

# IMF Working Paper

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## Government Involvement in Corporate Debt Restructuring: Case Studies from the Great Recession

*David A. Grigorian and Faezeh Raei*

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Monetary and Capital Markets

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**Prepared by David A. Grigorian and Faezeh Raei <sup>1</sup>**

Authorized for distribution by Udaibir S. Das

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**Abstract**

The paper examines recent episodes of government involvement in corporate debt restructurings. It argues that corporate debt restructuring is an important step toward recovery from a financial crisis. We then discuss the rationale for, and modalities of, the state intervention in corporate debt workouts through reviewing six countries with large scale corporate debt workouts. Case studies reveal that the costs of corporate sector rescue are significant and in several cases on par with the costs of financial sector bailouts. The paper sheds light on the importance of contingent liabilities and associated risks to government balance sheet from the corporate debt side and emphasizes the need for improved contingency planning for corporations with potential systemic impact.

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Authors' E-Mail Addresses: [dgrigorian@imf.org](mailto:dgrigorian@imf.org); [fraei@imf.org](mailto:fraei@imf.org).

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## I. INTRODUCTION AND MOTIVATION

Pressures from the global economic crisis and resulting tighter credit conditions have given rise to corporate debt problems across the world. High debt service costs, un-hedged foreign currency risk, and roll-over problems have threatened the solvency of corporations, including some systemically important ones, in a number of countries.

The widespread corporate debt problems have posed complications in a number of dimensions. First of all, debt problems have created real risks of disruption of activity/output as stressed corporates have difficulties meeting their working capital needs to secure production. This in some cases led to weaker capacity to service existing debt and further deteriorated the corporations' balance sheet. Second, the slowdown of activity contributed to unemployment and related social pressures. Third, corporate debt problems and the resulting increase in nonperforming loans (NPLs) endanger the already weakened banking system and further reduce the ability of banks to extend credit, thus slowing down the recovery. Debt over-hang thus became self-perpetuating as 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.<sup>2</sup> Fourth, government rescue efforts of embattled corporates typically entail direct fiscal costs and—to the extent the experience of past crises is of any guidance—may have increased the contingent risk in the future due to moral hazard.<sup>3</sup> The resolution of corporate debt problems thus became an important part of the recovery strategies across a range of countries affected by the crisis.

The condition of the corporate balance sheet turned out to be particularly relevant for the recovery of the banking system. Recent data show that nonperforming loans of household and corporate sectors take on an increasing trend in the years following the start of the crisis. In some countries and regions, nonperforming loans doubled in 2009 compared to 2008 (Figure 1, panels 2 and 3). As a result, banking asset write-downs continue to be significant and growing in 2010 compared to 2009 (Figure 1, panel 1). While the data do not allow us to distinguish between household and corporate nonperforming loans (NPLs) for all countries and regions, reporting from United States, U.K., and euro area shows that as much as 17 to 23 percent of writedowns in 2007–10 comprises commercial mortgage and corporate loans.<sup>4</sup>

Given the importance of interlinkages between corporate debt problems on the one hand and the recovery of financial system and overall economy on the other hand, several governments have embarked on measures to help facilitate the process of corporate debt resolution. The paper surveys recent corporate debt restructuring episodes in Latvia, Russia, Spain, UAE, Ukraine, and the United States and provides a comparison of modalities of government

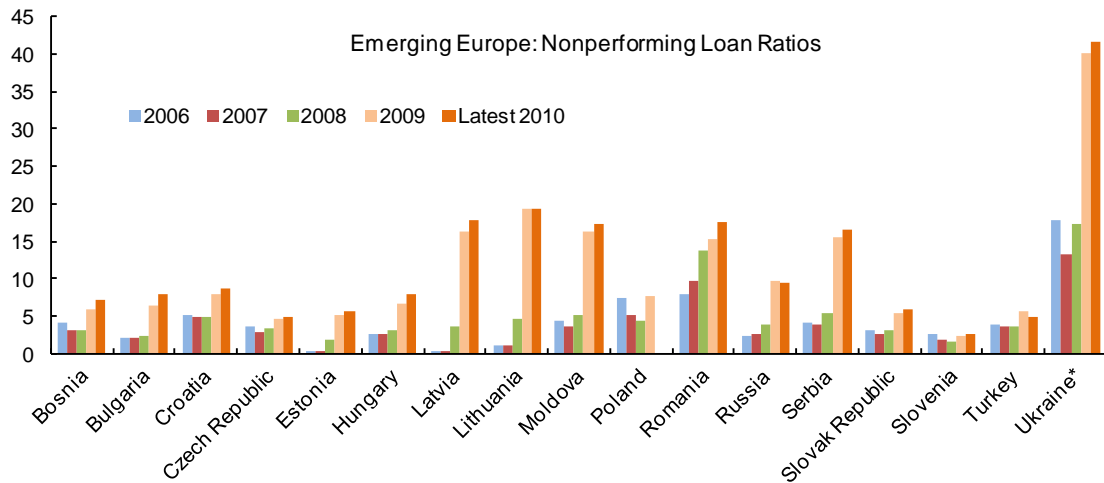
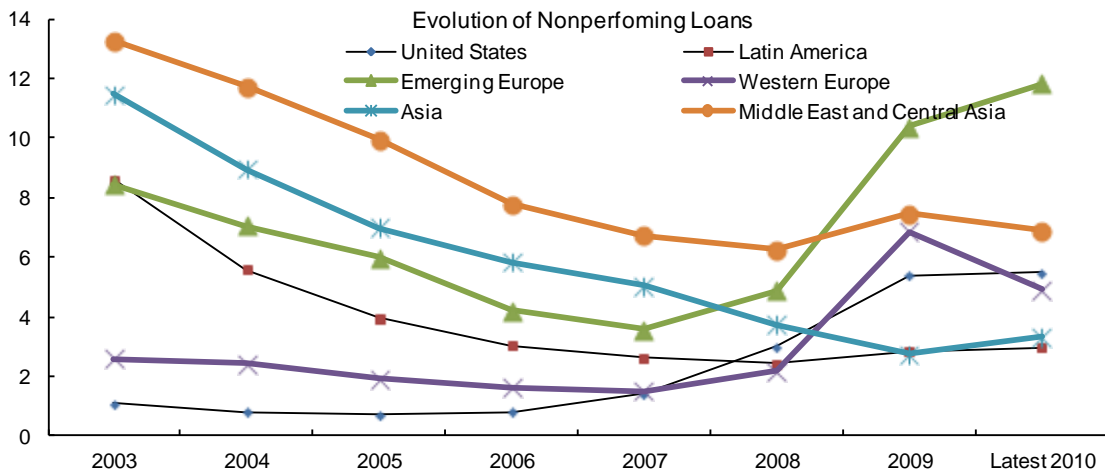
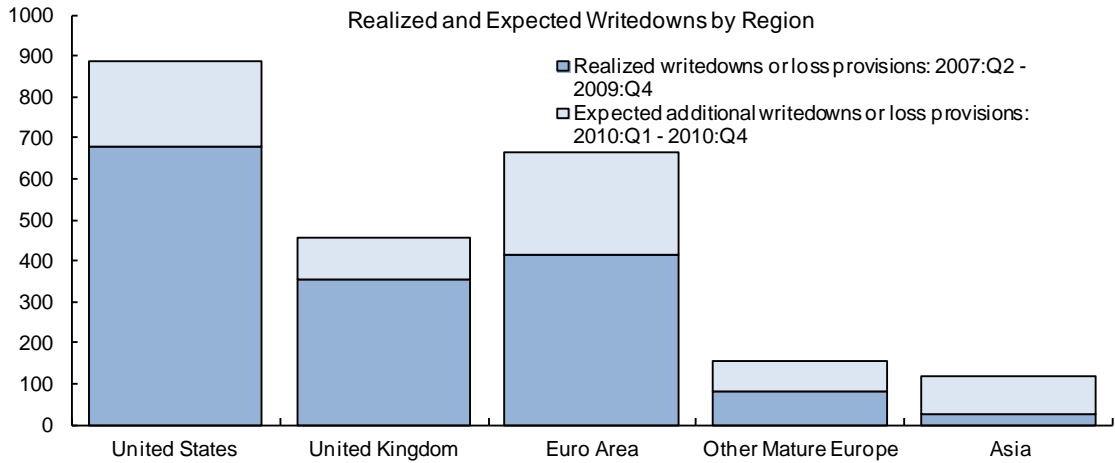
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<sup>2</sup> Chen *et al.* (2010) find a two-way causality between bank and corporate distress and to significant global macroeconomic and financial spillovers from either type of distress when it originates in a systemically important economy.

<sup>3</sup> See Stone (2000) and Classens *et al.* (1999) for a description of cross-country widespread corporate debt restructuring in Latin America and Asian crisis.

<sup>4</sup> See Table 1.2 in Global Financial Stability Report, April 2010.

Figure 1. Evolution of Nonperforming Loans



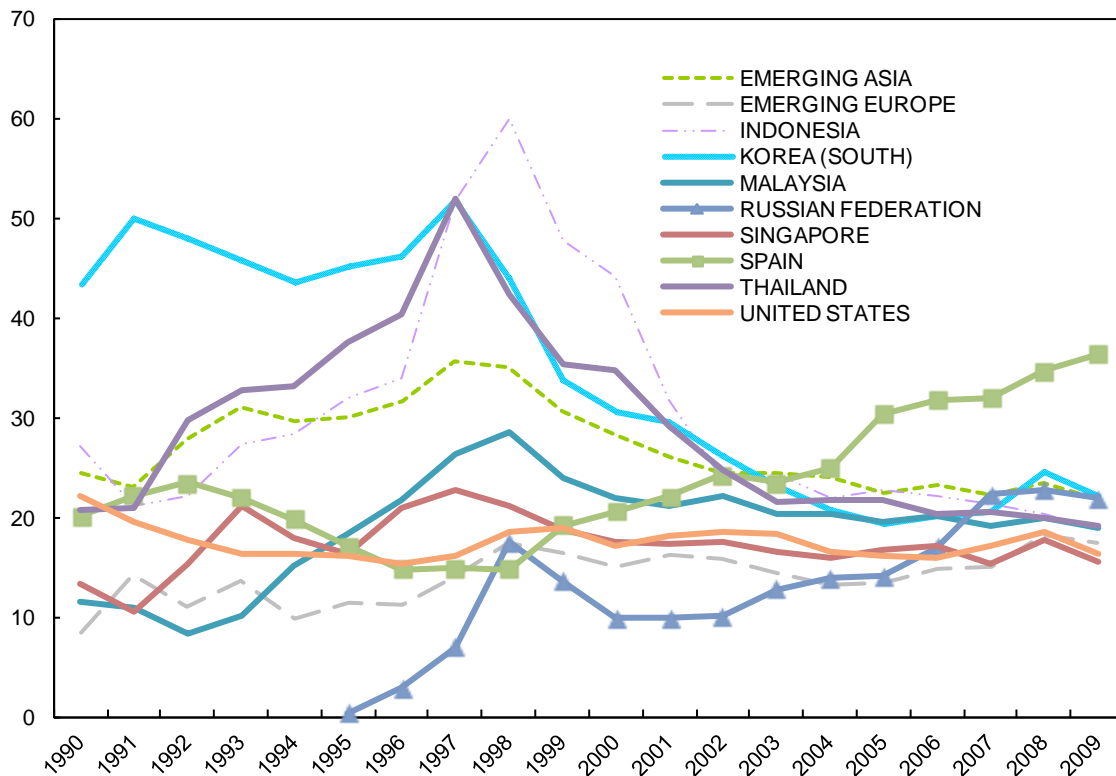
Source: IMF (2010b) and country sources.

