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**Corporate Debt Restructuring in East Asia:
Some Lessons from International Experience**

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Abstract

This paper summarizes some lessons from international experience for corporate debt restructuring in east Asia. Basic principles of debt restructuring are described, the experiences of Mexico, Chile, the United Kingdom, Hungary, and Poland are examined, and general lessons are drawn. The approaches currently being adopted in Indonesia, Korea, Malaysia and Thailand are then reviewed in the context of these lessons.

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I. INTRODUCTION

The high level of corporate debt is inhibiting recovery in east Asia through several channels. Onerous debt servicing costs are threatening the solvency of many corporations. Credit to small enterprises is being crowded out by banks that feel obliged to roll over loans to large heavily indebted borrowers. The adverse effect of an increase in interest rates on highly leveraged corporate balance sheets is limiting the scope for monetary policy. Moreover, the debt overhang is self-perpetuating: corporations are unable to deleverage by retaining earnings or issuing equity because of recession, but recession is being prolonged by the high level of debt.

In response, governments have initiated the process of comprehensive debt restructuring. Steps are being taken in Korea, which had the most highly leveraged corporate sector before the crisis, Indonesia, where corporations have been hit hard by the plunge of the rupiah, and in Malaysia and Thailand.

But the challenges posed by debt restructuring in east Asia today are formidable. The legal, tax, and regulatory infrastructure needed for debt restructuring did not previously exist, there is little institutional experience in the region with debt workouts, and restructuring is complicated by the intricacy of corporate balance sheets and the large number of players. Moreover, the poor overall performance of the corporate sector makes more difficult the separation of nonviable corporations (which should be shut down) from viable firms (whose debt should be restructured). Finally, each government must choose whether to take a leading role itself, which can accelerate debt restructuring but at very high fiscal costs, or adopt a private sector-led approach, which is market-based and imposes smaller fiscal costs, but will prolong the process.

This paper aims to inform the process of debt restructuring in east Asia by describing some general principles for debt restructuring, summarizing and drawing some lessons from

the experience of comparable countries, and reviewing the approaches currently being adopted in east Asia in the context of these lessons. This paper is not intended to be the last word on corporate debt restructuring; rather, the aim is to provide a systematic and brief overview of the general principles and the various approaches that have been taken in other countries. Not addressed in this paper are the separate set of economic and legal issues associated with bankruptcy and the restructuring of foreign debt, nor are the important areas of financial sector reform and corporate governance examined in depth because they are covered elsewhere.²

This paper is structured as follows. First, the general principles of corporate debt restructuring are described. This is followed by case studies of Mexico (twice), Chile, the United Kingdom, Hungary, and Poland. Next, the general lessons from these case studies are summarized. Finally, the approaches now being adopted in Indonesia, Korea, Malaysia and Thailand are reviewed against the background of these lessons.

II. GENERAL PRINCIPLES

A. Overview

The goal of corporate debt restructuring is the timely and orderly transformation and reduction of debt with a view to enhancing profitability, reducing leverage, and restoring credit to viable enterprises. To give creditors and debtors incentives to restructure debt in accordance with this goal, the specific approach toward debt restructuring must be tailored to the economic, institutional, and political circumstances at hand.

²Financial reform following a macroeconomic crisis is surveyed in Dziobek and Pazarbasioglu (1997) and Sundararajan and Baliño (1989), corporate governance is reviewed in Shleifer (1997) and Mayer (1996), and bankruptcy is reviewed in Bhandari and Weiss (1996).

Normally, the government takes a hands off approach and debt workouts are handled by banks or bank groups on a case-by-case basis. Government intervention is not needed because the number of troubled corporations is small and their macroeconomic importance is limited, financial information is sound, and banks and corporations have incentives to restructure debt--including the threat of bankruptcy.

In contrast, a comprehensive debt restructuring framework involving the government is needed when corporate debt problems are widespread or have macroeconomic consequences, market failures inhibit the debt restructuring process, and banks are short of the capital and expertise needed to workout debt on a large scale. In addition, extensive financial reform is needed in these circumstances because bank and corporate balance sheets are intertwined, and banks usually play a large role in restructuring owing to the unique information they have about their corporate customers (Fries and Lane, 1994). Further, a workable bankruptcy law is essential in order to give debtors an incentive to cooperate.

Comprehensive corporate debt restructuring can be divided into four parts:

- (i) Establishment of the appropriate macroeconomic, tax, and legal **environment**.
- (ii) Formulation of the debt restructuring **framework**.
- (iii) **Triage**, or separation of the viable corporations for debt restructuring (i.e., those whose value as a going concern, taking into account potential restructuring and at the "equilibrium" exchange rate and interest rates, exceed their salvage value) from the nonviable corporations that should be shutdown.
- (iv) **Financial engineering** involving debt reduction and debt-equity conversions.

