SPECIAL REPORT:

Dealing with Financial Distress

UBA RESEARCH

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Executive Director Uganda Bankers' Association Foreword

Financial distress is a condition that can be faced by both individuals and businesses and can occur even to the most successful of them. It is important for individuals and businesses to understand the causes and symptoms of business distress and learn when and how to manage or avoid being distressed to ensure success and sustainability. Businesses and individuals need to know and identify the symptoms of business distress early to manage them and limit the adverse impact on their businesses and lives.

The covid-19 pandemic was not only a financial distress trigger, but also a major cause of distress. Pre-pandemic, several businesses and individuals experienced financial distress, but covid-19 further escalated and exposed how fast successful businesses and individuals could fall into financial distress and/or bankruptcy due to external factors and shocks. The pandemic saw financial institutions, central banks and governments adopt drastic measures that previously could not have been considered. In this period of recovery and growth, it is necessary for individuals and businesses to know how they can be assisted to get back on their feet.

The role of financial institutions in supporting distressed customers cannot be emphasized enough. Financial institutions are at the forefront of supporting distressed customers but are also at risk of financial distress themselves. Financial institutions should understand the dynamics of financial distress to plan for and tailor solutions for their customers accordingly, without getting into distress themselves. SFIs therefore need to be cautious while offering support, establish strong relationships with their customers and regularly communicate and engage with them to curb financial distress in its early stages. Financial institutions should build and increase their resilience and position themselves to help financially distressed clients, especially in these unprecedent times.

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Executive Summary

Although the Coronavirus Disease 2019 (Covid-19) pandemic and the Russia-Ukraine war exacerbated financial distress, companies and individuals faced financial distress even before, caused by both internal and external factors. Some internal factors that cause financial distress include poor management and governance, poor financial management, diversion and loss of funds, high costs of operation, decline in sales, among others while the external factors include high interest rates, inflation, changes in macroeconomic policies and conditions, interruptions and/or blockages in the global or national supply chains, among others. When individuals and businesses are financially distressed and unable to meet their loan and other obligations and/or covenants, they pose a risk of financial distress to financial institutions through non-performing and or bad debts, and to other individuals, businesses and partners in their respective ecosystems and value chains.

Several measures have been taken by financial institutions, the regulator, government bodies, Ministries, Departments and Agencies, development and financial eco system partners, among others to help and support financially distressed companies and individuals. Some of the measures and interventions provided by the banking sector in partnership with government and the regulator include specific funds and guarantees, debt restructures, moratoriums, waivers of fees, interest and penalties, debt repayment holidays, regulatory reviews, decrease in interest rates, provision of training, upskilling, and advisory services. It is also expected that the Assets Reconstruction Company will be pivotal in supporting the distressed loan portfolios.

Financial institutions have faced challenges while offering support to their distressed clients for example information asymmetry, loss of key customer relationships, capital erosion, increased costs, increase in provisions for bad debts and ultimately bad debts. With the increased uncertainty occasioned by the adverse and uncertain macro-economic environment, it is harder to establish recovery timelines; increasing the risks associated with the recovery support and building resilience. To further assist and support distressed companies and individuals, it is important for the financial institutions to be aware of the signals of financial distress to engage meaningfully and support their customers recover and build resilience.

1.0 Introduction and insights from literature

Financial distress is a condition in which a company or individual cannot generate sufficient revenues or income, making it/them unable to meet or pay their financial obligations when and/or if they fall due (Hayes, 2021; Shilpa and Amulya, 2017). Early detection of financial distress potentially increases the likelihood of returning the company to financial health, which chances diminish overtime if no or inappropriate action is taken (Sehgal et al., 2021; Atuahene, 2018; Hayes, 2021; Jafaar et al., 2018). Financial distress is subjective in that two individuals who are in the same financial situation may have different levels of perceived financial distress (Prawitz et al., 2006).

According to Smits and Günther (2017), borrowing in general increases the odds of running into financial distress. However, borrowers from formal and regulated financial institutions suffer less financial stress compared to those from informal or semi-formal institutions. Non borrowers also experience financial distress which could indicate that observed financial distress might not capture over-indebtedness but rather a symptom of a general difficulty to make ends meet with a low and volatile income. Some borrowers may meet their repayment obligations at the cost of their household cutting back severely on food consumption, education, medical expenses, among others.