\* Due to differences in national accounting, taxation, and supervisory regimes, the level of NPL data are not strictly comparable across countries. The National Bank of Ukraine's approach to the loan portfolio classification is stricter than in other countries and Ukraine's NPLs represent loans classified as substandard (including those timely serviced), doubtful, and loss.

interventions and the underlying patterns. These countries differed in their approaches to handling the corporate debt distress and have employed both direct (i.e., budget-to-corporates) as well as the indirect (i.e., budget-to-banks-to-corporates) assistance methods to addressing them. Those that did not have previous experience with handling large-scale corporate distress also embarked on the reform of the legal, tax, and regulatory foundations for speedy and orderly restructuring. The scale of government interventions adopted in response to corporate debt problems mainly reflected the differences in the scope of the debt problem, the nature of the corporations involved, and the type of the debt observed across countries.

We find that wide-scale corporate debt restructuring as seen during the Asian crisis has so far been avoided. One potential reason could be that corporate sectors across countries were less leveraged prior to 2008 compared to 1997. Figure 2 reveals that, with the exception of Spain and Russia, the leverage ratios across countries have declined since the Asian crisis. While the scale of the problem remains smaller than that during the Asian crisis, conditions may deteriorate further. Corporate debt problems tend to lag a crisis by one to two years as the effects of crisis trickle down the economy and protracted recession dries up corporation's ability to service debt. This might particularly be the case in countries where the rate of NPL growth is accelerating to alarming levels making further state interventions likely down the road.

Figure 2. Corporate Sector Leverage in Recent Crises



Source: IMF staff estimates based on data from publicly traded companies.  
Median of debt to asset ratio of listed firms.

We also find that the cost of corporate sector bailout in some sample countries rivals those of the financial sector bailouts (see Appendix for details). Such costs have contributed to

heightened sovereign risk and brought debt sustainability considerations forward. This highlights the importance of adequate monitoring of risks for the government's balance sheet stemming from the corporate sector and the need for contingency planning.

In terms of modalities of intervention, we observe that all countries in our sample except the United States, although to varying degrees, undertook reforms of their insolvency law in order to streamline and expedite market-based corporate restructuring. When fiscal costs were involved they tended to be incurred through the extension of direct loans to and recapitalization of (state-owned) enterprises. This contrasted with the approach employed during the Asian crisis that had a much wider use of the Asset Management Companies for debt resolution.

The paper is organized as follows. Section II discusses the rationale, general principles, and modalities of government intervention and offers an in-depth discussion of the role of the financial sector and asset management companies in corporate debt workout. Considerations for the financial system are discussed and lessons from restructuring in previous crises are drawn. Section III offers a detailed discussion on studies of restructuring efforts in the above countries. Inferences are drawn based on the cases discussed but also against the background information from previous crises. Finally, Section IV summarizes our findings and draws conclusions for possible future government intervention in similar situations. Our findings are tabulated in the Appendix.

## **II. RATIONALE FOR AND MODALITIES OF CORPORATE DEBT RESTRUCTURING**

### **A. General Considerations**

The objective of corporate debt restructuring is a timely and orderly restructuring of corporate liabilities with a view to restoring the corporations' operation and financial viability. To achieve these objectives, debt restructuring can take the form of a rescheduling of repayment, a change in interest rate, a change in the currency denomination of the debt, or reducing the principal of the debt. Accordingly, it may or may not imply a change in the present value of debt but often provides some much-needed breathing room for corporations (such as, flow rescheduling). To the extent that a restructuring results in a reduction of NPV of debt, this poses risks to the creditors. Depending on the size of the reduction, restructuring corporate debt could potentially lead to a breach of regulatory norms by the creditor, its bankruptcy, and/or a push to merge.

In cases where the number of troubled corporations is small, their potential macroeconomic importance is limited and the financial system is sound, the rationale for government's involvement in corporate debt workouts is weak. In contrast, when corporate debt problems are widespread, with potentially sizable macroeconomic consequences, and market failures inhibit debt workouts on the required scale, a comprehensive approach involving government could be warranted.<sup>5</sup> In these cases, however, the framework of such involvement needs to be carefully defined. That choice typically involves weighing the costs of intervention against the need for a

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<sup>5</sup> Laryea (2010) and Stone (2000) discuss various bottlenecks and market failures that inhibit debt restructuring. For example, court capacity to handle large number of cases can be limited even in efficient legal systems. Attrition problems can plague voluntary loan workouts, with delays that are optimal for the individual negotiators but not for the economy as a whole.

speedy restructuring. The costs are not limited to the direct financial ones, and include indirect economic costs that could eventually appear from both action and inaction of the government.

Governments' specific role in an effective corporate debt restructuring process typically includes provision of: (1) appropriate legal foundations; (2) mediation and incentives for out-of-court resolutions; (3) direct financing; and (4) facilitation of restructuring by, for example, setting up Asset Management Companies. We discuss the foundations of, and the rationale for, these types of interventions in the remainder of this section.

Large scale debt workouts may require an overhaul of the legal framework and corresponding enforcement mechanisms. A workable insolvency law is essential for giving the sides incentives to cooperate. The government has a role to introduce or amend such a law to spur and start debt restructuring if the current framework is deficient. During the Asian crisis, some countries adopted frameworks to facilitate and encourage corporate restructuring that include using new bankruptcy provisions as an incentive for creditors and debtors to negotiate.

**Government's involvement as a mediator** is normally warranted if the court or administrator system is weak, if there are market failures or legal impediments inhibiting banks from effectively leading debt restructuring, sharing information, and forming a common strategy. Such factors include lack of cooperation and excessive negotiating power by debtors or creditors. Experience in several countries demonstrates that the government can play a constructive, yet informal role in facilitating an orderly workout of debts (the "London approach").<sup>6</sup>

**Direct government financial assistance** to facilitate debt restructuring is generally observed in cases where debt problems are pervasive and impose negative externalities on the economy. The incentives may include compensation to creditors for lengthening the maturities or providing guarantees for corporate loans. This approach was common in Latin American restructurings in the 1980s.<sup>7</sup> Sometimes, such support also includes direct lending to companies that are viable but are unable to access markets on their own. In addition to direct assistance to corporations, governments may provide indirect support to the corporate sector via assistance with bank recapitalization and liquidity provision. This approach is often used when corporate debt problems cause deterioration in bank balance sheets and affect the provision of credit, and reduce banks' capacity for debt restructuring. Cases include Chile (1981–83); Mexico (1995–97); Poland (1993); and more recently Russia, Ukraine, and Dubai.

**Asset Management Companies (AMCs)** have been used to spearhead the restructuring of corporate debt with a view to maximizing recovery of viable firms and supporting the viability

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<sup>6</sup> The "London Approach" refers to the approach taken by Bank of England during the U.K. recession of 1970, encouraging creditors and debtors to adopt a coordinated approach to the following principles: (i) minimizing losses to creditors; (ii) avoiding liquidation of viable debtors; and (iii) continuing financial support to viable debtors in out-of-court restructuring agreements. The approach is not enshrined formally to avoid excess legality and maintain flexibility and adaptability. Bank of England played the role of a broker in resolving disputes between the participating creditors. The approach was implemented in over 160 cases during 1987-97 in the U.K. Modifications of this approach have been implemented during the Asian crisis (see Stone, 2000, and Mako, 2001).

<sup>7</sup> For example, Chile and Mexico provided incentives/subsidies for banks to restructure and convert dollar-denominated debt into longer maturity local currency debt (Stone, 2000).



of the banking sector (Box 1). These companies, which could be private, public or a private-public partnership, can buy bad loans and provide equity to banks and corporations. The debt taken by such corporations can be converted to equity and eventually sold to the public. These corporations enjoy economies of scale in debt restructuring, facilitate the debtor-creditor negotiation and can develop secondary debt markets. They were prevalent in varying degrees during the Asian crisis (e.g., Indonesia, Malaysia, Korea, and Thailand), and also in Mexico during 1995–97.

Country experiences with wide-scale corporate debt restructuring in the past have been mixed and have involved lengthy and difficult processes.<sup>8</sup> While outcomes varied by country, the past experience indicates that a properly designed strategy would generally make the best use of limited fiscal resources, target interventions where needed most, leverage market-based solutions and private resources, bolster credit enforcement and insolvency laws, and preserve credit culture.

Tailoring a corporate debt restructuring strategy to individual country circumstances is a complex process involving attention to a number of key factors: (i) policy coordination; (ii) analysis of data to assess the dimensions of the debt problem; (iii) reform of the legal and institutional framework for enforcement of credit, particularly the corporate insolvency law; (iv) facilitation of out-of-court restructurings; (v) facilitation of voluntary standstills; (vi) identifying the rationale for government financing; (vii) consideration of different treatment for SMEs; and (viii) coordination with financial sector restructuring, particularly with respect to banks.<sup>9</sup>

## **B. The Role of the Banking Sector**

Despite the fact that typically a variety of creditor types are involved in corporate sector debt restructuring, rehabilitation of the banking sector remains a key priority for a corporate debt crisis containment and resolution. While a corporate debt workout is in the longer-term interest of banks, they must first support their own viability and establish loss absorption capacity prior to engaging in corporate debt workouts. The drain on bank capital due to the first wave of a crisis, coupled with the existence of a number of creditors that require some degree of debt restructuring, may lead to curtailment in lending (to both viable and nonviable firms) thus exacerbating the impact of the crisis.<sup>10</sup> Weaknesses in the banking sector could prolong the restructuring of the corporate debt: the weaker the banks are the less likely that the corporations will negotiate to restructure their distressed debt as they may expect to be better off negotiating with failed rather than operating banks. This may in part explain the appearance of strategic corporate loan defaulters in time of banking distress.