B. Frameworks

Formulation of the appropriate framework is probably the most complex and novel part of comprehensive debt restructuring and is dealt with in some detail in this section; the other three parts are addressed later in the paper. Debt restructuring frameworks can be

divided into four categories, which are overlapping and may be implemented concurrently. The categories are presented in ascending order of government involvement.

1. Government mediation

Government mediation between corporations and banks or between banks is warranted if there are market failures or other factors that inhibit banks from effectively leading debt restructuring. Such factors include a lack of cooperation, excessive negotiating power by either debtors or creditors, or a lack of incentives for banks or corporations to workout debt usually arising from poor supervision and bad governance. These factors can throw up obstructions to the close coordination needed for effective restructuring, including the sharing of information between banks, formation of a common strategy, and the provision of new credit during the negotiation process. Such obstructions can prolong or even preclude debt restructuring, resulting in excessive costs and even the unnecessary liquidation of debtors.

To avoid these pitfalls, the parties can ask the government to mediate informally, or in a more structured framework. An impartial government mediator playing the role of honest broker can establish a set of guidelines for triage and financial engineering, provide expertise, facilitate the sharing of information and establish a more congenial atmosphere.

2. Government schemes

Financial incentives to facilitate debt restructuring through a preset government-financed scheme can be useful if corporate debt problems are pervasive and impose negative externalities on the economy at large. Circumstances calling for financial incentives include troubled corporations too numerous for banks to handle, and a level of corporate debt so high as to have negative externalities such as a squeezing of credit to viable borrowers, or an unsustainably high level of corporate foreign debt that curtails capital inflows.

Government schemes usually involve insurance or subsidy incentives that are made available to creditors and debtors on a voluntary basis. These incentives include compensation to creditors for lengthening of debt maturities and grace periods, interest rate and exchange rate guarantees, and equity injections. The government must trade off the fiscal costs of the scheme against the benefits of more expedient debt restructuring for the players involved and from alleviation of the negative externalities. The circumstances that warrant schemes also call for additional government policies such as adjustments to fiscal and monetary policy stances to provide a supporting macroeconomic environment, and improvements in supervision, governance, and the legal system to ensure that the incentives are effective.

3. Direct bank recapitalization

Recapitalization of banks by the government is warranted if corporate debt problems are pervasive enough to undermine the health of the banking system, and banks are willing and able to work out debt on their own. The widespread interruption of corporate loan payments, which usually reflects macroeconomic instability, reduces or wipes out bank capital. Decapitalized banks may exacerbate instability by attempting to rebuild their balance sheets by widening the spread between deposit and lending rates, which effectively taxes successful corporations to fund the losses of unsuccessful corporations, or by cutting back on new lending to creditworthy borrowers. If new capital is all that banks need to restructure debt, i.e., they have the incentives and capacity for working out loans, then government involvement should be limited to restoring bank capital. However, before public funds are used to recapitalize banks existing shareholder equity should be written down including through loan provisioning to ensure tax payers do not bear more than their fair share.

The cleanest way for governments to recapitalize banks is by buying new equity shares, although recapitalization can and does take many forms. Banks can then narrow spreads and reduce unsustainably high levels of debt through writeoffs. Recapitalization is

more effective if it is linked to specific measures to restructure debt. The fiscal cost of bank recapitalization can be very large, and again must be gauged carefully against the benefits.³

4. Government asset management corporation

A new government asset management corporation is called for if the number of troubled corporations is large and there are microeconomic factors which severely inhibit debt restructuring. The most important of these factors are decapitalized and poorly managed banks, a shortfall of the expertise in banks needed to workout bad debt, an uneven balance of power between banks and corporations, a lack of corporate capacity and willingness to provide reliable financial information, and, again, systemic negative externalities such as a credit squeeze or unsustainably high foreign debt.

A government-financed asset management corporation can buy bad loans, provide equity to banks and corporations, negotiate with debtors, and take an active financial and operational role in restructuring. If bankruptcy courts are ineffective, an asset management corporation can also serve as an out-of-court bankruptcy mechanism, since the passing of legislation and the building of institutional infrastructure for effective bankruptcy procedures can take time (van Wijnbergen, 1992). The debt taken on by the asset management corporation is usually written down, and can be converted to equity and eventually sold to the public. The asset management corporation realizes economies of scale in the specialized area of corporate debt restructuring and can develop secondary debt markets. Banks benefit from higher capital, while corporations can expect to have their debt restructured more quickly.

³The fiscal cost of bank recapitalization for 19 countries that experienced crises during 1977-96 surveyed in IMF (1997, pp 78) averaged 8½ percent of GDP.