An overview of different categories of borrowers

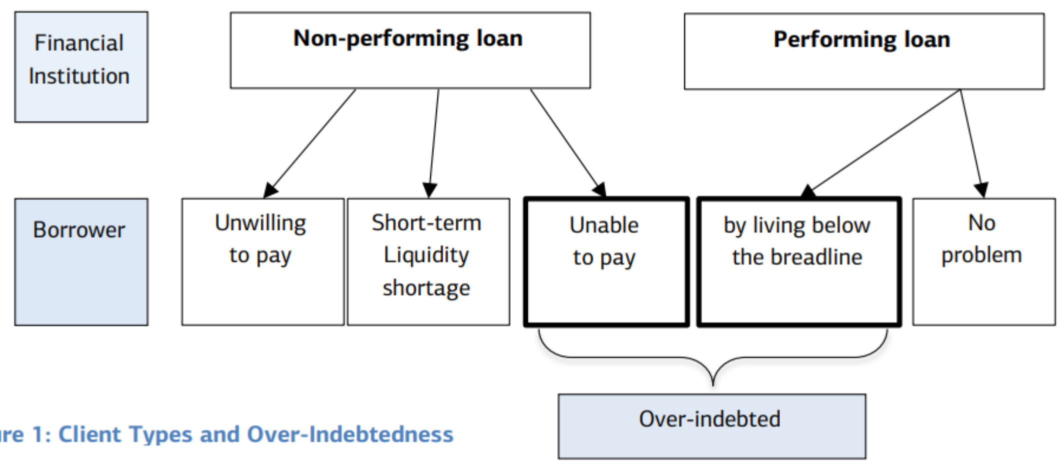


Figure 1: Client Types and Over-Indebtedness

Source: Günther et al (2014)

1.1 Causes and characteristics of Financial Distress

Financial distress can affect both the well managed and poorly managed companies because certain factors contributing to distress are beyond the company's control. The major causes of business financial distress include management failure, poor governance structures, funds diversion, sudden illness or death of the principal, legal challenges, drop in sales, increases in costs, natural disasters, unfavorable economic conditions and changes, structural changes, global pandemics, catastrophes, among others. Some major causes of individual financial distress include lost or reduced income; unexpected expenses; failure to adequately manage finances; sometimes divorce, among others.

The characteristics of financial distress among businesses include decline in profitability, intermittent and poor cashflows, high leverage and debt size, low, decreasing, and intermittent liquidity, limited shareholders, high frequency of defaulting on bills and debt payments, among others.

1.2 Bank distress due to financial distress

Financial distress among individuals and businesses, leading to difficulties in meeting loan obligations, poses a significant risk to banks due to non-performing loans or assets. This situation can result in restricted access to credit and create instability within the financial system. Banks play a critical role in facilitating recovery of the businesses, individuals, and the overall economy. Nevertheless, establishing effective long-term capabilities to support consumers in financial distress and successfully manage delinquencies required considerable time and substantial resources.

1.3 Managing Financial Distress

Successfully dealing with distressed debt requires a collaborative effort between borrowers and lenders, as there is no one-size-fits-all solution. When individuals and businesses encounter financial challenges, the most crucial step is to proactively communicate with their bankers and creditors. Explaining the current situation and working together to devise a viable solution before the situation worsens is of utmost importance. Similar to treating an illness, early detection of symptoms, identifying the root causes, and implementing appropriate measures are essential. Avoiding communication with lenders could lead to missed opportunities to preserve one's property and/or business (Mugambi, 2021).

In times of distress, customers require honesty and transparency. Avoiding the truth or providing sugar coated information can have severe repercussions in the long run (Callaway and Callaway, 2012). Financial advisors play a crucial role in preventing business owners from repeating the mistakes or bad habits that led to the crisis. Nevertheless, achieving a successful turnaround is not an immediate process; it often demands years of dedicated effort. Ultimately, the outcome of a turnaround hinges upon the commitment of the business' most valuable assets: its owners, management, employees, lenders, creditors, and turnaround specialist all of whom must wholeheartedly devote themselves to revitalizing the company (Collard, 1994).

There are several strategies to effectively address financial distress, which encompass various approaches for both business and individuals. Fir businesses, fundamental resolutions for financial distress may involve:

1. Financing strategies: Exploring different financial options to secure necessary funding and improve cash flow.
2. Turnaround financing specialists: engaging professionals with expertise in financial turnarounds to provide guidance and support.
3. Equity investors: Attracting potential investors to inject capital and strengthen the business.
4. Out-of-court remediation: Negotiating with creditors to reach a mutually agreeable workout plan.
5. In-court restructuring/bankruptcy: Considering legal restructuring options when necessary.
6. Soliciting third-party assistance: Seeking help from external experts or consultants with specialized knowledge.

Additionally, businesses can benefit from various business development services including:

- Governance and record keeping enhancement.
- Debt consolidation to manage multiple debts more efficiently.
- Debt payment strategies to avoid defaults and penalties.
- Seeking tax relief or arranging tax payment plans.
- Advisory support, including marketing, communication, product development, and reporting improvements.

