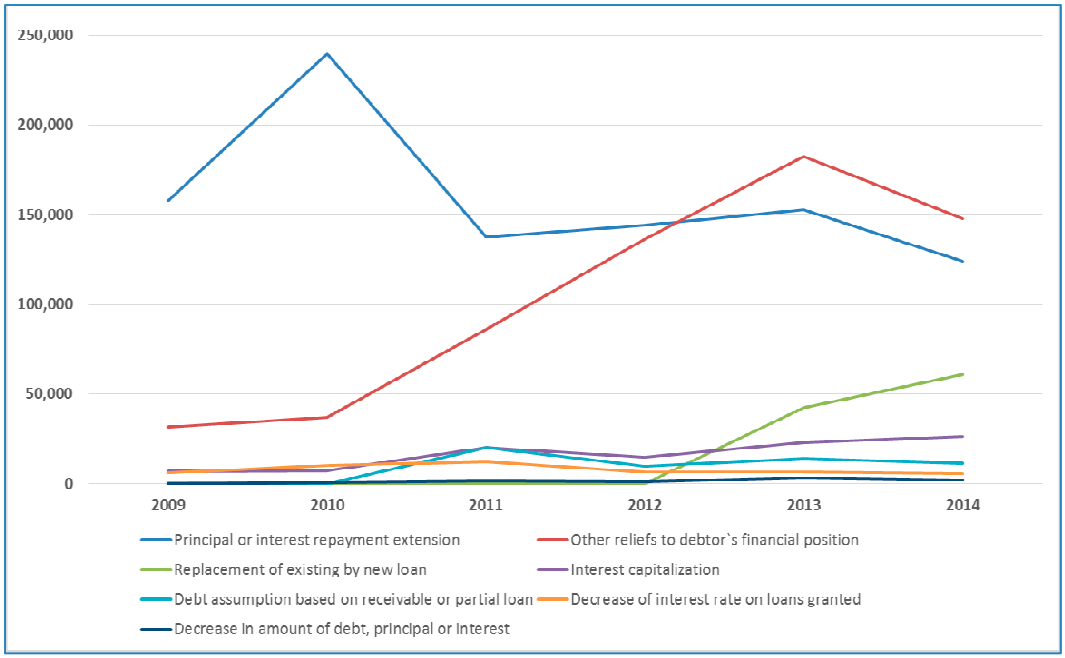
Status

16. Some banks' unwillingness to write-down and forgive principal impedes NPL resolution. Some NPL managers indicated the boards and shareholders of their banks were unwilling to grant debt forgiveness. This reluctance seems to be both a matter of principle and a reflection of the limited capital headroom to incur more losses.

17. The costs and administrative burden of managing foreclosed real estate may also incentivize banks to be less aggressive in resolving NPLs through foreclosure than what would be the case otherwise. Reportedly, there are very few third-party real estate management companies to whom banks can outsource the management and maintenance of real property. Foreclosure of real estate therefore serves to divert management time and operational resources to activities generally unrelated to the business of banking.

18. While, to date, there have been very limited sales of NPLs to third parties, some market participants are in active discussion with foreign investors toward this end. While most banks indicated that they see no prospect of selling individual NPLs or NPL portfolios to third parties, a few market players indicated that discussions with potential foreign distressed debt investors have been initiated and a market for troubled debts may soon emerge. This could create more opportunities for moving NPLs out of the banks.

Figure 7. Montenegro: Restructured Loans by Model
(In thousands of euros)



Source: CBM.

REGULATORY AND SUPERVISORY FRAMEWORK

A. Regulatory Framework

19. The CBM regulation applicable to asset classification, treatment of rescheduled and restructured nonperforming exposures, and the establishment of loss provisions[3] has been periodically relaxed since 2009. Classification standards were relaxed generally by extending the number of days past due that trigger classification into more conservative categories (see Table 1).

[3] Decision on Minimum Standards of the Credit Risk Management.

Table 1. Montenegro: Standard Loan Classification Criteria since 2008 (In days past due)

Classification Grades	Decision on Minimum Standards for Credit Risk Management		Decision on Temporary Measures for Credit Risk Management	Decision on Minimum Standards for Credit Risk Management
	Original baseline Sept/2008 (OGM, No. 60/08)	June/2009 (OGM, No. 41/09)	Nov/2010 (OGM, No. 66/10)	04/2012 (OGM, No. 22/12)-current
A	Borrower not being late with repayments over 2 year period	Unchanged	In the process of analysis of the borrower's creditworthiness and the allocation of assets in the appropriate classification group or sub-group, the bank may exclude criteria of lateness related to DPD.	<=30
B1	Borrower being late with repayments over 2 year period w/o specified No. of days	Unchanged		31-60
B2	<=60	<=90		61-90
C1	61-80	91-100		91-150
C2	81-100	101-130		151-270
C3	101-120	131-150		No C3 Class
C4	121-150	151-180		No C4 Class
D	151-180	181-270		271-365
E	>180	>270		>365

Source: CBM. Decision on Minimum Standards for Credit Risk Management 2012 replaced previous Decision on Minimum Standards for Credit Risk Management, adopted in 2008, and abolished Decision on Temporary Measures for Credit Risk Management, adopted in August 2009.

20. The regulation suffers other weaknesses relative to international best practice. Banks are permitted to classify assets in part on the basis of the nature of the underlying collateral rather than the borrowers' ability to repay. As a result for example, a loan can be treated as performing until it becomes 180 days past due when supported by specified financial collateral, or assigned a better asset classification status even if the quantitative and qualitative criteria may otherwise require it to be classified as nonperforming simply because it is secured by real estate. Moreover, some of the types of collateral that trigger preferential treatment are of doubtful quality, including for example unlisted debt securities issued by parties related to the debtor. The regulation also lacks adequate clarity on rules for restructuring or rescheduling loans and their subsequent reclassification to better categories which can lead to inconsistent implementation and enforcement.

21. The current provisioning regime is generally considered conservative for the poor quality classification grades (see Table 2)**.** Banks are required to make minimum provisions at the prescribed prudential levels on the total outstanding for each loan without setting off collateral. The lack of any provisioning against the A rated category is a weakness however. Provisioning rules have not been validated against actual outcomes. Given the information available in CBM's credit database it should be possible to analyze the correlation between actual loss outcomes on resolved NPLs and the rate at which they were provisioned under CBM rules.

Table 2. Montenegro: Provisioning Requirements by Classification Grades

Classification Grades	Decision on Minimum Standards for Credit Risk Management
	04/2012 (OGM, No. 22/12)-current (in percent)
A	0
B1	2
B2	7
C1	20
C2	40
D	70
E	100

22. The consequence of the loosening of asset classification norms has been to obscure information on the true state of loan quality, the level of NPLs, the sufficiency of loss provisions for individual loans, and the rate of progress in NPL resolution. Despite the relatively conservative provisioning requirements associated with the lower quality asset classification grades, the current regulation likely results in an understatement of NPLs, overstatement of the quality of NPLs, what would be appropriate provisions, and, thus, an overstatement of banks' regulatory solvency ratios. Moreover, the result is to provide a poor basis for supervisory evaluation of banks' asset quality, NPL resolution efforts, and the validity of cross-bank comparisons of progress.