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<sup>8</sup> See Mako (2003) and Classens *et al.* (1999) for example.

<sup>9</sup> Laryea (2009) provides an in-depth discussion of these elements.

<sup>10</sup> Franks and Sussman (2005) show evidence of this for a large sample of debt workouts between U.K. banks and corporations. For similar lessons from the Mexican experience, see also Krueger and Tornell (1999).

### Box 1. Types of AMCs

In terms of their institutional structure, AMCs could be government-sponsored, private or hybrid. In general, the choice of a particular structure depends on a number of factors, including types of assets, magnitude of the problem, depth of markets, and characteristics of debtors (see Ingves *et al.*, 2004).

Experience with government-sponsored AMCs has been mixed due to difficulties in balancing their conflicting public and market objectives. In particular, the governance structure that ensures independence of its operations, freedom from political interference, and accountability for the AMC's performance can be a difficult challenge. The effectiveness of government-sponsored AMCs is enhanced by subjecting their operation to clear sunset clauses. The case for government-sponsored AMCs is relatively stronger when the size of the debt restructuring problem is acute relative to the capacity of the private sector or special legal powers are needed to promote debt restructuring.<sup>1</sup> While government sponsorship may enhance the AMC's ability to resolve debt disputes quickly, it can be politically contentious and the use of special legal powers may distort the system of property rights.<sup>2</sup> In addition, government-run AMCs could be disadvantaged in that private information about the borrower may be lost (or difficult to transfer) when the assets are moved to the AMC.

Private AMCs, particularly where compensation structures are aligned to maximizing value in the recovered assets, tend to execute their functions more efficiently. Notwithstanding some of the attractive features of private AMCs, funding for such operations can be constrained during or following crises. Moreover in some cases close collaboration with financial regulators or government is beneficial (e.g., where the creditor bank is under resolution or when the debtor is a large strategic company). An innovative way of approaching asset management could be through hybrid public-private AMCs, leveraging both public and private resources and expertise.<sup>3</sup>

AMCs have proved relatively more effective in corporate debt restructuring episodes when there are a large number of troubled corporations, relatively homogeneous loans, or where AMCs bring specific restructuring expertise unavailable in the banks. Openness to leveraging international technical expertise to bolster local experience is also a comparative lesson for the effective use of AMCs.<sup>4</sup>

Thus far in the current crisis, reliance on AMCs has been limited.<sup>5</sup> However, some countries have established broader asset management programs (IMF, 2009b), including programs directed to removing distressed assets out of the balance sheets of banks,<sup>6</sup> while other programs have entailed guaranteeing high quality assets to support bank liquidity.<sup>7</sup>

<sup>1</sup> According government-sponsored AMCs with such special legal powers may be warranted in cases where the legal framework for the enforcement of creditors' rights is inherently weak or has been rendered dysfunctional by the effects of the systemic crisis.

<sup>2</sup> At a minimum, the granting of special legal powers should be temporary, fully transparent, and subject to proper oversight and mechanisms for judicial review.

<sup>3</sup> Examples are the recent initiatives to establish the Industrial Revitalization Corporation of Japan and the International Finance Corporation's Distressed Assets Recovery program, which raised funding and expertise for asset recovery efforts from both public and private sources.

<sup>4</sup> In a comparative study of AMCs in seven country cases (Finland, Ghana, Mexico, the Philippines, Spain and Sweden), Klingebiel (2000) concludes that the Swedish AMC was relatively more successful as an agent of corporate debt restructuring due to the some special circumstances: the assets acquired were mostly real estate related (which tend to be easier to restructure than manufacturing assets), and were a small fraction of the banking system which made it easier for the AMC to maintain its independence from political pressures and to sell assets back to the private sector.

<sup>5</sup> Ireland has recently established the National Asset Management Agency, a government-sponsored AMC primarily dedicated to property development loans; Germany established special purpose vehicles to take on

illiquid structured assets and “bad bank” public entities to deal with risky assets and non-essential business operations; and Iceland has enacted legislation to enable establishment of a government-sponsored AMC to support restructuring of nationally significant firms.

<sup>6</sup> For example, the public Private Investment Program in the United States.

<sup>7</sup> For example, the announced asset management programs in Australia, Canada, and Japan. In contrast, the U.K. Asset Protection Scheme is a guarantee scheme targeting losses on risky assets.

Banks tend to prefer a market-based approach of debt restructuring in order to avoid costly and slow court-based bankruptcy procedures.<sup>11</sup> However, in a systemic crisis, the incentives of the banks alone are not always sufficient to secure a speedy and efficient restructuring of corporate debt. Coordination failures and externalities may inhibit progress. An example of a failure to achieve an efficient outcome is related to the degree of concentration of ownership claims. Dispersed claim holding by the banks makes it harder for the borrower to negotiate better terms and may lead to asset grabbing and creditor runs. Concentrated claim holding, on the other hand, may result in the bank losing interest in the going concern value of the corporate debtor and liquidating it prematurely in order to ensure better recovery of the value of the loan. In addition, corporate debt restructuring could be more challenging in cases with material presence of non-bank financial institutions, such as hedge funds, with differing incentives from those of banks that could complicate the coordination of creditor action. Government’s intervention in securing the availability of resources and the right set of institutional arrangements for negotiating parties is, therefore, commonly required.

Bank recapitalization, involving some use of public funds, has been a common feature to restore capital depleted by widespread corporate defaults and to allow banks to take longer term rational decisions on corporate debt restructuring.<sup>12</sup> In some cases, the injection of public funds was made conditional upon some degree of banks’ progress in corporate debt restructuring (IMF, 2009a). This type of conditionality could be considered in general, provided that their introduction does not delay bank restructuring.

Some additional government measures to promote bank restructuring and support the role of banks in corporate debt restructuring include:

- Government support for setting up specialized advisory and investment banking services to facilitate negotiations between banks and corporations and minimize coordination problems;<sup>13</sup>

<sup>11</sup> Costs associated with diverting management time and effort away from running the firm, among other agency costs related to bankruptcy, have been highlighted by Jensen and Meckling (1976).

<sup>12</sup> All nine corporate debt restructuring studied by Stone (2000) included some government-sponsored bank recapitalization: Chile, 1981; Hungary, 1991; Indonesia, 1997; Korea, 1997; Malaysia, 1997; Mexico, 1981; Mexico, 1995; Poland, 1993; and Thailand, 1997. Indecisive action in the recognition of losses and recapitalization of banks has been a factor cited as prolonging the debt adjustment process in Japan during the 1990s (Claessens, Djankov, and Klingebiel, 1999).

<sup>13</sup> An example is the Corporate Debt Restructuring Committee (CDRAC) in Thailand. In principle, such government support could be through establishing government advisory agencies or providing financial support to present or new entrant private financial institutions offering specialized investment banking services.

- Offering tax and other financial incentives to banks (including to AMCs) to expedite out-of-court debt restructuring;<sup>14</sup>
- Enhance transparency (by using supervisory powers to require banks to disclose claims to relevant negotiating parties) to speed up debt negotiations;
- Ensuring enforcement of existing NPL classification and other regulatory guidelines to strengthen the banks' incentives to participate in debt restructuring;
- Defining a clear and concise timetable for various stages of the debt workout process. To achieve maximum participation from both sides and minimum disruption along the way, supervisory penalties for non-compliance could be imposed.

In the context of the current crisis, the cross-border dimensions of bank operations may complicate the design and implementation of government intervention. Capacity to exercise regulatory suasion over foreign banks and their affiliates may be limited. Where public financial support to the banking system is related to debt restructuring programs relieving the industrial or household sectors in one country, sharing these costs among governments can present a challenge. Although a greater share of foreign-owned banks may in effect result in a greater share of the adjustment burden being borne by foreign creditors, strategies that intentionally target foreign creditors should be avoided in view of the negative effects on access to international credit and investment, which could be needed to sustain economic recovery. However, the presence of foreign participants in the banking system can in certain circumstances support a corporate debt restructuring by enhancing financial resources and technical expertise that can be put into the debt restructuring effort.<sup>15</sup>

### **III. SELECTED RECENT DEBT RESTRUCTURING CASES**

This section reviews corporate debt restructuring in countries mentioned above in the aftermath of the recent financial crisis. It should be noted that developments in these cases are still unfolding, making the overall assessment conditional upon the final outcome.

#### **A. Russian Federation**

##### **Background**

In the wake of the global financial crisis, the Russian economy was hit hard by dual shocks (IMF, 2009b). The two key external drivers of Russia's prolonged boom—rapidly rising oil prices and massive capital inflows—reversed sharply in summer 2008 triggering an abrupt contraction in domestic demand. Investment plummeted, shattering the nexus of high growth in investment, productivity, and real wages that had powered consumption and the economic

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<sup>14</sup> Attaining a low-interest rate environment could have similar implications to providing government-subsidized loans to banks to facilitate the debt workout.

<sup>15</sup> In this respect, the presence of foreign banks in the Latvian banking sector appears to support the relative prospects of corporate debt restructuring in that country.

boom, bringing real GDP sharply down in 2009. Although rising oil prices and renewed capital inflows have provided some support to the ruble in 2010, the economy remains weak.

Troubles for the corporate sector began in the second half of 2008, when declining oil prices reversed exchange rate expectations, leading to ruble depreciation. This, in turn, brought about a massive drive by the highly indebted corporate sector (which had accumulated large sums of foreign currency debt during the boom years) to hedge foreign currency exposure.<sup>16</sup> Capital outflows, which reached \$131 billion in the fourth quarter, took various forms including shifts from ruble to foreign currency deposits and foreign debt repayments by the nonbank corporate sector.

As a result of higher unemployment and weaker demand, many companies have posted losses and faced difficulties in servicing their debt. Corporate NPLs doubled between September 2008 and March 2009 and are expected to continue to grow (Figure 2). Refinancing became a major obstacle for the corporations' liability management.