For individuals facing financial distress, some practical steps include:

1. Seeking support: Talking to family members or financial professionals for guidance and emotional support.
2. Financial assessment: Taking stock of income, expenses, spending patterns and debt to understand the overall financial situation.
3. Financial planning: Creating a well-thought-out financial plan to address current challenges and future goals.
4. Budgeting: Developing a realistic budget to manage income and expenses effectively.
5. Discipline and adherence: Cultivating the discipline to stick to the financial plan and budget,

6. Seeking professional advice: Consulting financial advisors or counsellors to explore suitable options.

By adopting these strategies and taking proactive measures, both businesses and individuals can navigate through financial distress and work towards a more stable financial future.

1.4 Supporting financially distressed staff.

Employee stress related to money matters is a significant concern (Fuhl, 2020). To enhance staff financial health, several approaches can be implemented such as:

1. Detailed benefit package explanation: Provide comprehensive explanations of benefits packages to ensure employees understand the financial support available to them.
2. Financial health quiz: Encourage employees to take financial health quizzes to assess their financial well-being and identify areas of improvement.
3. Financial counselling and resources: offer financial counselling services and provide access to helpful resources to assist employees in managing their finances better.
4. Personalized financial assistance: Tailor financial resources to the individual needs of the employees, acknowledging their unique situations.
5. Regular financial expert sessions: Organize regular sessions with financial experts in the workplace to discuss topics like investing, loan repayment options and mortgages.
6. Money coaching program: Implement a money coaching program to aid employees in effectively managing their finances and emotions related to money (Bellens and Pogson, 2020).

By implementing these strategies, employers can actively support the financial well-being of their employees, reducing stress and promoting a healthier work environment.

1.5 Considerations when dealing with financial distress.

When dealing with a borrower facing an impending default, lenders should begin by evaluating four critical factors:

1. Collateral type and value: Assess the ease of collateral realization, location, security interest and overall value of the collateral.
2. Lender’s position: Consider the lender’s voting rights and other stakeholders involved in the situation.

3. Lender's risk profile and relationship concerns: Evaluate the lender's risk tolerance, willingness to work with the borrower, any special relationships, and conduct a cost-benefit analysis of the potential loss from the borrower.
4. Business performance: Examine the overall performance of the borrower's business (Hadiwijaya and Manns, 2016).

Financial institutions should ensure they have sufficient expert resources to assess each borrowers' unique circumstances and offer appropriate and sustainable solutions to distressed customers. These actions should be taken promptly and aligned with the bank's overarching strategy, regulatory requirements, and Central Bank expectations. By approaching defaults in a systematic and thoughtful manner, lenders can better manage risk and maintain sound relationships with their borrowers.

1.6 Challenges in Managing Financial Distress

Managing financial distress poses several challenges, including:

1. Adverse impact on credit portfolio: Financial distress can have a negative impact on the overall credit portfolio of a financial institution, leading to potential losses and reduced credit quality.
2. Changing and increasing risk: The risk profile of distressed borrowers may evolve rapidly, making it challenging for institutions to adapt and mitigate emerging risks effectively.
3. Provision of relevant customer solutions at a faster rate: Addressing financial distress requires timely and tailored customer solutions, which can be demanding to provide promptly amidst rapidly changing financial circumstances.
4. Lack of or inaccurate information for decision making: Insufficient or unreliable information about distressed customers can hinder sound decision-making processes, making it harder to develop appropriate strategies for resolution.

and others.

2.0 Goal and Objectives

2.1 Goal

To unearth the right information and practices on financial distress and what can be done by individuals, companies, and financial institutions to enable sustainable recovery of financially distressed businesses and individuals, individually and collaboratively.