23. The adoption of IFRS accounting starting in 2013 may have created additional scope to delay NPL resolution. IFRS IAS 39 employs an incurred loss principle that in Montenegro, as well as many countries globally, has generally resulted in lower levels of provisioning relative to existing regulatory standards. Under IAS 39, bank in their published audited accounts establish provisions for the impairment of loan value. In simplest terms impairment is the difference between the loan amount and the net present value of anticipated future cash flows of the loan and collateral. Management's judgment as to the amount and timing of such future cash flows carries weight even though external auditors review these judgments. The result is that there is scope for management to be optimistic regarding borrower's repayment capacity, realizable collateral values and their

timing. In some cases the external auditors apparently have been unwilling to accept management's judgment, which has led to the auditors issuing only qualified opinions on certain banks' accounts.

24. Regulations applicable to holding of foreclosed real estate also have been relaxed.[4] The amendments enabled banks to hold a higher share of their own funds in immovable properties (acquired through loan collection and foreclosure) and fixed assets and to hold such as for a longer period.

B. Supervisory Practices

25. In 2013, the CBM introduced a requirement for banks to prepare problem loan resolution strategies, along with annual operational targets and quarterly reporting against those targets. The requirement applies only to loans formally classified as NPLs (those rated C, D, or E). The strategy is to cover a three-year period and be based on guidelines set out by the CBM. The strategies articulate the banks' NPL management goals, principles that have been adopted in pursuing NPL resolution, governance structures and operating responsibilities, and specific differentiated procedures being followed for NPLs of various types. Each bank defines annual quantified operating targets for the various NPL recovery and enforcement mechanisms that they are pursuing. Quarterly reports measuring progress against those targets are required to be submitted to the CBM, using a prescribed template. The CBM monitors progress against targets. The CBM reports that an important outcome of this effort has been to more systematically identify the better NPL management practices among the banks and to require lagging banks to upgrade their practices.

26. The variety of organizational approaches employed by banks in managing NPLs may suggest there remains scope for more intensive supervision of NPL management practices. As noted, some banks have transferred their lowest quality NPLs to special asset management vehicles (e.g., factoring companies) owned by their foreign parent companies. Those NPLs are then no longer subject to any supervisory attention. For retained NPLs, in most cases the borrower relationships are managed by designated workout units or, for the lowest quality NPLs, the legal staff. The extent of involvement by the line credit officers varies. In some cases, the originating loan officers reportedly remain involved in NPL workouts, whereas in others they do not.

27. While CBM supervises banks' adherence to its asset classification and provisioning standards as well as banks' capital planning and capital adequacy, the cited structural weaknesses in the asset classification rules results in under-provisioning that is a key constraint to more aggressive NPL resolution in some banks. Several banks expressed their aversion to incurring losses in excess of the regulatory provisions for an individual loan due to limited capital headroom.

[4] Decision on Minimum Standards for Bank Investment in Immovable Property and Fixed Assets.

C. Recommendations

28. Regulatory standards for asset classification and treatment of rescheduled and restructured nonperforming exposures should be tightened. Loans should be classified based on the borrower's repayment capacity, as assessed by quantitative analysis of future cash flows. The nature of any collateral should not influence the classification grade. Rescheduled and restructured loans should result in an upgrade in the classification when there is a consequent demonstrable improvement in debt repayment capacity, and when the borrower has demonstrated willingness to repay by several months of actual debt service under the new terms.

29. Loan-loss provisioning rules should be periodically validated against actual outcomes in the resolution of NPLs. The CBM should leverage its extensive database (supplemented as recommended in this note by data on NPLs that have been transferred into affiliates that currently do not report information to the database) to analyze the appropriateness of existing provisioning rules. Where significant disparities are identified, revisions to the required provisioning levels could be considered. A similar analysis could be undertaken to set a required provision for A-rated loans, which are currently exempt from any provision requirement. The provision for A-rated loans could be differentiated for different portfolios of loans (e.g., loans to real estate developers, consumer loans).

30. Where appropriate, banks should be required to raise additional capital to support the higher provisions that would result from tightening CBM asset classification, rescheduling, and restructuring standards, and to create headroom to absorb the losses that might be associated with more aggressive NPL workouts and write-offs. Simultaneous with preparations to tighten regulatory standards, the CBM should systematically estimate the likely consequences for capital adequacy in individual banks. This would best be achieved by commissioning an independent asset quality review of all banks. Where appropriate, the CBM should bring pressure to bear through its assessment of banks' ICAAPs to encourage the banks' boards and controlling shareholders to raise capital preemptively.

31. The CBM should consider requiring banks to organizationally separate certain NPLS of theirs into specialized workout subsidiaries. NPLs that are associated with clients that have no prospect of becoming profitable business relationships for the bank, or who do not conform to a bank's current business strategy, might best be transferred to a legally separate entity with its own governance arrangements. The transfers should meet the "true sale" requirements whereby the assets are priced appropriately, banks recognize the losses, if any, from such sale, and such transactions are at arm's-length basis. The CBM should subject all such transfers to a thorough scrutiny. The goal would be simultaneously to reduce the distraction of bank managers, which arises from having to deal with clients of no continuing interest to the bank, and to improve the management of the transferred NPLs by narrowing the focus of the subsidiaries' managers to solely value recovery, including by putting in place independent governance arrangements oriented to that objective. The specialized workout subsidiaries would remain subject to the CBM's consolidated

supervision of the parent banks. A number of market observers stated that improvement in NPL management could be achieved by establishing such specialized workout subsidiaries.

32. In order to analyze, regulate, and monitor the NPL problem in its entirety, the nonbank credit institutions and asset management vehicles that hold NPLs should be brought under some form of CBM oversight. Reporting the credit exposures held by these entities to the credit registry should be made mandatory. This will permit a more comprehensive analysis of NPL dynamics.

33. To strengthen the effectiveness of NPL supervision, including by implementing changes that are recommended in this note, the CBM should create a special unit dedicated exclusively to NPLs. The unit would be distinct from staff who are responsible for individual bank relationship management and for supervising the credit risk management function generally. The special unit would serve as a resource to all relationship managers and their teams. The mandate of the unit would be to formulate a system-wide diagnostic of troubled debts and the manner in which they are being managed and resolved, to advise on policy formulation (including with consideration of the recommendations in this note), to support implement of a strengthened policy and supervisory approach, and to generally drive systematic improvement in NPL resolution. The CBM should consider allocating additional resources to the Bank Supervision Department for this purpose.