### **Policy response**

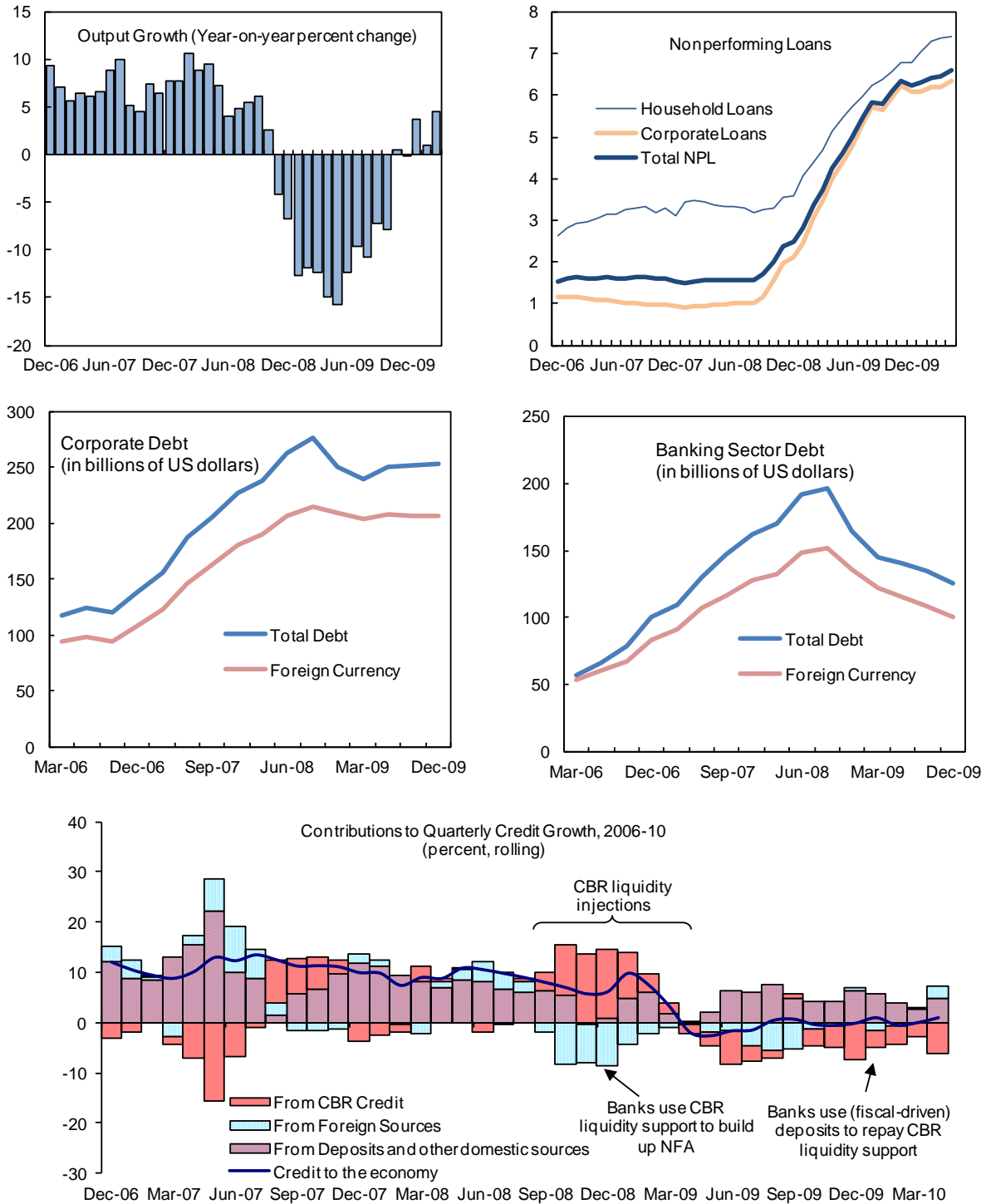
In the initial phase of the crisis, the authorities focused on containing the crisis through stabilizing the banking sector and maintaining exchange rate stability. To achieve these goals, the Central Bank of Russia (CBR) intervened heavily to manage the ruble's decline.<sup>17</sup> Moreover, CBR and Ministry of Finance introduced a range of liquidity, asset purchase, and recapitalization schemes to the banking sector to provide liquidity and cushion the reduced

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<sup>16</sup> The amount of corporate debt had more than doubled in two years reaching a peak of \$276 billion dollars in September 2008 (Figure 3). Throughout this growth, the share of foreign currency denominated debt had consistently remained high at around 80 percent of total debt. This made the firms highly vulnerable to large swings in the exchange rate.

<sup>17</sup> CBR interventions resulted in foreign reserves dropping by more than US\$200bn between their peak in August 2008 and early-2009. The CBR backed this up with interest rate increases in early February 2009.

Figure 3. Russian Federation: Credit and NPLs



Source: Central bank of Russia; Rosstat; and IMF staff calculations

access to external markets. The support measures stabilized the banking system in the early stages of the crisis. However, as output continued to drop, NPLs in the household and corporate sectors grew increasingly. Responding to growing NPLs, CBR introduced forbearance by easing loan classification and provisioning requirements in order to boost banks' abilities to absorb losses, restructure loans, and extend credit.

The government's plans to address corporate sector problems have been multifaceted and have evolved in the course of the crisis. At the outset, the government set up facilities to help select large companies who had become unable to rollover their large external debts. These companies (both state- and privately-owned) were deemed strategically important for the economy and employment. Later on, the government shifted to a more comprehensive approach to provide support for all companies through loans, tax cuts, and subsidies. In addition, corporate law was amended to encourage debt restructuring.

In October 2008, with the enactment of the federal law "On Additional Measures for Supporting the Financial System of the Russian Federation", the state-owned Vnesheconombank (VEB) became a key instrument in the governments' crisis management plans via two major lines. One was to extend direct foreign currency loans to strategic companies that had difficulty in servicing their foreign currency debt. The other was to provide banks with unsecured subordinated loans in order to boost the capital of banks against increasing NPLs as well as provide them with liquidity.

Drawing from CBR funds deposited at VEB, the VEB extended foreign currency loans to companies for servicing foreign currency debt, which they obtained from foreign financial institutions prior to September 25, 2008. The loans ranged from \$100 million to \$4.5 billion carrying an interest rate of at least at LIBOR+5 percent. By end-2008, the volume of the loans extended for refinancing indebtedness owed to foreign creditors reached \$9.8 billion, with the total reaching \$14.3 billion by June 2010.<sup>18</sup>

The first tranches of VEB loans under the government support scheme were extended to large and strategic corporations that faced difficulty in accessing credit and refinancing their debt. For instance, \$4.5 billion was allocated to the aluminum giant Rusal, secured against a 25 percent stake in another metallurgical giant, Norilsk Nickel; and Alfa Group received \$2 billion against its 44 percent stake in mobile phone operator Vimpelcom. Other companies that are reported to have obtained loans from VEB include the state oil giant Rosneft (\$800 million), the partially state-owned car maker AvtoVaz, and privately-owned property group PIK (\$262 million).

The loans for refinancing debts kept the highly indebted large corporations afloat and provided them with a chance to work towards restructuring their remaining debt. In the case of Rusal, the VEB loans saved the firm from asset sales and paved the way for debt restructuring and later an initial public offering. This has also been the case for AvtoVaz and PIK group (see Box 2 for details). In some cases the extension of loans was made conditional on a business plan restructuring and/or further debt restructuring.

In addition to providing assistance to large companies, the government shifted to a more comprehensive approach of supporting the corporate sector after the initial phase of the crisis

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<sup>18</sup> See <http://www.veb.ru/en/sup/supref/> and VEB 2008 Annual Report.

was over. This included reduction in early-2009 of the corporate tax rate from 24 percent to 20 percent and the tax rate on small enterprises from 15 percent to 5 percent. Moreover, loan program schemes for small and medium-sized enterprises were set up; and by end April 2010 \$1 billion of such loans had been disbursed by VEB. Finally, insolvency legislation was amended (twice, in 2008 and again in 2009), *inter alia* to encourage reorganization and use of insolvency procedures by the debtor and unsecured creditors.<sup>19</sup>

## **Box 2. Debt Restructuring in Russia**

### ***AvtoVAZ***

AvtoVAZ, Russia's largest car company, has been struggling with low sales and debt problems since the beginning of the crisis. Sales fell from 730,000 cars in 2008 to an estimated 340,000 in 2009. Credit, which was used to finance the purchase of about half of all new cars, had disappeared as the Russian banks' access to wholesale markets dried up. Unable to service its debt of approximately \$2 billion, the company's management started actions in the summer of 2009 to restructure the company's debt and offered several scenarios to its creditors. In September, there were unsuccessful talks with the company's two main creditors, Sberbank and VEB, on the possibility of debt to equity swaps to assist the company with its liquidity problems. The company continued talks about other options for restructuring the debt.

In November 2009, two of the three main shareholders, state-owned Rostekhnologii and French car maker Renault, stepped in to help the company in a deal brokered in large measure by the Prime Minister. Renault, with a 25 percent stake in the company, announced the provision of €300 million (\$424 million) to AvtoVAZ via in-kind transfers of technology and manufacturing equipment. The Russian government agreed to increase its financial support (direct and indirect) by RUB 50 billion (\$1.67 billion). At the end of December, RUB 28 billion (\$938 million) was injected into Rostekhnologii as additional capital to be on lent to AvtoVAZ as an interest-free loan which would later be converted to a larger equity stake. The proceeds of this loan will be used to help AvtoVAZ meet its obligations to its banks.

However, the loan was to be issued only after AvtoVAZ provided the Ministry of Industry and Trade, the Ministry of Economic Development, and the Finance Ministry with an acceptable medium-term business development plan, including a prospective investment program. The conditions for the loan also included signing a mutually-acceptable debt restructuring memorandum between Rostekhnologii, AvtoVAZ, and a group of creditor banks, which included Sberbank and VTB. An agreement was reached in April 2010.

### ***PIK Group***

In April 2009, one of Russia's largest private real estate developing companies, asked creditors for a 4-month standstill on its debt of about RUB 40 billion (\$1.34 billion). The company was hit hard by the sharp decline of the local real estate bubble and had posted a \$1.1 billion loss in 2008. Its key creditors—largely Russian banks—agreed to the standstill. Afterwards, the company announced its restructuring plan, aimed at replacing most of its short term debt with maturities extending over 5 years. As part of the restructuring plan, the company was to seek an additional \$500 million to complete projects. It reached a restructuring agreement with key creditors in December 2009. It obtained a 12-month loan of \$262 million from VEB to help refinance its maturing debt and has obtained state-guarantees to borrow \$400 million from Sberbank.

<sup>19</sup> The changes include the Law No. 296-FZ amending Federal Law No. 127-FZ –“On Insolvency (Bankruptcy),” which went to effect on December 31, 2008. The Law streamlines the legal framework for bankruptcy procedures with respect to Russian companies. The amendments refer *inter alia* to the publication of information on bankruptcy, discharge of the debtor's debts by third parties, sales of the debtor's enterprise, and activities of bankruptcy administrators. More information can be found from:

[http://www.whitecase.ru/russian/index.phtml?part=update&u\\_id=508](http://www.whitecase.ru/russian/index.phtml?part=update&u_id=508).