III. CASE STUDIES

A. Mexico—FICORCA Scheme

During the early 1980s Mexico adopted a government scheme to restructure corporate foreign debt following the disruption of external debt payments and the drying up of new lending in 1982. The government in early 1983 established the foreign exchange risk coverage trust fund (FICORCA), overseen by the central bank. The main incentive for corporations to participate in FICORCA was that they were able to swap their foreign debt for new peso-denominated debt under a government-guaranteed exchange rate set at the beginning of the operation, and at an extended maturity of 8 years or more with a 4 year grace period.

About \$12.5 billion in debt of some 2,000 corporations was restructured under FICORCA. The scheme was run by a staff averaging 50, and debt service payments were handled by Mexican commercial banks for a fee. The government assumption of foreign exchange risk resulted in large gains due to the maturity extension of the rolled over debts and the subsequent appreciation of the peso.

FICORCA was generally viewed as a success because the large amount of loans rescheduled under the scheme helped to resolve the problems that confronted the private sector in 1982. FICORCA created a stable environment for debt negotiations, fixed the exchange rate exposure for debtors, gave the debtors breathing space, and allowed for a lower interest rate on the foreign debt than the debtors could get on their own. Moreover, the government did not assume commercial risk. However, it should be kept in mind that the relatively narrow mandate of the FICORCA scheme meant that it did not have to take on many of the complex challenges faced elsewhere, such as the identification of nonviable firms, domestic debt restructuring, and creditor to creditor and creditor to debtor coordination problems. In addition, the government was exposed to exchange rate risk.

B. Chile

Chile recapitalized banks and implemented government schemes to restructure corporate debt during the early and mid-1980s. Debt repayment problems were prompted by the recession of 1981-83, which followed a decade of financial reform and a remarkable surge of financial intermediation (Velasco, 1989). To provide incentives for debt servicing and reestablish a sound banking system, the authorities improved bank supervision and regulation, recapitalized private banks by purchasing substandard loans at par in 1982, 1984 and 1986, and implemented several schemes given financial incentives for debt restructuring. Specifically, peso and dollar-denominated debts were rescheduled at a fixed real interest rate (7 percent in 1983, then 5 percent in 1984), and at a longer maturity (10 years and extended to 15 years), with a grace period of 5 years for principal and one year for interest, and borrowers were allowed to convert at a discount dollar-indexed loans into peso-denominated loans before restructuring them. The central bank provided large subsidies to the banks because the schemes worsened their liquidity and profitability.

The scope of the schemes and bank recapitalization was substantial. By end-1984, 21 percent of domestic credit had been rescheduled under easier terms. Moreover, loans sold by financial institutions to the Central Bank of Chile totaled US\$2.9 billion by August 1985.

Debt restructuring, complemented by bank recapitalization and financial sector reform, together with a strong economic recovery in the mid-1980s, contributed to a significant improvement in the liquidity and stability of the corporate and banking sectors. However, the measures can be seen as stretching out the impact of the crisis on the corporate and banking sectors, owing to the apparent lack of incentives for banks to separate viable from nonviable enterprises, as well as the need for multiple bank recapitalization, which reflected the insufficiency of the first recapitalization, and the slow pace of improvements in supervision

and corporate restructuring. Further, the central bank experienced large operating losses as a result of the schemes.

C. United Kingdom

The "London Approach" that has been used in the United Kingdom since 1989 (Kent, 1997) is the best known example of the government mediation approach. It is a set of principles implemented under the aegis of the Bank of England which is used to create a standard framework and to help corral banks into unanimity. The London Approach is not enshrined formally to avoid excess legality and because the framework needs to be flexible and adaptable and rest on voluntary bank acceptance. The principles are: (i) if a corporation is in trouble banks keep credit facilities in place and do not press for bankruptcy; (ii) decisions about the firm's future are made only on the basis of comprehensive information shared among all banks and parties; (iii) banks work together, and (iv) seniority of claims is recognized but there is an element of shared pain. The London Approach was applied with the involvement of the Bank of England in over 160 cases during 1989-97.

Adaptability is the strength of the London Approach. Of course, it should be kept in mind that application of the London Approach to corporate debt restructuring in the UK is facilitated by the favorable regulatory environment and macroeconomic stability, the negligible role of foreign creditors, and most important the infrequency and small scale of corporate debt restructuring. In this setting, the London Approach, supported by the sound reputation and objectivity of the Bank of England, has proved successful.