2.2 Research objectives

1. Provide knowledge to enable the understanding of financial distress and its causes.

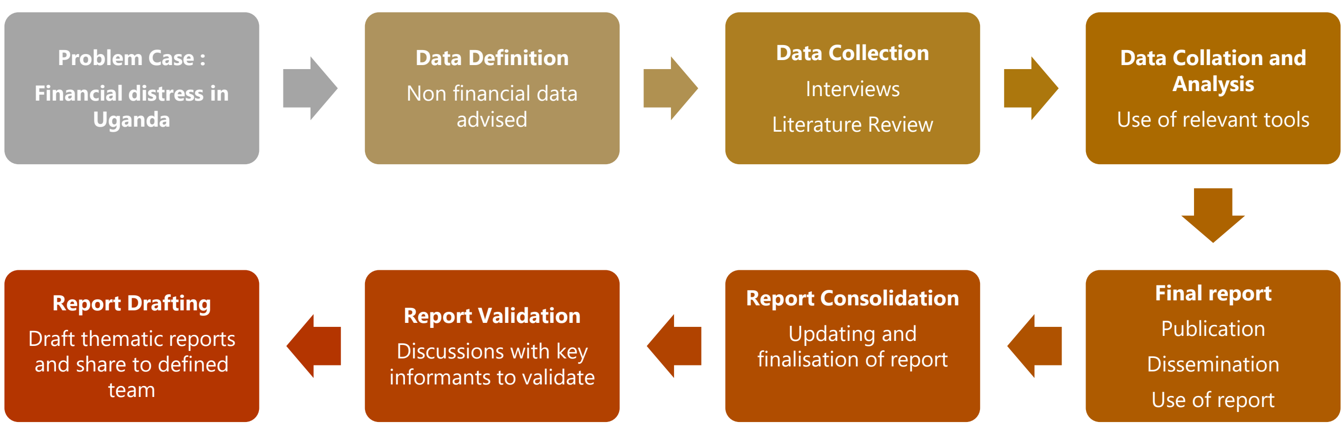
2. Explore ways that SFIs can help businesses and individuals manage financial distress sustainably whilst ensuring sustained health and survival of the relevant SFIs.

3.0 Problem Statement

According to Bank of Uganda (2022), private sector growth declined to an average annual growth rate of 8.1 percent in FY 2020/21 from 11.7 percent in 2019/20. The growth was mainly affected by weak credit demand from borrowers and risk aversion by lenders owing to the weak economic growth. The slow growth was aggravated by business closures due to lockdown measures instituted by the government to contain the spread of COVID-19 and the slow recovery when the economy reopened. Globally, banks are critical to the recovery of businesses and individuals and support the economic recovery of their respective countries. Building the right capabilities, skills, technologies, and abilities will enable the SFIs to support the recovery sustainably, manage the adverse impact of Covid-19 and other international shocks.

4.0 Methodological Approach

The research involved collecting data and/or information from Supervised Financial Institutions and the use of literature review. The methodological approach for this study is presented based on the research objectives, activities and expected outcomes as elaborated below.

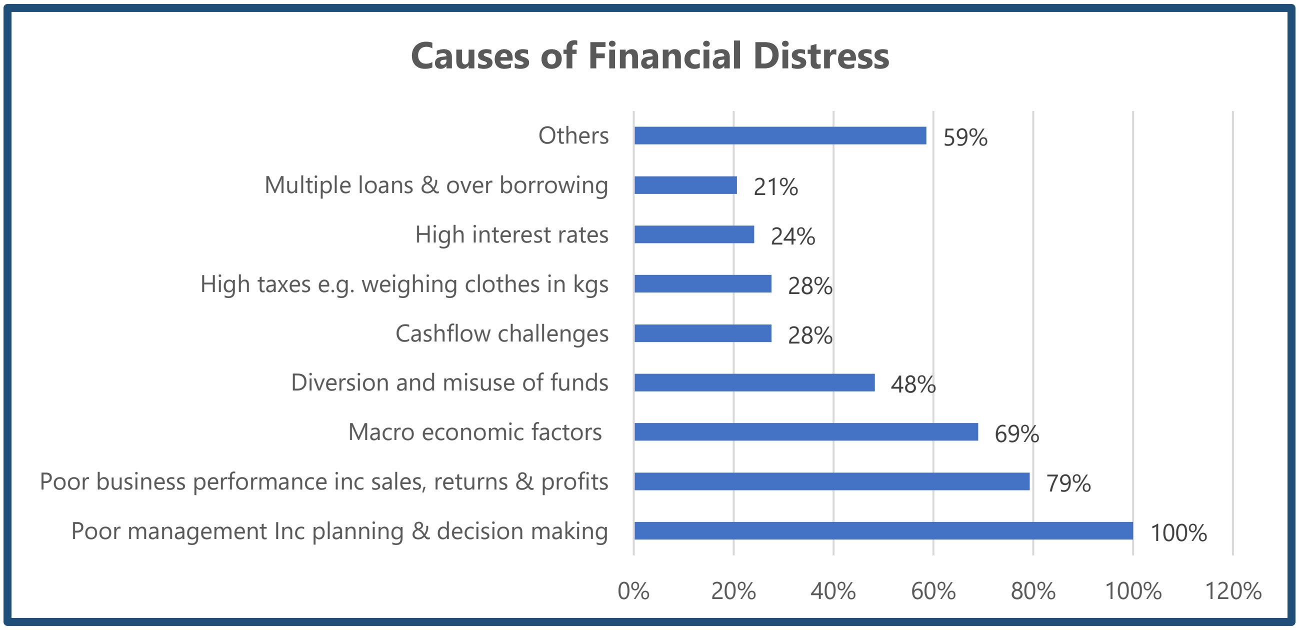


5.0 Key Findings and Insights

5.1 Causes of Financial Distress in Uganda

The survey results indicated that the key causes of financial distress for businesses and individuals in Uganda included poor management including poor decision making, planning and implementation, adverse macro-economic factors, diversion of funds and poor business performance including poor sales, high costs, low returns, and ultimately poor profits as shown in figure 2 below.