INSOLVENCY AND CREDITOR RIGHTS

A. Creditor Rights

Legal framework for securing and enforcing creditor rights

34. Montenegro legislation provides for several reliable and affordable means for protecting credit and minimizing the risks of debtor nonperformance and default, but implementation is still affected by several weaknesses. Numerous modern laws govern the different phases and contingencies of the life cycle of credit. Most of these laws are up to date and provide for varied remedies for resolution of both unsecured and secured loans in default. Relevant market participants generally agree that most of the system problems are due to weak implementation of a legislation that actually does not present significant flaws. The main laws that cover the fields of access, protection (security), and enforcement of creditor rights are the following:

- Law on Obligations –LoO (August 2008)
- Law on Ownership Rights –LOR (March 2009)
- Law on Secured Transactions (Movable Property) –LST (January 2003)
- Law on Enforcement and Securing of Claims –LESC (July 2011)
- Law on Civil Procedure –LCP (March 2004)
- Law on Courts –LoC (No. 5/2002)
- Law on Public Enforcement Officers –LPEO (December 2011)

- Law on State Surveying and Cadastre of Immovable Property –LSSCIP (May 2007)
- Law on Mediation –LoM (May 2005)
- Law on Notaries –LoN (November 2005)
- Law on Bankruptcy –LoB (December 2010)
- Law on Voluntary Restructuring of Debts towards Financial Institutions – LVR (April 2015)
- Law on Consumer Bankruptcy –LCB (August 2015)

Security rights over immovable assets (mortgages)

35. Montenegrin laws govern mortgages in a manner that is consistent with international best practice. Corporate lending is usually secured, with real estate—a favored form of collateral—and mortgage as the security mechanism preferred by most banks.[5] The bulk of the corporate loan portfolios are secured with mortgages. A creditor whose claim is secured by a mortgage is authorized, in the manner prescribed by law, to demand satisfaction of its claim by foreclosing the mortgaged property with priority over creditors who do not have a mortgage created on that particular property, as well as over any subsequently registered mortgage, regardless of a change in the owner of the encumbered immovable property.[6] The mortgage secures the entire claim, interests and other ancillary claims, and enforced collection costs.[7] In case of realization of the mortgaged property, the amount of the main and other subordinated claims secured by the mortgage shall be satisfied, with priority over other claims except taxes on the mortgaged property and the costs of the sale.[8] The priority of a mortgage cannot be changed without the agreement of all persons whose rights will be affected by the change.[9]

36. Creating security rights on immovable assets is not difficult. A mortgage shall be created by registration in the Real Estate Administration Department (READ), on the basis of: (1) a contract (contractual mortgage); (2) a pledge statement (unilateral mortgage); (3) a law (statutory mortgage); or (4) a court decision (judicial mortgage).[10] A mortgage agreement must be concluded in writing and authenticated by a competent body.[11] Mortgage contracts are typically drafted and authenticated by notaries. Both lenders and the READ authorities evaluate the notaries' intervention favourably, as it has reduced the flaws of such contracts and, consequently, diminished the objections proposed by debtors against mortgage agreements. In case there are several mortgages

[5] Fiduciary transfer of ownership rights over immovable assets (a form of security based on title) was popular in the past as a way of securing loans. Nowadays banks prefer mortgages, in particular due to the improved enforcement procedures that were introduced by law some years ago.

[6] LOR, article 308.

[7] LOR, article 315.

[8] LOR, article 347.

[9] LOR, article 325.

[10] LOR, article 318.

[11] LOR, article 319.

on the same immovable property, the priority of each mortgage shall be established according to the moment of submission of the request for its registration.[12]

37. Several immovable assets can be subject to a mortgage to secure any or all of a debtor's obligations. A mortgage may be created on an individual property that can be monetarily valued, as well as on a percentage of that property. A mortgage agreement may be secured by a future property.[13] A mortgage may be created on a building under construction, as well as on a separate part of such building (apartment, business premises, garages, and others) regardless of whether it has been already constructed or not, provided that a valid building permit is issued in accordance with the law regulating construction of buildings.[14] A mortgage can be created to secure conditional or future claims. If at the moment of creation of the mortgage the exact amount of the claim is not known, the maximum amount of the claim secured by the mortgage must be specified in the mortgage agreement.[15] Immovable property can be mortgaged in order to secure the debt of a third person.[16] A mortgage can be assigned to another person only together with an assignment of the secured obligation: the debtor's consent is not required, but the debtor must be informed of the assignment.[17]

Registry for ownership and security rights over immovable assets

38. The mortgage registration procedure is quite effective but the real estate registry system is still in need of improvement. The READ is the authority in charge of surveying land as well as keeping records of cadastral data and all transactions and rights on immovable property. Registration of mortgages is subject to a flat fee of EUR 10, and is done in one day in most cases according to information provided by READ authorities. The intervention of notaries in mortgage contracts has reduced the number of rejected registrations significantly. In 2014, 3.8 percent of mortgage registrations were rejected, which represents a significant improvement compared with 14 percent of requests typically rejected in the past. The READ is a single entity under the MoF, based in Podgorica and with 21 local offices that also keep titles. Information is kept in paper and electronically. The main server with a unified database is in Podgorica. Its basic information is accessible to any citizen that is registered as a user for free; notaries can search through more detailed data. All searches are free from cost. Under an ongoing project to survey land initiated in 2008, some 550,000 hectares have been surveyed so far, and approximately 250,000 hectares are now enrolled in the real estate registration system.

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[12] LOR, article 324.

[13] Such mortgage can be registered only when the property comes into existence (LOR, article 309).

[14] LOR, article 310.

[15] A claim is specific enough if the creditor and debtor, the legal ground and the maximum secured amount, are determined in the mortgage contract (LOR, article 315).

[16] LOR, article 322.

[17] LOR, article 326.

At present, cadastre covers most of the country's territory (including all towns) but land titling and cadastral information are still problematic in 8 percent of Montenegro territory, affecting around 100.000 hectares in rural areas. There are plans for resolving this situation in the next five years, but funding is not available yet.[18] Users of the registry system complain about cadastre not being up-to-date in some cases, in particular with respect to encumbrances that would not be properly registered or informed and, thus, could provide borrowers with an opportunity to mislead lenders. Delivery of the READ orders or decisions on mortgage registrations is subject to delays according to users of the system, who also consider problematic non-harmonized practices throughout different regional offices of the READ. The lack of autonomy of the READ could be hindering better organization, funding, and functioning.

Enforcement of claims secured with mortgages

39. The law provides an effective, non-judicial method for enforcing a mortgage claim over the secured asset. If a default has occurred and is not cured within 15 days from the day of delivering the notice of commencement of foreclosure to the mortgagor, the mortgagee may pursue one of the following remedies determined by the agreement: (1) extra-judicial foreclosure; or (2) enforcement of the mortgage according to the law regulating enforcement procedures (see *Enforcement of unsecured claims*, below).[19] Most secured creditors prefer the extra-judicial foreclosure, which is a brief and not contentious process conducted with limited involvement of the READ.[20]

40. The extra-judicial procedure for mortgage foreclosure would allow a creditor to recover its claim in 6–12 months (average, excluding exceptional cases where it could take longer). The mortgagee shall commence the process of extra-judicial foreclosure by registering a notice of sale in the READ and by delivering a copy of the notice to the mortgagor.[21] The notice of sale shall be published in two separate daily newspapers.[22] The default may be cured at any time before the sale of the mortgaged property by paying the amounts stated in the notice of sale.[23] The mortgagor may contest the mortgagee's right to foreclose the mortgage, if within 15 days of receipt of the notice of sale he/she submits a complaint to the court. Submission of the complaint does not postpone the foreclosure, except if the mortgagor produces evidence that the secured claim has

[18] Information received at a meeting with the READ authorities.