The resources for these operations were drawn from the National Wealth Fund (NWF) as well as CBR reserves, both by and large a product of oil export revenues of the recent past. Specifically, VEB received \$50 billion of CBR reserves for on-lending, with more funds from the NWF being placed on term deposit with VEB.<sup>20</sup>

## **B. Spain: Property Development Sector**

### **Background**

After a decade of rising property values and strong growth in the real estate sector, Spain's property boom started unwinding in 2008. The construction boom was by and large funded by debt. By mid-2008, Spanish construction companies owed approximately €156 billion to banks (KPMG, 2009). Property developers had debts of approximately twice that level. Mortgages and loans to property developers accounted for over half the loan portfolio of Spanish banks.<sup>21</sup>

The crash was triggered by oversupply of residential developments, softening demand, and increased regulation of sometimes dubious developments. At the same time, the global credit crisis cut off the supply of wholesale funds to Spanish banks, restricting their lending ability, leading to higher interest rates and tighter credit conditions for banks and property developers. A large number of real estate companies, faced with shrinking revenues and tighter financial conditions, were unable to repay or refinance their debt and were forced into bankruptcy or restructuring.

Due to prudent regulation and sound supervision, the banking sector had weathered the initial impact of the global crisis well. The dynamic loan-loss provisioning introduced in 2000 provided banks with two years' worth of cushion (€24 billion). However, as NPLs are increasing the buffer is running low. The weakness is emerging also from the funding side, especially wholesale funding, with forthcoming debt amortizations of about €170 billion in 2009–10 (IMF, 2009c).

### **Policy response**

Despite a large number of corporate insolvencies, Spain's approach to corporate debt restructuring has so far been market-based. During 2008, over 1,000 properties and building companies went into insolvency, a triple increase compared with 2007. In 2009, Spain witnessed some of the largest construction companies filing for bankruptcy protection and restructuring their debt (Box 3), either in-court supervised or out-of-court workouts.

Due to large number of troubled companies, Spanish government introduced an amendment to the insolvency law in March 2009, to create incentives for creditors to participate in out-of-court restructuring procedures. Under the previous law, out-of-court restructurings were not common: 90 percent of insolvency procedures ended with the liquidation of the company, reflecting the failure of the insolvency law to provide a credible approach for restructuring over indebted but viable companies. One of the issues that had created legal uncertainty was the potential

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<sup>20</sup> As of April 2010, RUB 404 billion (\$14 billion) of NWF had been used towards loans to banking system and an additional RUB 30 billion (\$1 billion) for direct loans to SMEs.

<sup>21</sup> See Aspachs-Bracons and Rabanal (2009) for more details on housing market developments in Spain.

rescission that may affect any restructuring agreement entered into during the period prior to the declaration of insolvency. In order for creditors to participate in an out-of-court restructuring, the government viewed it essential to protect creditors if the restructuring fails and the debtor were to become insolvent.

As highlighted by Núñez-Lagos and Alonso (2009), the main amendments introduced were: (i) the possibility of reaching out-of-court refinancing agreements with no claw-back risk (except in case of fraud) when documented by notary deed with the support of creditors representing 50 percent of liabilities and a viability plan approved by an independent expert; (ii) protection of debtors in pre-insolvency negotiation of an early creditors agreement; (iii) clarification on the status of certain claims; (iv) early liquidation of any of the debtor's estate; and (v) measures to reduce costs and simplify and speed up insolvency procedures.

The procedures for resolution and restructuring of the weak banks, particularly savings banks (with their heavy exposure to real estate) are slowly and gradually taking shape. In the initial phases of the crisis, Spain's bank assistance—in line with the common framework agreed by euro-area countries—was mostly in the form of loan guarantees and purchases of illiquid bank assets. Later with the increase of NPLs and deterioration of the balance sheet in some banks, a fund for recapitalization, restructuring, and consolidation of these banks was established in June 2009. Other measures taken include: (1) raising the limit on deposit insurance from €20,000 to €100,000; (2) establishing a €30–€50 billion fund to purchase high-quality securities issued by credit institutions; (3) providing government guarantees for credit institutions' new debt issues; and (4) creating the Fund for Orderly Bank Restructuring (on June 26, 2009) to oversee the administration of failed banks.

### **Box 3. Restructuring of Spain's Largest Real Estate Companies**

**Metrovacesa**, a publicly-traded property developer headquartered in Madrid, is Spain's largest real estate company. In February 2009, following a €738 million loss in the previous year, Metrovacesa's owners were forced to hand control to its creditor banks, swapping a 55 percent stake for a cancellation of €2.1 billion of loans that it could neither repay nor refinance.

**Inmobiliaria Colonial**, a publicly traded and second largest property firm in Spain, restructured €4.9 billion in debt by using an out-of-court workout mechanism. As part of the workout, in December 2009, two private-equity groups—Colony Capital Partners and Orion Capital Managers—agreed to purchase Colonial debt from Goldman Sachs, assuming Goldman's position as the lender. Colony and Orion converted debt with a nominal value of €1 billion into Colonial shares. It is reported that Goldman had lent as much as €1.5 billion to Colonial and sold the debt to Colony and Orion for €950 million, a substantial discount. Although few details are known (none of the parties disclosed detailed terms of the transaction), analysts believe that Colonial agreed to value the debt at 100 percent in the swap so that Colony and Orion will receive steeply discounted shares in exchange, and thereby stand to profit handsomely if Colonial shares appreciate.

**Martinsa-Fadesa**, a publicly traded company with €4.9 billion of debt, filed for bankruptcy protection in July 2009, making it Spain's largest bankruptcy. Martinsa is presently working on a debt repayment plan. As of August 2009, the debt repayment plan was backed by 54 percent of its creditors, including some Spanish banks. Martinsa-Fadesa was to repay 2 percent of a syndicated loan of over €5 billion before May 2010 and 3 percent in 2011. Repayments will rise to 25 percent in 2015 and 2016.

**Sacyr Vallehermoso**, one of largest developers, is selling assets to raise cash for its debt repayment. It has sold its toll-road arm and is in negotiation to sell its holding in Repsol YPF, Spain's large oil company.

## C. Ukraine

### Background

Due to its dependence on commodity exports (e.g., steel) and external financing, the Ukrainian economy was severely hit by the financial and economic crisis (IMF, 2009d). Growth in 2009 dropped by 15 percent and access to financial markets was lost. The Ukrainian currency, hryvnya, has been one of the currencies worst affected by the global financial and economic crisis. In the six months leading to February 2009, the hryvnya lost around 45 percent of its value against the U.S. dollar, even with substantial central bank intervention and controls. Strong downward pressure on the hryvnya was intensified owing to demand from corporates to pay off external debt. The severe downturn has left many borrowers unable to pay their debts, especially those denominated in foreign currency.

The banking sector was under severe strains due to tightening of external funding and rapidly increasing nonperforming loans. With higher NPLs, banks reported losses of about UAH 27 billion (3 percent of GDP) in 2009. For some banks, the capital cushions built during the 2009 have largely been eroded, and NPLs are unlikely to have reached their peaks.

In addition to the banking sector, the financial situation of the state-owned energy company, Naftogaz, severely eroded in the aftermath of the crisis, resulting in disputes over payments to Russia and creating massive costs for the government. Naftogaz had posted losses for a while (including 2.6 percent of GDP in 2009), reflecting the gap between domestic and imported gas prices, lower-than-expected sales to industry, and a rise in non-payments by utility companies. The dispute with Russia over nonpayment of imported gas costs erupted in January, causing disruptions in the supply of Russian gas to Ukraine, as well as to the Balkans and Central Europe. It was resolved after Naftogaz repaid its outstanding debt to Gazprom, and a new 10-year gas contract was signed in early-February. The contract ended Ukraine's privileged access to Russian gas and set gas prices according to market rates.

Ukraine: Nonperforming Loan Ratios

2003	2004	2005	2006	2007	2008	2009
28.3	30	19.6	17.8	13.2	17.4	40.2

Source: IMF (2009d) and IMF (2010b)

Note: Ratios include NPLs that are classified as substandard, doubtful, and loss. The NBU's approach to the loan portfolio classification is stricter than in other countries as, in addition to servicing status, loan classification also depends on borrower's financial conditions and collateralization level.

### Policy response

Facing with severe balance of payment problems, Ukraine obtained a two-year \$16.4 billion Stand-By Arrangement from the IMF in November 2008.<sup>22</sup> The subsequent disbursements provided Ukraine with some relief to design and conduct a restructuring and resolution plan for banking and corporate sector problems.

Initial response in the second half of 2008 was focused on the banking sector through establishment of a recapitalization unit in the National Bank of Ukraine. Later in 2009, debt

<sup>22</sup> The program later went off track in late 2009 and did not fully disburse due to disagreements over fiscal issues. A new 29-months program (\$15.1 billion) was agreed in August 2010.

problems of Naftogaz came to the fore, which resulted in government involvement and assumption of some of the liabilities. At that stage, steps were also taken to improve the regulatory environment for corporate debt restructuring.

The strained and undercapitalized banking sector was an impediment for corporate debt restructuring and required prompt action. The recapitalization process initiated by the National Bank of Ukraine (NBU) included a diagnostic phase to identify capital deficiencies, recapitalization plans, and resolution mechanisms for banks unable to meet the capital requirements. The diagnostic study of systemic banks (covering 38 banks accounting for 85 percent of total assets) revealed large capital deficiencies. Subsequently, in December 2008, two state-owned banks were recapitalized, through an injection of UAH 14.4 billion (\$1.8 billion) in line with the diagnostic study results. For the private banks, the results revealed a capital deficiency of UAH 30.5 billion (\$4 billion or 3 percent of GDP). The shareholders of the private banks were required to raise additional capital. While most private banks were able to raise the required capital, some have been or will be partially taken over by the government adding to the fiscal burden of the crisis management.