D. Hungary⁴

Hungary during 1991-95 took several approaches to corporate debt restructuring (Baer and Gray, 1995; Gray, 1996; Aghion et al, 1994). Under the tough “bankruptcy” law of 1991, firms with arrears of 90 days or more were required to file for reorganization (referred to as bankruptcy) or liquidation. Debtors then submitted reorganization plans to creditors under supervision of a trustee selected from a list maintained by the government. If agreement was not reached, then the debtor was liquidated. During 1992-93, 5,000 “bankruptcy” cases and 17,000 liquidation cases were filed. Despite the progress under this variation of the government mediation approach, a scheme resembling an asset management corporation was adopted in tandem with the 1993 bank recapitalization (banks were recapitalized four times during 1991-94 for a total of 9 percent of 1993 GDP). Under the new scheme, 55 firms were restructured by government directly, representatives of line ministries took part in the restructuring negotiations, and the State Property Agency (SPA) was given the right to purchase bad debts from banks if no agreement could be reached. All in all, almost one-half of the 603 large loss-making firms were the subject of reorganization or liquidation, but in many cases former managers retained power.

Thus the end result of corporate restructuring in Hungary was mixed; the early mediation approach met with some success, but the high degree of government involvement under then SPA was seen to slow and undermine the effectiveness of restructuring. The multiple and costly bank recapitalizations reflected delays in the improvement of supervision and regulation, the lack of turnover of bank management, and the absence of links between

⁴Relatively advanced transition countries are comparable to east Asia because they had systemic problems in the corporate sector. However, east Asia differs from transition economies in some important respects: debt has not been diminished by a burst of inflation, firms in east Asia have not gone into arrears on taxes or wages, the enforcement of property rights is not an issue, and corporations in east Asia have a higher level of foreign debt.

bank recapitalization and corporate restructuring. The slow improvement in corporate performance reflected the inability of the government to restructure or even monitor the corporations that came under its control. However, in the last several years commercial banks have been privatized and progress toward corporate restructuring has been substantial.

E. Poland

Poland successfully adopted elements of the bank recapitalization and government mediation approaches. Bank and corporate restructuring was addressed together in the Enterprise and Bank Restructuring Program (EBRP) enacted in 1993 (van Wijnbergen, 1994; Baer and Gray, 1996; Aghion et al, 1994). The large commercial banks were recapitalized only if they carried out a plan of debtor restructuring that was acceptable to the Finance Ministry. Under these plans, banks had to subject each debtor to liquidation or restructuring (“conciliation”). Conciliation agreements for working out bad loans provided for banks to negotiate a workout agreement on behalf of all creditors subject to the agreement of holders of 50 percent of the debt. The bank kept any loan recoveries and had a greater degree of authority under court-run bankruptcy, giving them further incentives to restructure. Technical assistance subsidies funded by donor agencies were provided for bank workout departments.

Borrowers accounting for 57 percent of loans classified as nonperforming at end-1991 had made full or partial payments by 1994. Evidence for the efficacy of the Poland approach is provided by Gray (1995), whose study of a subset of Polish firms concluded that these firms reduced total real debt by one-third and reduced bank debt by three-fifths. Furthermore, banks were in a much stronger capital position and had improved their credit evaluation capability, partly owing to measures that improved competition in the financial sector.

Poland’s approach appears to have resulted in an economically rational debt restructuring and a healthy banking sector at a relatively low fiscal cost (Dziobek and Pazarbasioglu, 1997) and therefore offers some positive policy lessons. First, corporate debt

restructuring and bank reform was effective because they were addressed together in an integrated and transparent plan. Second, conditioning bank recapitalization on corporate restructuring contributed to sounder banks and a more viable corporate sector. Third, government subsidies to banks to develop their debt workout expertise seemed to enhance the timeliness and quality of debt restructuring.

F. Mexico, 1995-97

Mexico adopted a government scheme and recapitalized banks to facilitate the restructuring of large domestic syndicated loans in 1995 (Lubrano, 1996). After the existing legal framework and bankruptcy laws proved to be inadequate for the restructuring of the domestic debt of large corporations in the wake of the 1994-95 crisis, the Coordinating Unit for Bank-Enterprise Agreement (UCABE) was established at the initiative of President Zedillo in January 1995 to set up guidelines, mediate in negotiations, and provide financial incentives for debt restructuring. This effort was complemented by bank recapitalization including through the purchase of bad loans by the FOBAPROA asset management corporation, capital market deregulation and improved accounting standards and bank supervision. UCABE consisted of two private sector and two public sector members and a small staff. Only corporations considered viable by the banks and for which the banks requested the assistance of UCABE were eligible. During negotiations, payments were suspended, and a lead bank made binding agreements with the concurrence of banks representing 60 percent of total bank credit. Debtors had to give creditors access to all financial information and creditors had to share information among themselves. Unsustainable debt was paid down through asset divestment, debt-equity conversions, or write-downs. Financial incentives provided through the National Development Bank of Mexico included an equity injection of \$9 million for individual restructured corporations, interbank debt-swaps, and loans for working capital.