Figure 1:Causes of financial distress in Uganda.

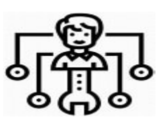
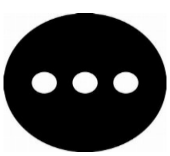


Other causes of financial distress identified and shown in the table above (others) include foreign exchange fluctuations, fraud and lack of controls, slow payment from government and domestic arrears, changing and tight regulations including tax regime, family issues and shocks especially those impacting the principal business owners, policy shifts and changes in technology.

5.2 Early Signals of Financial Distress

The respondents identified the signals that would indicate a business and/or an individual is distressed or likely to descend into distress to include defaulting, late settlement of loans and bills, bouncing cheques, regular requests for extra financing or top ups or credit extensions and overall decline in business performance including sales, revenue, collections, and ultimately profits. Others include increase in costs, debtor days and creditor days. The early signals of financial distress in Uganda are shown in table 1 below:

Table 1: Early signals of financial distress in Uganda

Icon	Early signals of financial distress	% Of respondents
	Defaulting on loans and bills including bouncing cheques	100%
	Decline in business performance including revenue, sales, costs, debtor days, creditor days and ultimately profits	95%
	Declining, irregular, and intermittent cashflows and banking	84%
	Regular requests for extra financing or top ups, and credit extensions	74%
	Restructuring of the business and loss of key staff including changes in key members of management and the board	26%
	**Others including:** • Borrowing from multiple and informal sources (16%) • Declining and intermittent stock levels (16%) • Declining relationship with bankers (16%) • Withholding key information (16%) • Sale of business assets (5%)	Various

Other key signals of financial distress include funds diversion, change in lifestyle for business principals, regular and/or unplanned changes in key business lines or products, and weak governance. It is important that the signals of distress are detected early to enable the right and honest conversations, guidance, and support to increase the chances of reversal.

5.3 Role of SFIs in Supporting Distressed Customers

SFIs in Uganda are supporting customers that are facing financial distress by offering both financial and nonfinancial support. Figure 3 below shows the role played by SFIs in supporting distressed companies and individuals.

Figure 2: Role of SFIs in Financial Distress.

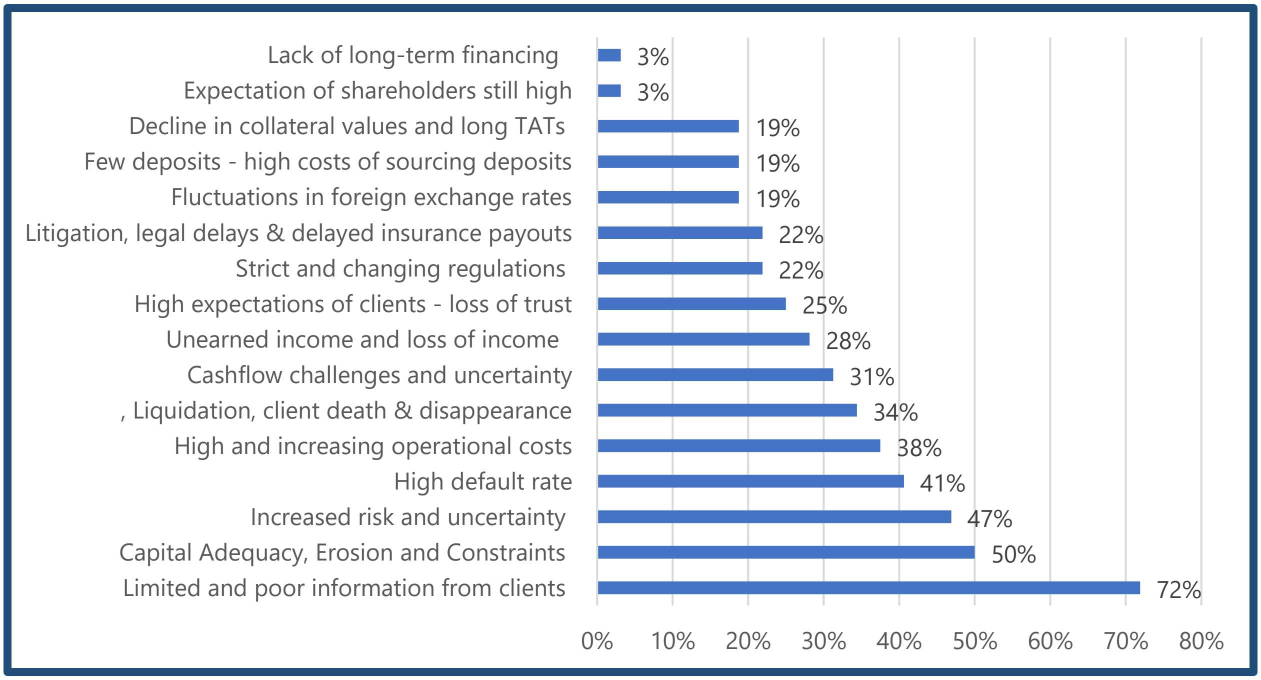
What SFIs are Doing and what more they can do
• Provision of support and top up financing, including long term financing • Provision of training, advisory services, and business development services • Debt restructuring, monitoring, and recovery support • Regular customer engagements and candid, guided communication - clarify expectations and provide feedback • Provision of the right products, services and channels for each category • Reduction in interest rates, waivers, penalties and provision of concessions • Lobbying for financing and risk guarantee support and funds from government and development partners • Protection of the rights of customers, shareholders, and all stakeholders • Information sharing and industry collaborations for the benefit of customers • Partner with industry and sector bodies to workout and deliver deliberate interventions