[19] LOR, article 335.

[20] Although a number of creditors complain about the READ staff inconsistent interpretation of some law provisions governing the extra-judicial procedure, the same creditors also recognize that the MoF (which is the authority in charge of resolving the appeals against the READ acts) has issued appropriate decisions to eliminate such inconsistencies. These have now diminished significantly.

[21] LOR, article 336, and LESC, articles 17 and 18, 3).

[22] At least 15 days before the date of sale, the notice of sale shall also be posted in a visible place on the property to be sold (LOR, article 338).

[23] LOR, article 339.

been fulfilled or is not due, that there has been a breach of the legal procedures, or that the mortgage has not been duly registered. The law specifies that courts shall pay special attention to the urgency of these disputes.[24]

41. The extra-judicial sale shall be done through public auction. The property shall be sold to the highest bidder.[25] At the first auction, the property cannot be sold for a price below the appraised value. If not sold, a second auction can be conducted at which the property may be sold at a price that is not below 50 percent of the appraised value. If not sold at the second auction either, a new one can be scheduled at which the property may be sold at a lower price, but not below the amount of the creditor's claim.[26] The mortgagee, who bids at the public sale, has the right to offset its bid to the extent of the full amount of the secured obligation, including unpaid interest, late charges, cost of sale, fees, and other expenses related to the mortgage.[27] Upon full payment of the purchase price by the winning bidder, the auctioneer is authorized to sign a purchase and sale agreement on behalf of the mortgagor, transferring the ownership of the property to the buyer.[28]

42. Appraisal standards need to be further strengthened. A draft Law on Accounting has been prepared by the authorities, aimed at regulating the conditions and manner of property valuation and other issues relating to accounting and valuation. The introduction of uniform appraisal standards and centralized disclosure of auctioning procedures, and prices obtained, could contribute to increased transparency in valuation processes.

43. Eviction of residents in foreclosed residential properties is difficult in practice. The LOR does not contemplate provisions for expedited eviction of the debtor and/or other tenants from the realized property. The LESC establishes provisions for evicting realized immovable properties, requiring the intervention of a public enforcement officer who shall issue a decision ordering to the judgment debtor and other persons who occupy the property to evict it and hand it over to the buyer.[29] Implementation of such orders, however, is not easy and could take a long time (up to two years, according to some banks). This ineffective mechanism for vacating foreclosed properties could affect the auction prices, because few potential buyers would be interested in buying occupied properties.

44. Recovery rates of mortgage loans would be affected more by commercial/market factors rather than legal issues. With respect to the usual recovery rate of a loan secured over real estate, banks report very different experiences: 90–100 percent, in some case; other banks indicate recovery rates in the region of 50–75 percent, and one bank mentioned a recovery rate lower than

[24] LOR, article 343.

[25] LOR, article 342.

[26] LESC, article 173.

[27] LOR, article 342.

[28] LOR, article 345.

[29] LESC, articles 183 and 184.

50 percent of the loan amount. The law, however, provides substantive protection to secured creditors. Secured claims enjoy the highest priority vis-à-vis other classes of creditors, both outside and in insolvency proceedings, after the costs of the sale and taxes related to the collateral have been deducted.[30] Thus, if the typical recovery rate of loans secured by real estate is low in banks' current experience, this would likely be a consequence of loans originally under-secured or currently impacted by present market conditions (low demand and depreciation of the value of immovable assets)—rather than an effect of the legal framework governing those loans.[31]

Security rights over movable assets (pledges)

45. Both possessory and nonpossessory pledges (i.e., security interests with rights *in rem* over movables) are adequately regulated and quite used in financial transactions. Its creation, registration, and enforcement do not present significant problems. Security rights in movables may be created by delivery of the collateral to possession of a pledgee, or by registration without delivery of the property (registered pledge).[32] A pledgee is entitled to satisfy its claim, interest accrued, costs incurred by keeping the collateral, as well as costs incurred by enforcing the pledge, from the price obtained by the sale of the collateral, prior to other creditors of the pledgor.[33]

- **Possessory pledge.** A pledge contract obliges a debtor or a third party (pledgor) to deliver a creditor (pledgee) a movable property, so that he/she can have priority over other creditors in satisfaction of his/her claim by foreclosing the pledge (if his/her claim is not satisfied when due); whereas the creditor is obliged to keep the received property and return it undamaged to the pledgor upon satisfaction of the secured claim.[34] A pledgee shall acquire a security right when the property subject to the pledge contract is delivered to him/her.[35] A pledge may be created to secure future, as well as conditional obligations.[36] If the pledgor is a business entity, the pledge contract may establish that the pledgee has the right to sell the collateral through extra-judicial public sale, if his/her claim is not satisfied when due.[37] Exceptionally, when the pledgor is a natural person (not being a registered entrepreneur), the pledgee may commence extra-judicial public sale through auction, if the pledgee and pledgor agreed so at the time when the creditor's claim was due.[38] A pledgee may sell the collateral at the market or exchange price, if

[30] LOR, article 347; LoB, article 53.

[31] Some lenders have mentioned a cultural issue that should be considered where realizing residential properties in small towns: nobody would bid for purchasing a financially distressed neighbor's home.

[32] LOR, article 269.

[33] LOR, article 295.

[34] LOR, article 270.

[35] LOR, article 271.

[36] LOR, article 274.

[37] LOR, article 284.

[38] LOR, article 288.

such a manner of sale is contemplated in the pledge contract.[39] A pledgor may contest the right of a pledgee to enforce the pledge in extra-judicial procedure, in the same way and with the same effects established with respect to mortgage foreclosure (see *Enforcement of claims secured with mortgage*, above).[40]

- **Registered (nonpossessory) pledge**. The Law on Secured Transactions (LST) governs nonpossessory pledges that can be granted by any person in favor of any creditor to secure any debt. Any movable asset that may legally be transferred pursuant to the applicable law may serve as collateral.[41] In principle, a pledge secures the entire amount of a secured obligation, including unpaid principal, interest, penalties, costs of repossession, maintenance, sale, and any other obligations secured. Unless provided in the pledge agreement, a pledge does not secure future advances of money that have not been advanced or committed to be advanced to the pledgor at the time the pledge was created. A pledge may secure one or more obligations. A secured obligation may be identified generally or specifically; it does not need to be in existence at the time the pledgor grants the pledge.[42] Nonpossessory pledges must be implemented in writing[43] and shall be registered before a competent registry. Registration is effective upon the entry into the records of the registration office of a notification statement that contains pledge information as specified in the LST. The effective time and date of the registration shall be the time and date the notification statement was presented to the registration office.[44]

Registry for security rights over movable assets

46. Pledges and liens over movable property are registered at the Secured Transactions Register (STR), which is easily accessible, inexpensive, and secure. The STR started operating in May 2003 and it is a single institution for the whole country, situated at the Commercial Court in Podgorica. All information is kept electronically and is publicly available online for free. At present, however, submission of new applications on-line is not allowed, so registration must be done by submitting an application form in person or by fax to the registrar in Podgorica. Notwithstanding this, the electronic database is complete and new software is being developed to allow electronic filings in the future. Only the pledgee (or its agent) may request registration.[45] Registration is usually

[39] LOR, article 289. Market price means the price at which the same or similar things are regularly sold under the usual circumstances at the place and at the time of the sale of collateral.