UCABE was formally dissolved on May 1, 1997 after restructuring 31 loans worth about \$2.6 billion, and FOBAPROA purchased bad loans equivalent to 15 percent of GDP.

The financial incentives provided by UCABE seemed to facilitate restructuring in the context of rapid improvement in the macroeconomic and external environment and a relatively small number of debtors. The experience of UCABE points to the advantages of a flexible approach explicitly backed by the government and the centralization of information under one entity. However, at the same time poor supervision and a lack of transparency resulted in very large and not yet fully realized costs from the bad loans purchased by FOBAPROA.

IV. GENERAL LESSONS

A. The economic and institutional environment

- *Macroeconomic stability must be entrenched to foster debt restructuring transactions.*

Debt restructuring makes more urgent the need for entrenchment of macroeconomic stability because stable prices, interest rates and exchange rates are needed for debtors, creditors and potential investors to have enough certainty to value and close transactions. Macroeconomic stability proved to be a precondition for debt restructuring in Mexico in 1995 and in the transition countries.

- *Financial reform is needed to recapitalize banks and improve their incentives.*

Banks should have enough capital to give them the leverage to write-off debt without widening spreads and to negotiate with large creditors on equal terms, no matter which restructuring approach is chosen. At the same time, supervision should be improved to ensure banks have incentives to workout debt. Limits on bank exposure to their largest borrowers can help establish an arms-length relationship. Financial reform accelerated restructuring in Mexico in the 1980s and in Poland, in contrast to the experience in most transition countries.

- *Tax and regulatory disincentives to restructuring should be removed and new incentives designed carefully.*

Taxes that penalize debt forgiveness and loan loss provisioning and restrictions on foreign ownership should be removed, and legislation to remove impediments to debt-equity swaps should be enacted. Any new incentives for restructuring should be temporary to avoid erosion of the tax base and have sufficient safeguards to prevent abuse. For example, Thailand is allowing for the deduction of debt writeoffs from taxable creditor income, but only through end-1999.

- *Bankruptcy procedures should ensure the timely liquidation of nonviable firms.*

Effective bankruptcy procedures provide incentives to workout debt outside a formal restructuring framework and assure that credit is not absorbed by nonviable firms. However, bankruptcy court control of debt restructuring has important disadvantages, including the inability of courts to handle a large volume of cases, a strong liquidation bias in bankruptcy laws, and a lack of expertise by the courts. The absence of effective bankruptcy procedures slowed restructuring in transition countries and in Mexico in 1995.

- *Corporate governance must be brought up to international standards.*

Effective corporate governance is needed to push managers to not only restructure debt, but also to operate profitably and thereby avoid future debt reschedulings. Accurate, timely and accessible financial information on corporations is essential. Russia (Aghion et al, 1994) and Romania (Begg, 1996) offer vivid examples of how bank and interenterprise debt problems can persist without improvements in corporate governance.

B. The Debt Restructuring Framework

- *The tradeoffs between public or private sector-led restructuring hinge on the systemic consequences of the debt overhang and market efficiency.*

Public sector-led restructuring entails high fiscal costs and raises potential moral hazard problems, but should eliminate the debt overhang more quickly, which is of greater concern when corporate debt problems are delaying economic recovery.⁵ Alternatively, private sector-led restructuring has the advantage that the outcome is determined by market forces, but this approach is more prolonged, and therefore is more appropriate when markets operate efficiently and corporate debt problems are limited.

- *The government mediation framework is appropriate if debt restructuring is limited in scope and the environment supportive.*

This approach offers flexibility and adaptability, but requires a credible government mediator, macroeconomic stability, and the appropriate regulatory setting, all of which are attributes of the United Kingdom where the London Approach has been successful.

- *Government schemes can be useful if large-scale debt restructuring imposes externalities and is slowed by market failures, but this approach has pitfalls.*

It may be worthwhile for the government to offer financial incentives if the level of debt is high enough to impose negative externalities such as a credit squeeze or cutoff of external financing, or market or regulatory failures slows the debt restructuring process. In particular, these schemes can address the exchange rate risk posed by foreign debt in an uncertain macroeconomic environment, as in Mexico. The pitfalls to be avoided include politicization and overly generous and long-lasting incentives, as in Chile.