To increase incentives for corporate debt restructuring, in addition to the overhaul of the banking sector, the authorities embarked on reforms to facilitate voluntary out-of-court rehabilitation, although the initiatives have not been completed yet and remain work in progress. The court supervised restructuring processes are generally long, costly, and result in unnecessary liquidations of solvent firms..<sup>23</sup>

However, the saga with Naftogaz was the highlight of corporate debt problems in Ukraine. Years of subsidized gas sales and recent high oil import prices deteriorated the finances of the company and forced the company to seek restructuring of its debt. With the involvement of government, the liabilities of Naftogaz were swapped for government guaranteed bonds worth \$1.6 billion, or 2.7 percent of GDP (Box 4). This would be comparable to recapitalization costs of the banking system that were estimated to be about 3 percent of GDP in 2009 and an expected 2.4 percent of GDP in 2010 (IMF, 2009d).<sup>24</sup>

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<sup>23</sup> In Ukraine, the court procedure for bankruptcy shows a very low rate of creditors' claim payout (9 percent on average against 28 percent in the Eastern Europe and Central Asia). Bankruptcy-related procedures absorb 42 percent of the value of the business and restoration of debtor's solvency and/or declaring him bankrupt lasts 3 years on average and leads to liquidation of 90 percent of companies involved. See "Bankruptcy System in Ukraine: Through the Past to the Future," Foundation for Effective Governance. Available at: [http://www.feg.org.ua/en/news/foundation\\_press/164.html](http://www.feg.org.ua/en/news/foundation_press/164.html).

<sup>24</sup> Bank recapitalization so far has been by and large in the form of recapitalization bonds. They were issued to the state-owned UkreximBank (UAH 4 billion, at 9 percent interest) and state-owned OschadBank (Savings Bank) (UAH 10.4 billion, at 12 percent interest) and subsequently repoed at the NBU for liquidity.

#### **Box 4. Ukraine's Naftogaz**

The finances of the state-owned gas company worsened in recent years due to higher imported gas prices from Russia and subsidized domestic gas sales. Unable to pay the principal of a \$500 million bond due on September 30, 2009, Naftogaz announced a desire to restructure the debt one week before the due date. The announcement offered to swap its \$500 million unguaranteed debt maturing in a week for fresh sovereign-guaranteed bonds with a higher 9.5 per cent coupon and five-year maturity. Investors were given a deadline of October 19 to accept or reject the offer, with modest extra incentives offered to bondholders who tendered their bonds before October 8. At the same time, Naftogaz started negotiations with its bilateral creditors to convert their loans into the new Eurobond.

On October 19, the company announced that 93 percent of the bondholders had agreed to the exchange and that the remaining bondholders would be brought in at a special bondholders meeting, as provided for in the collective action clauses of the old bond. On November 5, Naftogaz announced that it had completed the restructuring not only with its bondholders but with all its bilateral lenders as well, with the old debt being converted into a new \$1.6 billion government guaranteed Eurobond, maturing in 2014 and with an annual coupon of 9.5 percent. The company itself was restructured from a state-owned entity into a public joint-stock company with the shares owned by the government.

In light of the large fiscal risks to the government balance sheet, several steps were taken towards streamlining and operational restructuring of Naftogaz and safeguarding public funds. Government accounts were broadened to include the deficit of Naftogaz in the government deficit and SBA targets were modified. To boost the finances of Naftogaz, the authorities increased the domestic gas tariff and in addition to debt guarantee, recapitalized Naftogaz through recapitalization bonds equivalent to 2.7 percent of GDP in 2009. Finally, changes are planned in the corporate governance and accounting/reporting systems. The government commissioned an international audit firm to put in place a monitoring framework for the finances of Naftogaz and to establish a regular (monthly) and timely public reporting of key financial data.

### **D. Latvia**

#### **Background**

Latvia underwent a severe economic contraction. Real GDP declined by 4 percent in 2008 and 18 percent in 2009, with the recovery expected to start in late-2010 and into 2011. Prior to that, in 2000-07, Latvia grew at annual rate of 9 percent, making it one of the fastest growing economies not only in Europe but in the world. The growth was accompanied by huge reliance on private capital inflows. In 2006 and 2007, the current account deficit grew to more than 20 percent of GDP. Between 2005 and 2008, wages doubled. Much of the demand was channeled into property, causing a bubble in real estate prices.

The Latvian private sector was heavily indebted and large FX exposures existed both in the banking and corporate sector. The largest share of debt is attributable to the banking system. The corporate sector has also a high level of debt, with the households being considerably less indebted. The same pecking order holds for the three sectors' share of foreign currency denominated debt. A majority of bank debt and more than one third of corporate debt are denominated in foreign currency. Household debt is mainly in the form of residential mortgages.

Corporations and households faced significant debt distress. The decline in economic activity significantly reduced the ability of private sector to repay debt. NPLs increased sharply. Between end-2008 to October 2009, loans overdue more than 90 days increased from 3.6 percent to 15 percent of total loans, almost equally distributed between the household and corporate sector.

Banks are restructuring many of these loans (by offering borrowers grace periods on principal payments, capitalization of interest and extending loan maturities) and this has created losses of about 5 percent of GDP. While easing the borrowers' cash constraints, the methods applied do not reduce the debt overhang. Banks may be reluctant to write off principal due to the impact on their capital as well as tax disincentives. For residential loans that cannot be restructured, banks have started to lease back properties to the previous owners, rather than selling collateral in the current environment.

### **Policy response**

To date, debt restructuring in Latvia has predominantly taken place in the financial sector with several bank recapitalization plans. These, however, came at a significant cost, estimated at 4 percent of GDP in 2008 and an estimated 7–8 percent of GDP each year until 2012 (IMF, 2010a). With the continued rise of NPLs, the banking system remains fragile and its stability depends upon the continued involvement of the largest foreign banks that account for around 55 percent of bank assets. They agreed to maintain their exposure to Latvia and are committed to providing capital and liquidity to their subsidiaries in compliance with regulatory limits.

The approach to corporate debt restructuring has been market-based with the government facilitation through improvement in the insolvency law and incentivizing out-of-court restructuring. Companies typically lack experience in restructuring, with inadequacies in accounting and recording standards generally hindering restructuring. In August 2009, a committee consisting of all stakeholders including ministry of Justice issued guidelines for out-of-court restructuring in line with international standards. Moreover, amendments to the Insolvency Law and other credit enforcement laws have been approved by the parliament to help streamline liquidation procedures, support rehabilitation of debtors, and facilitate speedy debt resolution. A public campaign was launched in July 2009 to communicate these changes to relevant stakeholders have.

These initiatives will help reduce the risk of debt overhang impeding the recovery. However, with the gradual increase of nonperforming loans, government fiscal involvement in corporate restructuring may be unavoidable. Moreover, companies remain highly exposed to FX risk (with gross exposure at 64 percent of GDP) with only a limited subset of corporates naturally hedged either through FX assets or through export revenue. This creates a situation where debt servicing will become increasingly difficult, should a devaluation of the national currency occur. On the other hand, if the peg holds, a combination of overvalued currency and deep and prolonged recession will also depress debt servicing capacity.

## **E. The Emirate of Dubai**

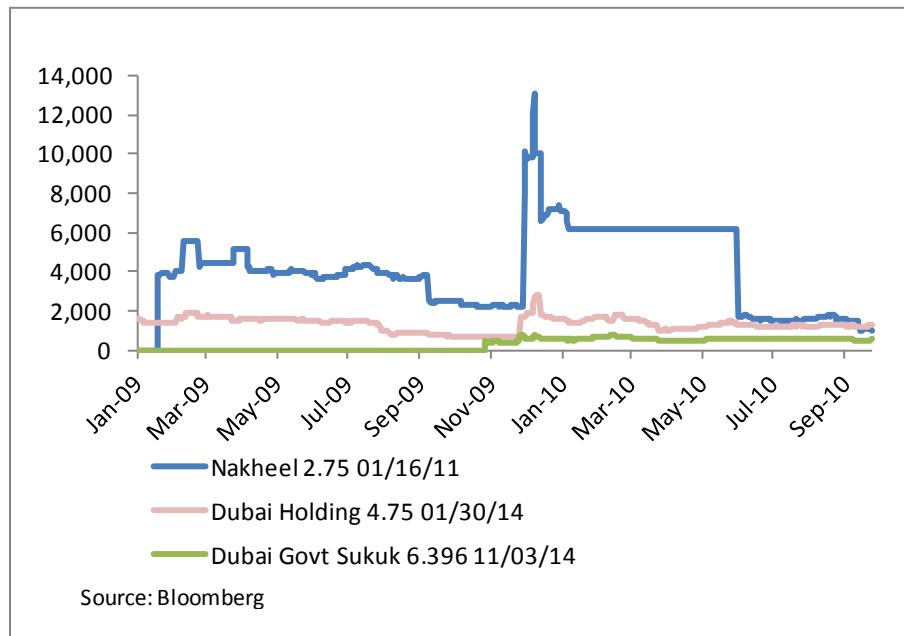
### **Background**

The economy of the U.A.E., and, particularly the Emirate of Dubai, came under strain in 2009 as the slowdown in global economic activity and tightening of financial conditions severely affected all three engines of growth of Dubai and the U.A.E. as a whole: oil sector, logistics/business services, and property development. A further blow came when Dubai World (DW), a government-related enterprise (GRE) with large real estate investments announced in November 2009 that it is seeking a standstill and restructuring of part of its debt. The surprise development put Dubai in the spotlight and disturbed global markets as investors tried to

evaluate the scope and extent of the debt problem and its spillovers within and beyond the region. Uncertainties also revolved around the health of other Dubai GREs, the extent of domestic banks' exposure to the distressed corporations, the legal terms of some of financial instruments used. Market participants were also unsure about the strength of financial support to GREs from the governments of Dubai and Abu Dhabi as well as the federal institutions.

DW's weaknesses were particularly prominent in its real estate activities. In the boom years, DW ventured into large-scale leveraged real estate developments, particularly through its Nakheel subsidiary.<sup>25</sup> DW borrowed large amounts abroad and benefited from a perception of government guarantees, where investors effectively treated their borrowing as quasi-sovereign. The spreads on Nakheel bonds shot up significantly after the standstill announcement and government's clarification that the Nakheel bonds did not have an explicit government guarantee (see Figure 4).

Figure 4. Spreads of Selected Dubai Bonds



### Policy response

UAE's policy response to the global crisis targeted the general economic slowdown. In 2008, the central bank lowered interest rates and deployed new liquidity support facilities for local banks (e.g., wider range of collateral, dollar swaps, etc.). The federal government, on the other hand, introduced a deposit insurance scheme, a 3-year guarantee on non-deposit liabilities, and rolled out a large recapitalization scheme, providing AED 50 billion (or \$13.6 billion) as

<sup>25</sup> The property boom was fueled with massive financing particularly from abroad. Between 2004 and 2008, domestic credit to the private sector as a ratio of non-oil GDP rose from 80 percent to 140 percent. The domestic credit boom was accompanied by an increase in foreign borrowing mostly through GREs. Overall foreign borrowing as a share of non-oil GDP rose from 30 percent in 2004 to about 100 percent in 2008 and the amount of debt that needed to be refinanced each year from 10 percent to 20 percent.

deposits in the banking system.<sup>26</sup> In early 2009, the central bank also subscribed to a \$10 billion bond issued by the government of Dubai. Although direct exposure of banks to real estate was limited due to prudential regulations, the indirect exposure deteriorated the overall performance of loan portfolio in aggregate. The ratio of NPLs almost doubled from 2.5 percent in June 2008 to 4.6 percent in November 2009 (Box 1; IMF, 2010c).