Financial institutions should form partnerships with government, development and international entities to secure patient and long-term capital and risk guarantees at favorable rates. This approach will facilitate longer term financing at lower costs for critical sectors like education, real estate, tourism, and hospitality; as well as for formal financial institutions like SACCOS and VSLAs. Understanding the diverse categories of customers and sectors, along with their unique characteristics, will enable financial institutions to design tailored interventions for different customer groups and sectors. In cases where business recovery is not feasible, financial institutions should provide support to distressed businesses and customers to aid in their recovery and preserve as much value as possible, including to optimal realization of collateral.

5.4 Challenges and Costs of Supporting Financially Distressed Customers

The key challenges faced by SFIs in supporting distressed businesses and individuals include lack of customer and macro information which makes assessment of customers challenging, capital erosion and constraints impacting adequacy, increased risk, and uncertainty, and high and increasing default rates. Other challenges are also shown in figure 4 below.

Figure 3: Challenges faced by SFIs in supporting distressed customers.



5.5 Other Challenges in Supporting Customers Who are Financially Distressed

In supporting distressed customers, the SFIs face a wide array of challenges, all informed by their structure, strategy and operating framework, customer base, and lending portfolio. The key challenges as articulated by the respondents are as follows:

a) More requests for restructurings and noncompliance were occasioned by the financial distress.
b) Increase in provisions for bad debts and bad debts, negative impact on asset book, ultimately adversely impacting bank earnings, profitability, and liquidity.
c) Poor cooperation from the clients including unavailability, fraud, and unethical behavior.
d) Increased costs associated with restructurings and reorganizations.
e) Fraudulent staff behavior that benefits the customers and/or injures the SFI.

f) Ambiguity in macros and government actions culminating in increased risk and uncertainty.
g) Challenges in regulatory compliance and sanctions thereto.

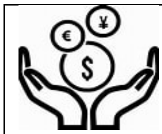
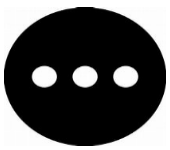
Financial institutions face challenges when providing support to financially distressed businesses and individuals, including concerns related to staff capability, skills, fraud, and dishonesty. To address these challenges, SFIs must ensure their staff receive proper training and upskilling. Additionally, they should modify the performance contracting process and deliverables to prioritize recovery efforts instead of focusing solely on business growth and expansion. This shift in approach will enable financial institutions to better navigate the complexities of supporting distressed entities and individuals effectively.

5.6 Considerations When Supporting Financially Distressed Customers

During this period of escalating customer distress, the financial institutions are providing financial and non-financial support to their customers. The key considerations of the SFIs when evaluating a distressed customer before they provide support are shown in table 2 below:

Table 2: Considerations when supporting financially distressed customers.

Icon	**Considerations**	**% Of respondents**
	Wholistic look at the business - including management, liquidity, capital adequacy and business condition	82%
	Reasons for the distress, extent of distress, potential recovery, and efforts of business owner during the relevant period	79%
	Cash flow projections from the business and other sources of income	70%
	Sector outlook and macro-economic factors – including the related projections	61%
	Past repayment behavior of customer and their account conduct	55%

	Cost of funds and purpose for which the funds are being requested	58%
	Collateral and guarantees support.	33%
	**Others including:** • Transparency & customer communication – 12% • Internal and regulatory guidelines – 12% • Advice by experts & financial advisors – 3% • Level of provisions held by SFI in sector and in respect of the customer - 3%	Various

Throughout the recovery period, it is crucial for the customers to allocate time to prepare their businesses and staff to receive recovery support and loans. Financial institutions have specific requirements and expectations from their customers, and by understanding and fulfilling these criteria beforehand, customers position themselves to receive the necessary support promptly. SFIs should proactively engage with customers, tailoring their conversations and engagements according to each customer group and sector's unique needs, to effectively support them.