- *Bank recapitalization is warranted under similar conditions as for government schemes but where banks are better qualified to workout debt.*

When debt problems impose negative systemic externalities and banks are undercapitalized, direct bank recapitalization is preferable to an asset management corporation if banks are

⁵The very rapid pace of corporate restructuring in East Germany during 1990-94 under the Treuhandanstalt entailed high fiscal costs (Aghion et al, 1994).

better suited than the government to workout debt. But recapitalization creates a fresh moral hazard problem: banks may have incentive to gamble the new capital on risky loans with the expectation that they will again be recapitalized if these loans do not pay off, as in Bulgaria and Hungary (Aghion et al, 1994; Begg, 1996). To avoid the moral hazard problem, recapitalization should be complemented by measures that improve bank supervision and governance, as did Poland, especially if banks end up owning a large share of the corporate sector. Tying bank recapitalization to specific bank measures to restructure corporate debt, again as in Poland, can be helpful.

- *An asset management corporation is warranted to address systemic debt restructuring if bank-led debt restructuring is infeasible, but this approach has its own pitfalls.*

Decapitalized and poorly managed banks, a large number of debtors, and systemic externalities can warrant creation of a government-financed asset management corporation. However, to be successful, an asset management corporation should avoid multiple inconsistent goals and aim at maximizing loan recovery, avoid politicization, and be sufficiently funded. The government should avoid recapitalizing banks through the asset management corporation by paying above-market prices for bad loans as in Chile and Mexico in 1995-97, because this is nontransparent. In addition, complementary government policies in the areas of corporate governance, financial sector reform are usually needed.

C. Financial engineering

- *Less than unanimous creditor approval of reorganization plans speeds debt restructuring.*

The restructuring process will be slowed if minority creditors threaten liquidation of the debtor to force majority creditors to buy them out on favorable terms. This coordination problem can be avoided by less than unanimous creditor approval of reorganization plans, which can be enforced by government moral suasion as under the London Approach, by *a priori* creditor agreement to a set of principles, or through bankruptcy proceedings.

- *A standstill on payments to banks provides viable debtors with breathing room.*

A debt payment standstill during negotiations allows cash-strapped corporations to continue operation while their viability is being decided, as under the London Approach.

V. CORPORATE DEBT RESTRUCTURING IN EAST ASIA

A. Background⁶

The systemic financial crisis of the corporate sector in east Asia is rooted in the interaction between the aggressive export-oriented growth strategy initiated in the 1970s and the system of corporate governance and finance. Under this approach government-controlled banks directed loans to chosen export-oriented industries. Regulatory barriers and other factors helped constrain issuance of bonds (which today constitute a small share of corporate liabilities) and limited the role of foreign banks. Bank borrowing was dominated by a small number of conglomerates, which in turn were dominated by a few owners unconstrained by international standards of corporate governance. Nevertheless, economic decision making from the top down worked well when export products were relatively unsophisticated and economic conditions favorable.

However, changes in policy coupled with international capital market integration in the 1980s greatly increased the riskiness of corporate balance sheets. Most important, the lifting of restrictions on foreign borrowing and high domestic growth triggered a surge of capital inflows that resulted in the overleveraging of poorly supervised banks and corporations. Corporations, lulled into a false sense of security by stable exchange rates pegged to the U.S. dollar, did not hedge their foreign currency exposure. Initially, most of the inflows financed

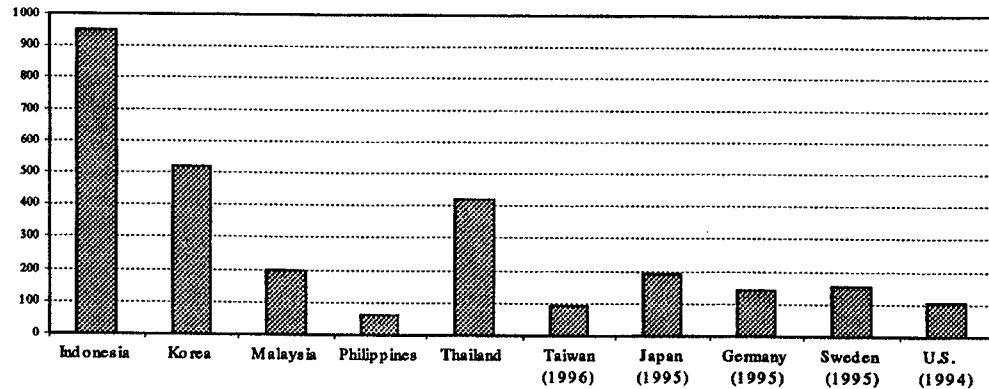
⁶For an overview of macroeconomic developments during the east Asia crisis see World Bank (1998), Roubini (1998), and Kochhar et al (1998). Gobat (1998) reviews the emergence of corporate debt problems in Korea.

investment in export-intensive manufacturing and efficient import competing activities, but more recently a growing proportion was directed at nontraded and protected sectors, which further increased balance sheet vulnerability.