The policy response to the DW standstill involved further assurances (that the central bank would stand behind the banks) as well as a new loan of \$10 billion from Abu Dhabi to Dubai, allowing the latter to pay a large Nakheel bond coming due in December 2009.

The corporate restructuring so far has been limited to DW holding company and its Nakheel subsidiary. After the general initial announcement on the restructuring of \$26 billion of DW debt, several healthy subsidiaries were excluded from restructuring in subsequent announcements.

Shortly after the standstill announcement on November 25, 2009, the Ruler of Dubai issued a decree to establish a special insolvency regime to facilitate the reorganization and debt restructuring of DW and its subsidiaries. This was deemed to be necessary, as DW—a company established pursuant to a decree issued by the Ruler of Dubai—was not a normal U.A.E. company subject to insolvency frameworks in the U.A.E., namely, the federal framework or the Dubai International Financial Centre (DIFC) framework. Moreover, it was argued that subjecting Dubai World and its subsidiaries that operate under several legal regimes within the U.A.E. to a unified system would minimize the potential of applying different insolvency frameworks. While the DIFC insolvency regime is generally regarded to be broadly consistent with international standards, the federal insolvency framework has been rarely used and was not seen as suitable for complex multi-creditor insolvency proceedings. In addition, the decree also established a special tribunal to adjudicate disputes relating to debt restructuring of the DW Group (IMF, 2010c).

In addition to involvement in the legal facilitation, the government appointed a chief restructuring officer to lead the process. A restructuring plan was announced in March 2010 (Box 5). Under the plan the government will provide \$9.5 billion of new funds to DW and Nakheel in addition to \$11 billion made available previously to pay interest, provide working capital, and repay Nakheel bonds. According to the announcements, about \$20 billion of government claims would be converted to equity. To undertake such support, the government of Dubai had set up Dubai Financial Support Fund (DFSF) in early-2009, which was funded by a \$20 billion bond program. The bonds were purchased by the central bank (early 2009), and the Government of Abu Dhabi and the banks it controls (late 2009). As such, the cost to the central bank and the Government of Abu Dhabi for support of Dubai would be about \$20 billion. While it remains to be seen whether the investments will generate adequate returns, the support was provided given the strategic importance of the assets in question, reducing the risk of contagion to the wider economy and banking system and for sustaining Dubai's growth prospects in the future.

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<sup>26</sup> These deposits were subsequently converted into regulatory capital for all banks that maintained an 11 percent Tier-1 capital ratio. Several banks received direct injection of Tier-1 capital from their respective emirates' governments.



### **Box 5. Restructuring of Dubai World and Nakheel**

On March 25, 2010, four months after the standstill announcement, Dubai World (DW) and its subsidiary, Nakheel, announced the submission of their restructuring proposals to the creditors. The announcements outlined the principles of the proposal but did not offer much detail on the financial side. In the months that followed, DW worked with creditors to secure their buy-in. On October 27, 2010 Dubai World announced complete support of its creditors. Nakheel is still progressing towards its target participation rate. We summarize the details of the restructuring plans below.

**Dubai World Holding:** The restructuring covers financial debt of \$24.9, of which \$14.4 billion is owed to some 90 banks abroad and in U.A.E, with the balance owed to the government of Dubai. Banks were asked for maturity extension and large interest reductions. The \$14.4 billion debt is divided into two tranches: a \$4.4 billion tranche with a 5 year maturity and 1 percent interest, and a \$10.0 billion tranche with 8 year maturity, 1 percent interest paid each year, an additional payment of 1.5 to 2.5 percent upon maturity, and a shortfall guarantee by the Government of Dubai between \$1 and 4 billion. There are various further options on the 5 and 8 year tranches depending on whether the loans are in dollars or AED, and the mix between shortfall guarantee and interest at maturity. It is proposed that the government of Dubai, acting through DFSF, will convert its share of claims (\$10.5 billion) into equity. In addition, the DFSF is committed to providing new funds up to \$1.5 billion to Dubai World for the company's working capital and interest payments.

**Nakheel:** Under the plan announced in May 2010, the government (again, through DFSF) will provide \$8 billion new equity to Nakheel (subject to a successful restructuring) and convert its existing \$1.2 billion debt into equity. The new funds will be mostly used to complete the construction of existing projects. Those customers who invested in long term projects through down payments can swap into near-completing projects, a credit towards land/property during a 5-year period, or cash (without accrued interest) at the end of the period. Trade creditors and suppliers will be paid off with a combination of 40 percent and 60 percent of cash and publicly traded security with 10 percent annual interest rate, respectively. The remaining Nakheel bonds will be paid off in full and on time. The remaining bank creditors will receive principal and accrued interest through maturity extension at commercial rates. Payments to trade creditors began disbursing in September and discussions with banks are underway. Nakheel is expected to complete the restructuring by end-2010 and be separated from Dubai World to become a direct holding of government of Dubai.

## **F. United States Auto Industry**

### **Background**

The automotive industry in the United States (and Canada) represents an example of bailout of large and strategically important corporations in the advanced economies where in normal times government ownership and financial support of corporations is rare. The U.S. Treasury created the Automotive Industry Financial Program (AIFP) in December 2008, in order to avoid a significant disruption of the U.S. automotive industry due to the risk that such a disruption could pose to financial market stability and the broader U.S. economy. Due to linkages with the auto industry in Canada, the governments of Canada and the province of Ontario also provided financial support to subsidiaries of the U.S. automakers in Canada to avoid decline in manufacturing output and employment.

The situation at the three major auto companies—General Motors, Chrysler, and Ford, known as the Big Three—had been getting bleaker for some time. For a decade, the companies had been losing market share to importers and struggling with high labor and pension costs. The financial crisis made the credit conditions for these companies very tight and eventually forced two of

them into bankruptcy. Overall, sales dropped by 18 percent between 2007 and 2008, with sales of SUVs plunging about 40 percent.<sup>27</sup>

In November 2008, as economic conditions deteriorated, the Big Three appealed to the government for financial aid. The rationale for the appeal, and the subsequent approval by the government, was that they were too big to fail: the Big Three accounted for almost 50 percent of sales in the United States in 2008 and directly employed 240,000 workers (CRS, 2009). Their failures would have had a devastating impact on the overall auto industry, suppliers and the rest of the economy. According to some estimates the industry employs around 500,000 workers across the country, concentrated in a few states (e.g., representing one third of all manufacturing employment in Michigan).<sup>28</sup> The auto industry in Canada is also highly linked with that of the United States. Canada-U.S. auto trade represented 20 percent of total bilateral trade in 2007. The auto industry in Canada represents 14 percent of the country's manufacturing output and employs 150,000 workers (Brunel and Hufbauer, 2009).

### **Policy response**

In September, 2008 the Big Three applied for \$50 billion to pay for health care expenses and avoid bankruptcy and ensuing layoffs. A bill to provide up to \$25 billion in direct loans to auto companies was introduced in November 2008, which, however, did not get a passing vote in Senate (CRS, 2009).

On December 19, President Bush approved \$17.4 billion in emergency bailout funds from TARP for GM (\$13.4 billion) and Chrysler (\$4 billion), subject to oversight conditions. These funds were disbursed during the final days of 2008 and in early-2009. The two automakers had testified before Congress that if they did not receive federal financial assistance before the end of the year, they could be forced into bankruptcy. Ford did not require such assistance. The Bush Administration also loaned a further \$5 billion under the TARP for General Motors Acceptance Corporation (GMAC) and \$1.5 billion for Chrysler Financial, the two manufacturers' respective credit affiliates.<sup>29</sup>

The Loan and Security Agreement of December 31, 2008 between Chrysler and General Motors Corporation (individually) and the Treasury Department laid out conditions for access, including submission of a restructuring plan. Upon the receipt of these plans, a Task Force was formed in February 2009 with an objective to review the plans and make specific recommendations to the President regarding the way forward, including as pertaining to access to funds. On March 30, 2010, the Task Force issued an assessment stating that the submitted plans were not sufficient to put companies on viability path, and that the government will work

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<sup>27</sup> For more details on production volumes and market shares across categories and manufacturers, see Table 1 and related discussion in CRS (2009).

<sup>28</sup> "Treasury Announces Auto Supplier Support Program: Program Will Aid Critical Sector of American Economy," US Treasury Department Press Release, March 19, 2009. Available at: <http://www.ustreas.gov/press/releases/tg64.htm>.

<sup>29</sup> For a detailed list of loan and equity investments in the auto industry, see the table on Automotive Industry Financing Programming in the latest TARP Transaction Report. Available at: <http://financialstability.gov/latest/reportsanddocs.html>.

with congress on further actions.<sup>30</sup> The prospects of avoiding bankruptcy by these companies were further reduced as the updated 2008 statements (showing larger-than-expected losses) were issued. Ultimately both Chrysler and General Motors filed for bankruptcy (Box 6).

The difficulties in the automotive sector have had significant impacts on government finances. Since December 2008, the U.S. government has provided about \$81 billion (\$67 billion net as of October 2010) in loans and equity investments to the two stressed auto manufacturers and the auto-finance company GMAC, which has not filed for bankruptcy.<sup>31</sup> The governments of Canada and Ontario have provided \$2.4 billion to support the restructuring of Chrysler Canada and have offered \$9.5 billion to support GM, which has a major subsidiary in Canada.

### Box 6. U.S. Car Industry

The need to address the long-term structural weaknesses became more evident as the estimates of the financial needs grew and the industry's conditions eroded further with the deepening of the financial crisis. These developments ultimately forced Chrysler and GM to file for bankruptcy protection. *Chrysler* filed for Chapter 11 bankruptcy protections on April 30, 2009. The case was completed on June 10, 2009, with the United Auto Workers' retirees' medical trust and Fiat owning major shares in the reorganized Chrysler, and the United States and Canadian governments retaining small stakes. On June 1, 2009, *General Motors* filed for Chapter 11 bankruptcy proceedings, which were completed on July 10, with U.S. government investing a total of US\$49.5 billion under the TARP.<sup>32</sup> This resulted in the following ownership structure for GM: U.S. Treasury (61 percent), United Auto Workers Union (17.5 percent), the Canada Development Investment Corporation (7.9 percent), the government of Ontario (3.8 percent), and the bond holders of the Motors Liquidation Company (9.8 percent). *Ford*, which entered the crisis in a somewhat stronger financial position, did not avail itself of government loans, but undertook an out-of-court debt restructuring and labor negotiations and raised equity through a share sale in May 2009.