5.7 Signs of Financially Distressed SFI Staff and How SFIs Have Supported them.

Signs of Financially Distressed Staff

- Bounced cheques and delayed payment of obligations
- Staff borrowing from other sources including staff, money lenders
- Borrowing pattern – regular requests for loans and top ups
- Distractions at work – frequent phone calls, absenteeism from work
- Spending habits - inconsistent with income
- Bad Credit Reference Bureau Reports
- Always in need of money
- Decline in performance occasioned by stress and financial pressure

What SFIs are doing/ can do to support financially distressed staff

- Financial health clinic including financial literacy training, debt consolidation & management, decision making and planning
- Provision of professional counselling services to staff and close family
- Provision of subsidized staff loans and advances
- Restructure of staff loan obligations without recourse
- Provision of refunds for specific costs incurred by staff and their families e.g. medical costs and COVID-19 tests
- Provision of in cash benefits in the place of staff events e.g. staff parties, etc
- Funeral support in the form of cash or funeral services to staff who lost their parents, spouses or children to COVID-19
- Maintanance of staff & benefits - salaries, no layoffs or reductions, etc
- Support in the establishment of staff SACCOs

5.8 Risks and Risk Mitigation

Due to the changing landscape, there are evolving and escalating risks in the banking sector. 74% of the respondents advised business and operational risks as being the most prevalent risks that the SFIs will face, whilst 47% advised that credit risks underlined by the risk of default will be a significant risk for their respective SFI.

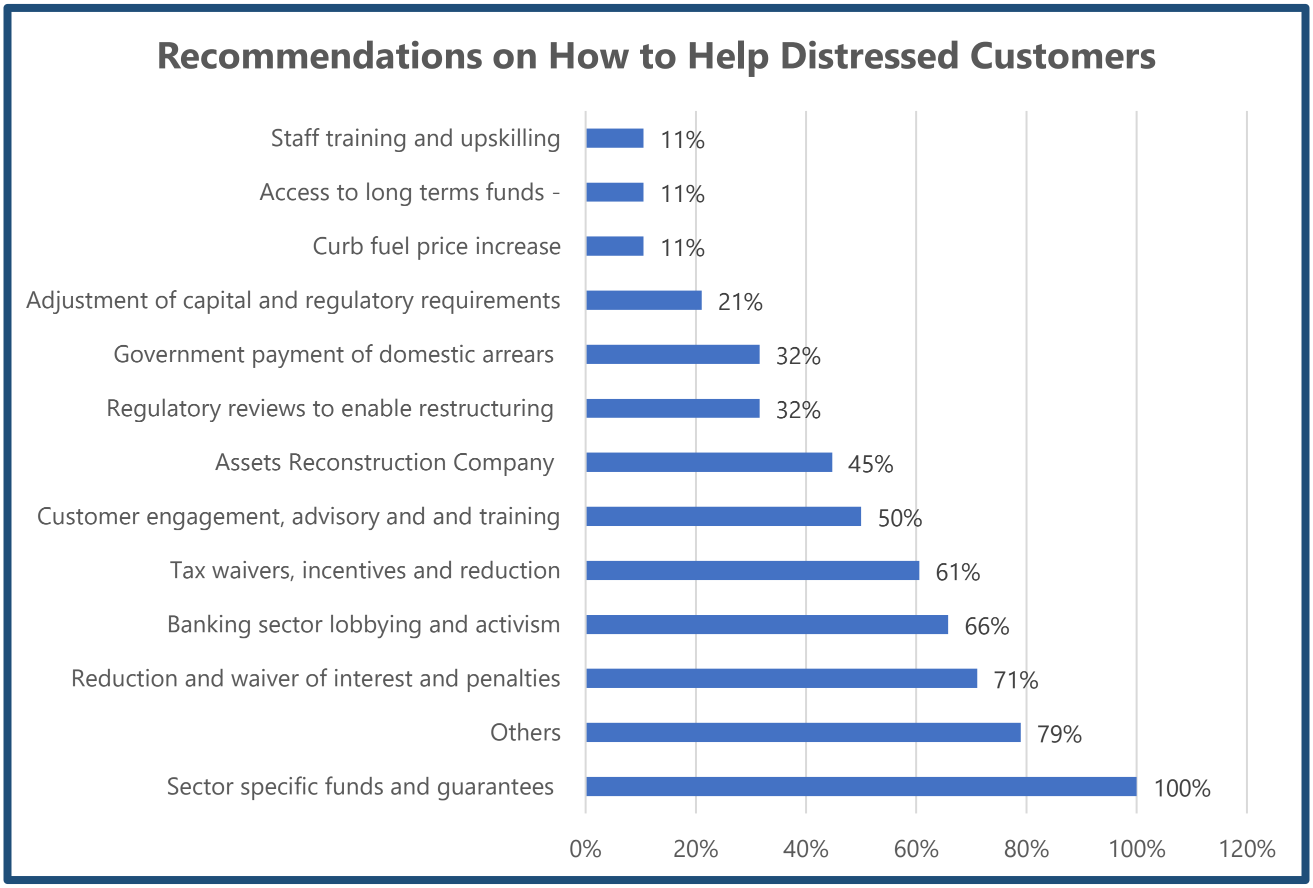
To manage the enhanced and evolving risks, 89% of the respondents advised ensuring updated and versatile credit approval and management process, and heightened customer due diligence. 50% of the respondents advised customer engagement, communication, and relationship mitigation as being key actions to take. Other risks as advised and how they will be mitigated are shown in figure 5 below.