[40] LOR, article 291.

[41] LST, article 3.

[42] LST, article 4.

[43] LST, article 6.

[44] LST, article 15.

[45] The pledgor must have consented to the registration of the pledge – the law provides that the pledgor is deemed to have authorized the pledgee to register the statement by signing a pledge agreement.

done the same day, unless more time is granted to the creditor for completing the documentation.[46] Initial registration fees are not expensive.[47] Extension, deletion, or additions to existent files shall pay a EUR 20 flat fee. Searches are possible through the internet or at the STR's office in Podgorica (either directly in person, or by telephone or fax), against the name of the pledgor or pledgee, or the serial number of serial numbered equipment. From January 2014 to September 2015, the number of filed documents was 11,790. The historical total number of entries (May 2003–September 2015) is 67,599.[48] The STR is not interconnected with other databases that are related to movable property; notably, the Registry of Vehicles (Ministry of Interior), where ownership rights over such assets are registered. This lack of coordination between the mentioned registries may create inconsistent information on the same asset.

Enforcement of claims secured with registered (nonpossessory) pledges

47. The law contemplates several effective means of enforcement of nonperforming loans secured by a pledge over movable property. First, the creditor has the right to take possession of the collateral upon the debtor's default and proceed with asset realization. Secondly, the creditor may also proceed by filing an application for execution with the court, requesting an order authorizing the collateral to be seized and delivered to the creditor. Objection against the application for execution is not allowed.[49] Upon the application for execution, a court shall call a hearing limited to the following issues: (1) whether there is a perfected pledge; and (2) whether there has been a default.[50] Upon a finding that is favorable to the pledgee, the court shall issue an order designating an execution officer and directing the officer to seize the collateral from the pledgor, or whoever is in possession of the collateral, and deliver it to the pledgee or its authorized agent. The execution officer need not give prior notice of seizure to the pledgor or any person in possession of the collateral. A pledgee, after lawfully taken possession, may sell, lease, or otherwise dispose of the collateral. Disposition of the collateral may be by public auction or by private disposition.[51] Thirdly, the creditor may opt for using the enforcement procedure before the public enforcement officers, contemplated in the LESC (see *Enforcement of unsecured claims*, below).[52]

[46] The effective time and date of the registration shall be the time and date the notification statement was presented to the Registration Office (LST, article 15).

[47] (1) EUR 20 for a transaction of up to EUR 10,000; (2) EUR 50 if the transaction amount is EUR 10,000 – 200,000; and, (3) EUR 100 for transactions above EUR 200,000.

[48] Information provided by the Director of the STR.

[49] A pledge agreement under which a pledge has been perfected shall have effect of an executive title (LST, article 20).

[50] Upon such a showing by the pledgee, the burden shall be upon the pledgor to prove otherwise (LST, article 20).

[51] The method, manner, time, place, and terms of the disposition must be "commercially reasonable" (LST, article 20).

[52] LESC, articles 17 and 18, 5) and LST, article 20.

48. Pledge enforcement works quite effectively in practice. Most creditors inform that less than six months are needed for forced collection of a loan secured by a pledge, where the debtor does not vigorously challenge the claim; otherwise, enforcement could take longer (12–18 months, average). Banks report a varied range of recovery rates of nonperforming loans secured by a pledge. Some banks' average recovery rate is 90–100 percent, whereas others recount recoveries lower than 50 percent of the loan amount. As with mortgage claims, it seems that low rates of recovery of some pledge loans may be the result of insufficient collateral or asset value depreciation rather than deficiencies of the legal framework for protection of secured rights. Some lenders also mentioned material difficulties in repossessing the collateral, and instances of lack of collaboration from the police to that end—particularly in small towns.

Enforcement of unsecured claims

49. Upon implementation of the Public Enforcement Officers (PEO) in 2014, enforcement petitions of monetary claims shall be submitted to a PEO and not to a court. Enforcement of loans shall be ordered on the basis of a number of documents specified by the LESC.[53] To this end, the creditor must hold either an "enforceable document" (typically, an enforceable court decision or court settlement)[54] or an "authentic document" (most commonly, promissory note or bill of exchange, and cheque under protest).[55] The PEO must decide on an enforcement petition within five days from the day of receiving the petition.[56] By way of a writ of enforcement, the PEO shall adopt entirely or partially the enforcement petition. The writ of enforcement shall request the debtor to satisfy the claim (within three or eight days, depending on the title) together with the determined costs, and order enforced collection of such claims.[57] Means of enforcement to satisfy a monetary claim are: sale of movables, sale of immovables, transfer of monetary claim, transfer of claim for handing over movables or immovables, conversion into cash of other property rights, transfer of funds kept in a bank account, sale of shares, and sale of holdings in business organizations.[58] The PEO shall levy enforcement on funds and assets that he/she believes are the most suitable, and that will provide for the most favorable satisfaction of the creditor's claim.[59]

50. The law restricts the number of complaints that a debtor may lodge and establishes rather tight deadlines for enforcement procedural stages, which, in practice, are not always met. The debtor may file a complaint ('appeal') against a writ of enforcement or a PEO's order within five days from the day the writ/order is serviced.[60] The reasons for complaint that a debtor may

[53] LESC, Title II.

[54] LESC, article 18.

[55] LESC, article 25.

[56] LESC, article 40.

[57] LESC, article 41.

[58] LESC, article 26.

[59] LESC, article 27.

[60] LESC, article 47.

argue are limited and defined by law.[61] When filing a complaint, the debtor must present all reasons for contesting the writ of enforcement and attach all evidences with the filing; otherwise, she shall lose the right to present additional facts and propose evidence.[62] A complaint shall not withhold the execution of the writ of enforcement based on a promissory note or an enforceable document.[63] A court panel (thee judges) shall decide on the complaint within 15 days.[64] In many cases, however, the law deadlines have not been met because: (i) debtors tend to abuse the process; and (ii) until recently, courts have had to deal with an excessive number of cases of different nature. This second reason for procedural delays has been addressed by recent institutional and legal reforms. Now, a single judge hears and decides on a debtor's complaints in the case of enforceable titles or promissory notes.[65] Courts' workload has been alleviated upon the implementation of the PEOs system (see *Institutional framework: courts*, below). Another delaying factor mentioned by lenders is the frequent conversion of enforcement cases in time-consuming civil litigation procedures. Courts would apparently order such conversion in many cases where the debtor is just trying to delay enforcement. According to the experience of the majority of the financial institutions interviewed, the average duration of an enforcement procedure would be in the region of 6–12 months, if the debtor does not challenge the claim, and 18–24 months (sometimes longer), if the debtor introduces several complaints and appeals, or enforcement procedures are converted to civil litigation cases.