The regional crisis that began in mid-1997 is buffeting corporate balance sheets and cash flow. Domestic banks are no longer willing and able to provide financing. Corporations are further squeezed by the dropoff of capital inflows, which also resulted in large exchange rate depreciations that increased the cost of servicing foreign debt. At the same time, domestic debt servicing costs were raised by higher interest rates, and profits were hit by falling domestic demand. As a result, already-lofty corporate debt-equity ratios in east Asia increased to levels well beyond the international norm (Chart 1).

Chart 1. East Asia and Other Countries, Corporate Debt-Equity Ratio, 1998

(in percent)



Sources: Gobat (1998) and IMF staff estimates.

The high level of corporate debt and systemic nature of the problem in east Asia has led to the adoption of each of the four comprehensive approaches to corporate debt restructuring presented in Section II. A case-by-case bank-led approach to debt restructuring is not feasible because banks have limited experience with loan workouts, low capital adequacy ratios, and a history of government influence and poor supervision (Gobat, 1998

World Bank, 1998 and IMF, 1997). At the same time, corporations have systemic importance, complex balance sheets and are highly leveraged. While the importance of debt restructuring to recovery has been recognized, the policy responses are still evolving owing to the complexity of the problem and the still unsettled state of financial markets.

B. Country Experiences ⁷

1. Indonesia

In Indonesia steps have been taken toward improving the institutional environment and establishing the modalities for debt restructuring using government schemes, bank recapitalization, and an asset management corporation. A government scheme providing incentives for foreign creditors to reschedule their debts to corporations on specified minimum terms was agreed between the government and foreign commercial banks in June 1998. The Frankfurt Agreement is to be implemented by the Indonesia Debt Restructuring Agency (INDRA), which is similar to FICORCA, and was established by Presidential decree in August 1998.

Banks are being recapitalized in several ways and some bad loans are being hived off into an asset management unit. The Indonesia Bank Restructuring Agency (IBRA) has assumed control of troubled private banks and is reviewing them for liquidation or recapitalization and the other private banks and state banks are being reviewed. An Asset Management Unit is being set up within IBRA to swap bad debts for government bonds.

The government has also recently put forth a set of general principles for the restructuring of domestic and foreign debt on a voluntary basis with a view to accelerating debt restructuring and promoting interim financing to cash-strapped companies. Under the "Jakarta Initiative", the approach would be as follows. Each over-leveraged company invites

⁷Developments through end-September 1998 are summarized in this section.

its major creditors to form a steering committee which selects a chair and an outside advisor. The primary creditors agree to a standstill, and if the company is operating at a loss the creditors consider providing new funding which is treated as senior credit. Based on complete financial statements, the debtor submits a financial rescue plan to the steering committee, which is reviewed and reported on by the committee advisor. If the report indicates that the company is viable, a final consensual plan is agreed. If not all of the creditors agree, a "pre-negotiated" plan established by the bankruptcy law and under commercial court approval can come into force subject to the approval of a minimum share of creditors. A Task Force composed of a senior representative of all relevant ministries and agencies and advised by a private Advisory Restructuring Committee has been established to remove regulatory obstacles and provide a forum for "one-stop" regulatory approval of filings.

Finally, the incentive of debtors to restructure has been enhanced by other measures. Bankruptcy procedures have been improved through revisions to the bankruptcy law and improvements in its underlying institutional infrastructure. Restrictions on debt-equity conversions are being lifted, procedures for foreign direct investment are being streamlined, a new arbitration law is in place and accounting and auditing rules are being improved. However, it is too early to say whether the debt restructuring framework with a minimal degree of direct government involvement will prove to be sufficient, and the pace of restructuring has been slowed by the uncertain macroeconomic setting.

2. Korea

Korea is adopting each of the common debt restructuring frameworks under the aegis of the Financial Supervisory Commission, which reports to the President. Incentives for debt restructuring have been enhanced by regulatory changes in shareholder rights and accounting and reporting standards, legislative changes and capital account liberalization to develop domestic capital markets, and measure to improve private sector competition. The exchange

of short-term foreign debt of commercial banks for government-guaranteed debt of longer maturity in early 1998 helped restore macroeconomic stability.

The reform and recapitalization of banks and non-bank financial institutions (NBFIs) is proceeding along several fronts. Banks and NBFIs have been taken over and recapitalized by the government, reorganized under government supervision, and liquidated. A number of purchases and mergers have taken place prompted by injections of government capital. A portion of bank assets have been shifted to the Korea Asset Management Corporation (KAMCO), which through end-September purchased 39 trillion won of nonperforming bank assets some of which has been sold to foreign investors. The supervision of banks, including of connected lending and large credit exposures, has been significantly strengthened.