Figure 4: Risks and Risk Mitigation

6.0 Overall Recommendations

100% of the respondents recommended establishment of sector specific funds and guarantees including stimulus packages for the relevant customers, 71% recommended reduction and waiver of interest rates and penalties for selected sectors whilst 66% recommended banking sector lobbying and activism resulting into industry wide reforms to ultimately benefit the customers. The other recommendations are also shown in figure 6 below.

Figure 5: Recommendations on how to assist distressed customers.



Others include digitisation, equity capital infusion, data collection, partnerships with Fintechs and government, and improving and increasing access to markets.

Figure 6: Insights and Recommendations

Recommendation	ST	MT	LT	Stakeholders
Review and change staff performance management process including: • Contracting & evaluation • Training focus • Medium term rather than short term outlook • Fraud awareness & support • Focused staff training & upskilling	✓			a. SFIs b. Bank Staff.
Provision of funding to distressed and recovering customers including sourcing	✓	✓	✓	a. SFIs b. BOU

of cheaper funds to enable provision of the same to customers				c. Development partners d. Provider of long-term financing
Waivers and concessions including: • Debt restructuring • Lower interest rates • Accrued interest. • Penalties • Charges	✓	✓	✓	a. SFIs b. BOU c. GOU d. Development Partners
Work with government and development partners to help establish sector specific development and recovery funds		✓	✓	a. SFIs b. BOU c. GOU d. Development Partners
Access longer term funds – and provide appropriate funding to customers with delayed recovery		✓	✓	a. SFIs b. BOU c. Development partners d. Provider of long-term financing
Review the credit approval process with specific emphasis on: • Changing risk appetite • Changing view of customer • Focusing on remediation • Perfect collateral and valuation • Quick recovery • Prioritizing & embedding mediation	✓	✓	✓	a. SFIs b. BOU c. Development partners d. Provider of long-term financing e. Insurance companies f. Surveyors g. Judicial system
Lobby for the following: • Government payment of domestic arrears • Establishment of recovery funds • Changes in laws and regulations • Improvement of the legal system to improve TATs. • Tax waivers and incentives	✓	✓	✓	a. SFIs b. BOU c. GOU d. Development partners e. Provider of long-term financing f. Uganda Revenue Authority
				a. SFIs b. BOU

Asset Reconstruction Company (ARC) role should evolve with a focus on remediation and recovery		✓	✓	c. Development partners d. ARC e. MOFPED/ GOU
Customer engagements including: • Training & information provision • Advisory services • Business development services • Digital awareness & safety	✓	✓	✓	a. SFIs b. BOU c. Development partners d. Customer groups e. Training & BDS service Providers
Establishment of industry utilities that will enable overall industry improvement in the following: • Fraud detection and management • Information collection, sharing & dissemination. • Customer awareness and training	✓	✓	✓	a. SFIs b. BOU c. Development partners d. Provider of long-term financing e. Uganda Revenue Authority f. Fintechs & ICT service Providers
Digital awareness and safety to increase customer adoption and usage of the various channels	✓	✓	✓	a. SFIs b. BOU c. Customer groups
Work with professionals e.g., financial advisors, turnaround specialists, attorneys, etc. with specialization in helping distressed and recovering firms	✓	✓	✓	a. SFIs b. Customers & Customer groups c. Turnaround Specialists d. Legal firms e. Audit firms
Create new asset classes that attract capital while ensuring the impact of the capital is broad based		✓	✓	a. SFIs b. BOU c. Development partners d. Financial sector institutions

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