51. Unsecured loan recovery chance and rate seem to be strongly conditioned by the availability of funds deposited in debtors' bank accounts, which can be blocked. Both corporate and households debtors are currently experiencing solvency and liquidity problems, according to information provided by several stakeholders. The law provides creditors with a mechanism for blocking a debtor's bank account (s), which is particularly effective where the debtor is a legal entity. A bank holding a promissory note issued by the borrower (legal entity) may directly request to the central bank a blockage of the debtor's bank account, which is immediately implemented and extended to all accounts of such debtor in different banks. In many instances, this mechanism allows the creditor to either collect its claim (totally or partially), or to force the debtor to negotiate a debt arrangement. If the debtor is a natural person, blocking his/her bank account(s) is neither so expeditious (it requires PEO's intervention) nor particularly effective: blockage of one account is not automatically extended to other accounts and, in most cases, there are no funds available in the blocked account(s). If there are no funds in the blocked accounts, the recovery rate

[61] For example, a complaint against a writ of enforcement adopted on the basis of authentic document may be filed if: (1) the document on the basis of which the enforcement is ordered is not an authentic one under law; (2) the claim referred to in authentic document has not occurred; (3) untrue content is included in the authentic document; (4) the obligation referred to in the authentic document has not matured; and (5) the obligation has been fulfilled or has ceased in another manner (LESC, article 58). LESC, article 50 specifies the reasons for complaint against enforceable documents.

[62] LESC, articles 50 and 58.

[63] LESC, articles 49 and 60.

[64] LESC, article 48.

[65] According to recent amendments to the LESC.

of unsecured loans would depend on the existence of other free assets of the debtor that could be attached and realized in the enforcement procedure. Here, again, the interviewed banks experience varies significantly, but most banks report recovery rates lower than 50 percent of unsecured loans in enforcement proceedings.

B. Legal Framework for Insolvency

Bankruptcy proceedings for enterprises

52. The Law on Bankruptcy (LoB) is largely consistent with international best practice[66] and provides for both liquidation and reorganization of legal persons, individual entrepreneurs and business organizations that do not enjoy the status of legal persons. Debtors not eligible under the LoB regime are: (i) bodies, organizations, and institutions financed from the budget of Montenegro, budgets of local councils, and state funds; (ii) central bank or independent regulatory bodies; and (iii) legal persons with special bankruptcy proceedings regulated by separate legislation.[67] Consumers' bankruptcy proceedings are governed by a separate law passed in August 2015 (see *Consumer bankruptcy*, below).

53. Both liquidation and reorganization are formal procedures conducted before a specialized court, but the material competence of this court is too limited. The competent court is the one having jurisdiction over the area where the bankruptcy debtor's registered office or permanent residence is located.[68] At present, there is one Commercial Court, based in Podgorica, with jurisdiction over the whole country. The President of the Commercial Court and four judges of the Court's Bankruptcy Department deal with bankruptcy proceedings (see *Institutional framework: Courts system*, below). The bankruptcy judge's competence, however, is limited to the main decisions that should be issued in the bankruptcy proceeding, but many other disputes that may (and typically do) arise in the course of bankruptcy shall be referred to other judges from the Civil Litigation Department of the Commercial Court. Such is the case with, for example, disputes over creditors' claims, voidable transactions, and others. This divided competence contributes to delays in bankruptcy proceedings and creates the risk of inconsistent interpretation of similar conflicts related to the same bankruptcy case.

54. Secured claims are highly protected in bankruptcy proceedings, ranking above all other creditors classes, but fully secured creditors are not allowed to be members of the creditors' committee.[69] Secured creditors are not considered "bankruptcy creditors."[70]

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[66] An exhaustive evaluation of the bankruptcy system against international standards would require conducting an *Insolvency and Creditor-debtor Rights Report on the Observance of Standards and Codes* (ICR ROSC).

[67] LoB, article 11.

[68] LoB, article 14.

[69] LoB, article 53, 2) establishes that secured creditors shall be entitled to satisfaction from the proceeds of the sale of the property that they acquired security on. After that, unsecured creditors will collect in the order of satisfaction contemplated in article 54 and according to the seniority of classes established by article 55. The exercise of security rights, however, may be temporarily postponed in the cases referred to in Articles 64 and 65 of the LoB.

Consequently, they are entitled to full satisfaction from the sales proceeds of the secured asset, with priority over all other claims (see *Security rights over immovable assets*, above).[71] After that, costs of bankruptcy and unsecured creditors will collect in the order established by law. Costs of bankruptcy (administrative expenses) have priority to collect in full from the bankruptcy estate before all bankruptcy creditors. Bankruptcy creditors are satisfied according to the seniority of their respective classes: (i) creditors of a lower seniority class may only be satisfied after full satisfaction of creditors of a higher seniority class; and (ii) creditors of the same seniority class shall be satisfied proportionally to their claims amount (pro rata).[72] The law specifies three classes, namely: (1) several labor claims constitute the first tier; (2) the second tier includes obligations with the state that have matured over the three months prior to initiation of bankruptcy proceedings; and (3) the rest of the unsecured creditors shall be included in the third tier.[73] The exercise of security rights may be temporarily postponed by a judicial decision aimed at protecting the debtor's property during preliminary proceedings,[74] but the secured creditor may request adequate protection or cancellation of the enforcement prohibition.[75] The creditors' committee shall include three to five creditors who have the largest unsecured or partially secured claims.[76]

55. The LoB slightly improved the effectiveness of bankruptcy liquidation. Though the number of bankruptcy cases is increasing (see Table 3, below), most liquidation proceedings would now be completed in less than a year, according to information provided by the Commercial Court authorities (in the past, however, bankruptcy liquidation took longer: 18–30 months or more). Delays typically occur because selling the debtor's assets requires several auctions under current market conditions. Disputes arising in the course of bankruptcy proceedings also contribute to delay liquidation. In reorganization, the procedure terms are rather tight: if a plan is not approved and confirmed within four months, liquidation must be initiated. Secured claims collection amount (in either liquidation or reorganization) is similar to the recovery rates secured creditors typically obtain where enforcement is conducted outside insolvency proceedings. If the proceeds obtained through collateral realization are insufficient to cover a secured claim in full, the unsatisfied amount of such claim will be treated as unsecured and shall participate as prorated within this class of claims in distribution.[77] Unsecured claims recovery rates in bankruptcy are usually low: less than 50 percent, according to most stakeholders who were interviewed.