The Corporate Restructuring Agreement (CRA) provides guidelines for debt restructuring. The CRA was signed in June 1998 by 200 financial institutions who agreed to follow specific procedures for debt workouts and to subject themselves to binding arbitration and lies somewhere between a mediating body and a government scheme. The arbitrating body is the private Corporate Restructuring Coordinating Committee (CRCC), consisting of 8 members, which has the power to impose a solution among creditors signing on to the CRA. The CRA is expected to facilitate debt restructuring through the sharing of information via the Financial Supervisory Commission and precommitment to a common procedure.

The procedure works as follows. A creditor meeting on the restructuring of a debtor can be called by one of eight major banks ("Lead Banks"), or by institutions who hold more than 25 percent of a corporation's debt. A standstill on debt repayments applies until the committee decides to extend it for a maximum of 6 months. A decision is then taken, with the approval of creditors holding 75 percent of the debt, to either workout the debt, or liquidate the corporation. If no agreement can be reached the issue is put up for arbitration by the CRCC. Upon agreement among banks or following an arbitrated decision, the lead bank

negotiates with the debtor. Each lead bank has an internal debt workout unit and an advisory group of external experts (investment banks, accountants etc.) who have complete access to financial information. The advisors will recommend a course of action to maximize the return to creditors. The lead bank will then attempt to obtain agreement from other creditors. Again, if agreement cannot be reached, the solution is arbitrated by the CRCC.

Korea has made important progress toward establishing a supporting macroeconomic and regulatory environment for debt restructuring. It remains to be seen whether the government will need to take a more proactive role to facilitate debt restructuring especially for the largest corporations.

3. Malaysia

Although Malaysia has relatively low corporate leveraging indicators compared to other countries in east Asia, some signs of stress have begun to emerge, including an increased number of filings for court protection from creditors. In response, the authorities have established the elements of a restructuring program in the form of a special purpose vehicle for bank recapitalization (Danamodal), an asset management corporation (Danaharta), and a Corporate Debt Restructuring Committee. The next steps would be further development of an overall strategy encompassing bank triage and private and public sector bank recapitalization, the appropriate valuation of non-performing loan purchases, and the workout of corporate debt. To improve the incentives for corporate debt workouts, measures could be taken to enhance bankruptcy procedures and improve corporate governance.

4. Thailand

In Thailand, the government is also implementing broad measures to improve incentive and is taking each of the four major approaches to debt restructuring. To encourage banks to restructure their holdings of corporate debt, the classification rules for nonperforming loans after they have been restructured have been relaxed. Tax impediments to debt restructuring

have been removed; to help speed up restructuring and prevent permanent erosion of the tax base, many of these exemptions will expire at end-1999. Moreover, the government has eased restrictions on foreign participation in the economy.

Financial institutions are being recapitalized in several ways. Many finance companies and several banks have been closed or are being rehabilitated, and recapitalization and provisioning agreements have been signed with all the extant institutions. Significantly, financial institution recapitalization will be linked to the signing of binding agreements with debtors. The losses of the Financial Institution Development Fund (FIDF), which is the lender of last resort for the finance system, have been converted into government debt. The Financial Sector Restructuring Agency (FRA) is auctioning the assets of closed institutions. An asset management corporation has been established to workout bank loans.

A Corporate Debt Restructuring Advisory Committee (CDRAC) has been established, chaired by the Bank of Thailand, and including representatives from the financial and corporate sectors. The CDRAC has developed a list of financial advisers with expertise in corporate debt restructuring, and approved a nonbinding debt restructuring framework which draws on the London Approach and provides a clear statement of the approach that is expected to be adopted in corporate workouts involving multiple creditors. By July, about 70 different private corporate loans worth 5.4 billion baht (\$130 million) were restructured. The pace of restructuring could be accelerated by improving the bankruptcy process to make more credible the threat of foreclosure.

C. Conclusion

Governments in east Asia are taking the first steps toward debt restructuring in recognition that the high level of corporate debt is inhibiting recovery. These efforts have concentrated on improving the macroeconomic and institutional setting: financial markets have been stabilized in most countries, financial sector reform including bank recapitalization

is well underway, corporate governance and accounting standards have been enhanced, tax and legal disincentives for debt restructuring are being removed, and bankruptcy procedures revised. To improve the incentives for debt restructuring, several of the countries have established government schemes, and all are recapitalizing banks, have set up an asset management corporation and have created frameworks involving various degrees of government mediation. The process of debt restructuring itself is now in train.

Of course, the road to successful debt restructuring is long, and the international experience provides some guideposts for east Asia. First, all the modalities of debt restructuring should be finalized in a transparent way. Second, financial reform should proceed quickly to give banks the leverage and incentives to restructure debt. Third, bank recapitalization should be linked with debt restructuring. Finally, it remains to be seen whether in east Asia a more active government role will be needed to enhance restructuring incentives.

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