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[70] Bankruptcy creditor is a person who on the day of initiation of bankruptcy proceedings has an unsecured claim against the bankrupt debtor (LoB, article 50).

[71] LoB, article 53, 2).

[72] LoB, article 54.

[73] LoB, article 55.

[74] LoB, article 64.

[75] LoB, article 65.

[76] LoB, article 44.

[77] LoB, article 53, 6).

Table 3. Montenegro: Bankruptcy Cases		
	Opened / Pending	Resolved
2014	497	509
Six months 2015	327 [12 months projection: 654]	351
Source: Podgorica Commercial Court.		

56. The business rescue culture is underdeveloped: reorganization is not extensively used, so most bankruptcy cases end up in liquidation. Under the Montenegrin law, reorganization may be considered as a debtor/creditor driven procedure supervised by a judge who is in charge of ensuring the legality of the process. After being approved by a majority of creditors who are divided by classes, the plan must be confirmed by the judge. To this end, the judge does not evaluate the substance of the plan.[78] There is not sufficient experience yet with the use of reorganization under the LoB regime. In less than 10 percent of bankruptcy cases, there is a reorganization attempt, but very few really succeed and avoid the liquidation of the enterprise.[79] An enterprise in liquidation, however, may be sold as a functioning unit, which is a modern and effective way of rescuing a distressed business where reorganization failed.[80] Anecdotal evidence gathered during the mission indicated that some bankrupt enterprises would have been sold as a going concern to foreign investors and, in this way, avoided piece-meal liquidation of its assets. Finally, the law does not contemplate an expedited procedure for court confirmation of prepackaged reorganization plans (see *Out-of-court debt restructuring*, below).

Consumer bankruptcy

57. The recent Law on Consumer Bankruptcy (LCB) could negatively affect both the collection of existing NPLs and the issuance of retail loans secured with mortgages. This new law, passed in August 2015, establishes a radical exemption in favor of a bankrupt debtor's house, which cannot be sold in bankruptcy—not even to satisfy security rights created over such immovable assets, provided that this is "commensurate with the basic housing needs of the consumer."[81] If such provision is applied to loans secured with a mortgage created before the

[78] LoB, articles 159 – 177.

[79] Anecdotal evidence gathered during the field mission.

[80] LoB, articles 142 and 143.

[81] LCB contemplates special rules applicable in bankruptcy liquidation, specifying in article 51, 4) that, at the request of the consumer, a real estate he needs for housing purposes may not be sold: 1) if he does not own another real estate; 2) if he does not have another form of accommodation available, nor is he able to get one; or, 3) if the real estate in question is commensurate with his needs and with the needs of his immediate family. LCB does not contemplate appropriate safeguards to protect security rights created over a bankrupt consumer's house.

entering into force of the LCB, most of such loans would actually be considered unsecured and its collection prospects could be significantly reduced. As for the future, individual loans secured with mortgages will likely disappear from the market if the mentioned prohibition of enforcement of a consumer's house in bankruptcy remains in force, and no adequate safeguards are provided to protect the rights of secured creditors. The impact on financial inclusion, credit access, and cost (in particular, for households and SMEs) should be carefully considered.

C. Out-of-Court Debt Restructuring and Corporate Reorganization ('Workouts')

Workouts practice and legal environment

58. Creditors generally express favorable views with respect to voluntary debt restructuring, but collective (i.e., a plurality of creditors/one debtor) agreements or plans voluntarily negotiated out-of-court ('workouts') are not frequent. Some creditors interviewed considered workouts as being "satisfactory," "faster and cheaper than formal proceedings," but others expressed skepticism about collective negotiations, mainly because most banks are not yet used to adopt a cooperative attitude toward such approach and prefer to rely on their individual security rights exclusively. Culture appears to be problematic because the general legislation does not seem to pose obstacles to typical workout techniques. Creditors report they would be able to perform a broad range of restructuring activities, involving asset sales, discounted debt sales, debt write-offs, debt rescheduling, debt and enterprise restructurings, and exchange offerings (debt-to-debt and debt-to-equity exchanges). Notwithstanding this, in practice, most debt restructurings are individual (i.e., one creditor/one debtor), and only debt rescheduling and/or interest reductions are extensively used. Debt write-off ('haircuts') and conversion of debt into equity ('debt-to-equity swaps') are rarely utilized.

59. The recently enacted Law on Voluntary Restructuring of Debts should be complemented by additional legal measures. This law (aka the 'Podgorica Approach') establishes a framework to facilitate out-of-court negotiations and debt restructuring between a debtor and a plurality of creditors, providing tax[82] and loan-provisioning[83] incentives. It also protects transactions

[82] A creditor that has entered into the financial restructuring agreement with the debtor, purchasing the debtor's claims or purchasing the debtor's debts to other creditors, shall be exempt from the payment of value-added tax for that purchase of claims and/or debts. Also, when establishing the taxable income of a creditor that has entered into a financial restructuring agreement, the debt reduction granted under such agreement shall be recognized as a deductible loss (LVR, article 35). From the debtor's perspective, article 36 of the LVR establishes that upon request of the debtor that has entered into the financial restructuring agreement, the competent authority responsible for tax collection shall grant to such a debtor repayment of the matured tax debt in instalments, as follows: (i) tax debt of up to EUR 100,000 in 6 monthly instalments; (ii) tax debt exceeding EUR 100,000 in 12 monthly instalments. If the payment of the matured tax debt has been subject to enforced collection, the enforcement procedure shall be discontinued.

[83] According to LVR, article 37, a bank may keep the debtor's loan that is the subject of the concluded standstill agreement in the same classification category it was classified before the entry into force of the standstill agreement,

(continued)

that could be entered into by the debtor and some creditors in a workout that otherwise would be at risk of being challenged in bankruptcy proceedings under the avoidable transactions regime.[84] Eligibility for using the LVR mechanism, however, is restricted to creditors holding claims classified as B and C exclusively, which could exclude from such mechanism a reorganization plan that encompasses all claims, as it is usually needed in cases of serious financial distress or insolvency. Also, the out-of-court debt restructuring mechanism needs to be complemented by a fast-track procedure to confirm workout plans previously approved by a legally defined majority of creditors ('prepackaged plans'), making such plans obligatory with respect to all creditors. This would encourage creditors to participate in out-of-court negotiations and limit threatening attitudes from minority creditors ('hold-outs'). Debt reductions ('haircuts') negotiated in a workout under LVR should not be considered debtor's income for tax purposes. Finally, several activities should be implemented, namely: (1) dissemination of the potential benefits of using the new legislation, in particular if one or two initial successful cases could be presented and openly discussed in a workshop; and (2) strengthening the capacity of all stakeholders (including the mediation center, banks, other potential creditors and the business community). To this end, the support and participation of the CBM, the Association of Banks, the Chamber of Commerce, and the mediation center will be very important.

Tax issues

60. Where LVR mechanism is not used, tax legislation does not provide incentives for the restructuring/resolution of distressed debt. Several tax obstacles or disincentives for debt restructuring and nonperforming loan resolution have been preliminarily identified, including: (i) debt reduction (haircut) will be considered as debtor's income and taxed as such; (ii) for income tax purposes, creditors will not be able to deduct haircuts as bad debts because there will be no proof of unsuccessful collection as required by tax law; and (iii) creditor repossession of immovable collateral is subject to the same tax applied to any other transfer of real estate property (3 percent over real market value). In the past, it was unclear whether or not NPLs assignment was subject to VAT, which acted as a disincentive for such transactions. The current tax law interpretation of the

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but no longer than for two months. Otherwise, during the asset classification and the calculation of potential loss provisions, banks may treat the debtor's loan restructured under LVR system as a new loan.

[84] LVR, article 38 specifies that the debtor-creditor relations that are the subject of a financial restructuring agreement may not be challenged in bankruptcy proceedings initiated against the debtor. LoB establishes a comprehensive regime for avoiding numerous transactions performed by the bankrupt debtor (LoB, articles 122 to 132). Legal transactions and other legal actions entered into or taken before initiating the bankruptcy proceedings, that are interfering with equal satisfaction of bankruptcy creditors or damaging the creditors, as well as legal transactions and other legal actions putting some creditors in a more favorable position over the others, may be voided by the bankruptcy administrator, on behalf of the bankruptcy debtor, and by the creditors, in accordance with provisions of the LoB (LoB, article 122, 1). In the context of voidance, the failure to enter into a legal transaction or failure to take an action shall be equal to the legal transaction or legal action (LoB, article 122, 2). However, no legal transactions entered into or actions taken may be voided if undertaken to: (i) execute an approved reorganization plan of the bankruptcy debtor undertaken after initiating the bankruptcy proceedings; and (ii) continue business operations, undertaken after initiating the bankruptcy proceedings (LoB, article 129, 1).

Ministry of Finance has clarified that a sale of bad debts to a third party should not be considered as VAT taxable.[85]

D. Institutional and Regulatory Frameworks

Institutional framework: Courts system

61. The courts' workload has diminished after the Public Enforcement Officers ('PEOs') system was implemented in 2014, a much needed reform that is improving the institutional framework for debt resolution. Debt enforcement used to be under the competence of the courts exclusively. Commercial court judges dealt with cases involving legal entities, and basic courts had jurisdiction over the enforcement of natural persons' debts. The Law on Public Enforcement Officers ('LPEO') transferred the competence to deal with these cases from the courts to PEOs –independent professionals in charge of a public service, who are licensed and supervised by the Ministry of Justice (MoJ).[86] Monetary claims enforcement fall now under the competence of PEOs.[87] After April 2014, the MoJ licensed 30 PEOs—12 of them are working with territorial jurisdictions in Podgorica. The new system is alleviating the courts' workload, which, until recently, was usually mentioned as the main reason for enforcement delays. For example, in Podgorica, the basic courts used to receive 9,000–12,000 cases per year. Such workload was impossible to process timely by the Enforcement Department of the mentioned court, staffed with just two judges. Those cases are now dealt with by 12 PEOs (in practice, this means multiplying by 6 the number of "courts" in charge of such cases). Not surprisingly, the two judges of the Podgorica basic courts received this year only 250 new enforcement cases.[88] The PEOs have also reduced the workload of the Commercial Court Enforcement Department.[89] Users of the PEO's system consider that, though some PEOs should improve their capacity and skills, time for enforcement is now shorter and gains in efficiency are also becoming evident.[90] At end-2015, the MoJ will conduct an in-depth evaluation of the PEOs performance.

[85] Information provided at a mission meeting with the MoF authorities.

[86] LPEO regulates in detail the PEOs license requirements (including exams), as well as the control and supervision of these professionals. It also contemplates a Chamber of PEOs and a Disciplinary Commission, but the MoJ adequately keeps significant supervisory functions with respect to the behavior and performance of PEOs.

[87] As regards enforcement, now the Courts keep competence only in cases aimed at: (i) restoring an employee's employment; (ii) implement a child's custody; and, (iii) forcing a debtor to perform an action that can only be personally performed by him/her.

[88] Information provided by Podgorica Basic Court and MoJ authorities.

[89] Information provided at the meeting with the Commercial Court authorities.

[90] Anecdotal evidence gathered over the mission meetings with several stakeholders.

Institutional framework: Insolvency administrators

62. Better qualification of insolvency administrators is needed to improve the effectiveness of bankruptcy proceedings. The MoJ regulates the insolvency administrator profession, mainly by issuing the Rulebook for Insolvency Administrators. The MoJ is also in charge of organizing and taking exams, every four months, on legal matters and accounting concepts that should be approved to obtain an insolvency administrator certificate. At present, there are 203 licensed insolvency administrators. Relevant stakeholders consider that only a reduced number of such administrators are skilled enough to perform their roles in bankruptcy proceedings adequately. Many others need to improve their capacity to handle bankruptcy proceedings more effectively. The law does not establish that insolvency administrators shall receive continued education or revalidate their license periodically.

E. Recommendations

63. To strengthen the legal framework for creditor rights, the authorities should consider: (1) specifying detailed provisions in the Law on Ownership Rights to expedite the eviction of foreclosed residential properties; (2) ensuring the effective collaboration of the officers in charge of implementing such eviction and the repossession of movable assets subject to secured transactions; (3) providing adequate funding to the Real Estate Administration to complete cadastral information and titling of all Montenegro territory; (4) interconnecting the Registry of Vehicles and the Secured Transactions Register; and (5) putting into operation the software that will allow electronic filing of secured transactions at the register.

64. The insolvency framework for enterprises could be improved by amending the Law on Bankruptcy to: (1) allow secured creditors to be members of the creditors' committees; and (2) concentrate under a single judge (bankruptcy judge) the competence over all disputes that may arise in the course of bankruptcy proceedings.

65. To avoid that the Law on Consumer Bankruptcy negatively affects both the collection of existing NPLs and the issuance of retail loans secured with mortgages: (1) clarify by regulation or by amending the law that the debtor's house exemption from being sold in bankruptcy shall not apply with respect to security rights created before such law entered into force; and (2) enable liquidation of a debtor's house in bankruptcy in presence of a valid mortgage agreement, unless adequate safeguards specified by law allow the mortgage creditor to recover at least the foreclosure value of the property.

66. Improve the out-of-court debt restructuring framework by: (1) extending the Law on Voluntary Restructuring eligibility to all creditors' claims; (2) creating further tax incentives to out-of-court debt restructuring, whether or not the Law on Voluntary Restructuring mechanism is used in a particular case; (3) introducing in the Law on Bankruptcy a fast track court procedure for debt restructuring ('prepacks'); and (4) strengthening the capacity of all stakeholders and disseminating the potential benefits of using the new legislation.

The institutional framework for NPLs enforcement and bankruptcy proceedings should be enhanced by: (1) improving the capacity and skills of the PEOs through mandatory continued training and periodic evaluation of their performance; and (2) establishing that insolvency administrators should also receive mandatory continued education and must revalidate their license periodically.