While the largest in size, the financial assistance to GM and Chrysler was not the only federal aid given to the auto industry in 2009. Other forms of direct and indirect assistance to these companies and/or the auto industry in general include: "Cash for Clunkers" program, dealer financing and warranty protection, supplier assistance, financial support for alternative fuels and advanced technology vehicles (see CRS, 2010 for further details).

The prospects for recouping such costs depend on the success of the companies' operational restructuring and financial performance. GM returned to profitability in the first quarter of 2010 for the first time in three years, with net earnings of \$865 million. Later in April, the company announced that it had repaid the \$8.1 billion direct loan portion of \$60 billion in aid it received from the U.S. and Canadian governments. The repayment of the remainder depends on a public share offering which is likely to take place by end-2010.<sup>33</sup> Chrysler posted losses in

<sup>30</sup> "GM & Chrysler," The White House Blog, March 30, 2009. Available at: <http://www.whitehouse.gov/blog/2009/03/30/gm-chrysler>.

<sup>31</sup> For a detailed list of loan and equity investments in the auto industry, see the table on Automotive Industry Financing Programming in latest TARP Transaction Report. Available at: <http://financialstability.gov/latest/reportsanddocs.html>.

<sup>32</sup> "General Motors to Repurchase Treasury Preferred Stock: Cumulative Return to Taxpayers Reaches \$9.5 Billion," US Treasury Department Press Release, October 28, 2010. Available at: <http://www.treas.gov/press/releases/tg930.htm>.

<sup>33</sup> On October 28, 2010 the Treasury announced that it has accepted an offer by General Motors to repurchase its \$2.1 billion of Series A preferred stock, conditioned on the closing of the proposed initial public offering of GM's common stock. Available at: <http://www.treas.gov/press/releases/tg930.htm>.

2009 but is expected to break even in 2010. A portion of its loan matures in December 2011, with the balance due in June 2017.

#### IV. CONCLUSIONS

The paper starts with the premise that corporate debt restructuring is an important step toward recovery from a financial crisis. Due to interlinkages between the balance sheets of corporations and the financial sector, without an effective corporate debt restructuring bank lending is likely to remain constrained. This in return will slow down corporate recovery and growth prospects. We then discuss the rationale for, and modalities of, state intervention in corporate debt workouts. The role of the banking sector, as a key stakeholder in corporate debt restructuring is discussed. The paper then reviews six country cases with sizable government-facilitated corporate debt workouts.

The paper sheds some light on importance of contingent liabilities and associated risk in assessing governments' fiscal stance. This is becoming critical as more observers are now in a search for adequate measures of governments' net worth and sovereign risk. The extent of governments' (implicit or explicit) contingent risk could add a more forward looking element of fiscal challenges faced by sovereigns to the conventional measures of indebtedness (e.g., debt-to-GDP, etc.). It is important to note that protracted debt problems in one particular sector of the economy, if not properly contained, could spill over to other sectors due to ensuing weaknesses in the banking sector. This could then result in pressures to come up with direct fiscal spending to support the corporate sector but also to reduce tax rates on already weakening tax base.

The paper shows that perception of government guarantees to state-owned and strategic private entities could change the behavior of both debtors and creditors and have implications for the pricing of quasi-sovereign risk (e.g., Ukraine and Dubai). The findings also emphasize the need for contingency planning for too-big-to-fail companies—both state- and privately-owned—that have potential systemic impact. Prudent management of state-owned companies in tranquil times could help avoid counter-cyclical interventions at a time of crisis when the opportunity cost of fiscal resources is particularly high. Lessons learned from this crisis should perhaps be included in the tool box for good liability management in countries across all income groups. The specific findings of the paper are discussed in detail below.

**Origins:** Sources of corporate vulnerability were primarily related to problems with rollover of debt falling due, a large portion of which was FX-denominated (e.g., Russia and Latvia). In addition, weak business practices and corporate governance in some GREs contributed to the problem: in Ukraine, Naftogaz accumulated losses due to subsidized prices and conducting quasi-fiscal activities; in Dubai, weak risk management practices contributed to over-leveraging of the balance sheets of corporations.

**Rationale for intervention:** A key feature of the cases reported in the paper—with the exception of Spain and Latvia—is the governments' sizable support of the large and strategic companies. Such companies—both state- and privately-owned—were seen as too big to fail, that is, important either as strategic assets or for employment and social safety net considerations.

**Sequencing:** Initially, most countries focused on containing the risk of financial crisis and therefore focused on recapitalizing banks. This initial wave of recapitalizations was not linked to corporate distress: corporate problems emerge with a lag. As credit tightened and corporate debt problems deepened, efforts focused on direct assistance to corporations and improving the institutional setting for debt restructuring.

**Modalities of interventions:** Government interventions had the following forms: (i) direct lending; (ii) recapitalizations/equity injections; (iii) government guarantee of liabilities; and (iv) legal reform. Direct lending took place in Russia, United States, and Dubai. Equity injections as well as government guarantees were used in Dubai and Ukraine. Latvian and Spanish corporates received no (direct or indirect) financial support and relied on strengthening market-based debt restructuring mechanisms. Except for the United States which has well-established insolvency laws, all countries in our study amended or reformed the law to facilitate (both out- and in-court) restructuring. In the case of Russia, tax cuts were used to provide some relief. In some cases, government support was accompanied by demands for operational restructuring. Compared to the previous widespread corporate debt restructuring cases in Asia, the use of AMC's to take on corporate loans from the banking system has been limited.

**Sources of assistance funds:** In most cases with direct government support (e.g., United States, Dubai, and Ukraine), funding for problem resolution came from the budget. In Russia, financing was secured through a drawdown of FX reserves and balances from the SWF.

**Financial burden on the government and contingent liabilities:** The direct financial costs of government interventions varied significantly across countries. While the fiscal and contingent costs in corporate debt restructuring episodes are somewhat smaller compared to the costs of financial sector support, they ranged from zero (where no fiscal resources were deployed, see above) to 10 percent of GDP. In terms of realization of contingent risk and moral hazard, the jury still may not be out for a while longer! However, it should be noted that contingent risks built up in the years before the crisis due to corporate sector debt have in some cases already translated into fiscal costs (Dubai and Ukraine)

In general, government-initiated debt restructuring and related measures have helped avoid large-scale corporate insolvencies in the sample countries. These measures provided confidence to the markets, stabilized expectations, but when financial may have also created moral hazard. They also came at a (direct and indirect) cost to the taxpayer. These interventions weakened the governments' balance sheets as they accepted assets of questionable financial value in exchange for new resources that had ample alternative use in crisis times. In cases where the value of government's investment depends on the performance of companies going forward, the extent of fiscal losses/gains will remain uncertain until the assistance is unwound.

Going forward, NPLs appear to be on the rise (especially in Latvia and Ukraine) and more widespread corporate debt problems could emerge. It remains to be seen whether more active government intervention would be required in these countries or whether measures already in place to address the first wave of corporate debt problems could be sufficient. At this stage, it is safe to conclude that to avoid corporate debt crises from becoming a major problem again, conditions for orderly and orderly debt workout should be created and maintained. While the exact figures are not available at this point, it is likely that the net costs to the governments from involvement in corporate debt workouts will be inversely related to the extent of operational restructuring imposed on the corporations after the restructuring. In cases of large state-owned

enterprises, governance and disclosure practices need to be brought up to international standards to prevent problems stemming from poor management and moral hazard from reappearing in the future.

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## Appendix. Overview of Corporate Debt Restructuring in Select Countries

	UAE (Dubai)	Latvia	Russia	Spain	Ukraine	United States
Debt restructuring measures	<p>Out-of-court restructuring of bilateral debt through negotiations with banks' creditors committee and with trade creditors. Bonds/Sukuk will be paid in full.</p> <p>Introduction of a special solvency regime for Dubai World in case out-of-court restructuring does not work.</p>	<p>Developed out-of-court work-out guidelines; developed and implemented an information strategy to raise public awareness about new insolvency framework, and provided training to government and private stakeholders about out-of-court restructuring.</p>	<p>Loans to large and strategically important companies to repay their foreign currency debt.</p> <p>Restructuring of several partially state-owned corporations.</p>	<p>Widespread debt restructurings (largest developers all restructured debts) undertaken on case-by-case basis, all market based (i.e., no government involvement.)</p>	<p>Plan to develop a government-facilitated voluntary framework for restructuring corporate and household debts.</p> <p>Some progress in voluntary, bank-led restructurings of corporates.</p>	<p>Loan and equity investments in GM, Chrysler, and GMAC.</p>
Government intervention in response to the crisis in bank and non-banking sector	<p>Recapitalization of banks (done a year before, not in relation to DW).</p> <p>Government loans to troubled GREs and conversion of government claims to equity.</p> <p>Government through Financial Support Fund, provided loans and funds for repayment of bonds and for interest and operational costs. Some of the funds will be converted to equity.</p> <p>The funds are obtained through government's \$20 billion bond to Abu Dhabi and the central bank.</p>	<p>Recapitalization of domestic banks.</p> <p>No direct financial subsidy to corporate sector.</p>	<p>Recapitalization of banks. Regulatory forbearance of NPLs</p> <p>Initial response was to focus on helping selected large companies via directed loans and subsidies from Central Bank, state banks and the state-owned VEB. Focus later shifted to more comprehensive approach of helping strategic companies (largest employers in regions) and sectors via state guarantees, procurement, tax cuts, and bank recapitalization.</p>	<p>Assistance provided to banking sector in line with common framework agreed to by euro-area countries.</p> <p>No direct financial subsidy to corporate sector.</p>	<p>Recapitalization of banks.</p> <p>Financial subsidy was provided to state-owned gas company, Naftogaz, restructured debts in September 2009: swapped \$500 million unguaranteed debt maturing within a week for fresh sovereign-guaranteed bonds with higher coupon and five-year maturity; also negotiated with bilateral creditors to convert loans to the Eurobond).</p>	<p>Recapitalization of banks. asset purchase and debt guarantee schemes for financial sector.</p> <p>Providing loans to GM, Chrysler, and GMAC and eventually acquiring stakes in these companies and overseeing the restructuring process.</p>

	UAE (Dubai)	Latvia	Russia	Spain	Ukraine	United States
Cost of Corporate support <sup>34</sup>	\$10-\$20 billion some in the form of equity increase and some new funds. New funds are also equalized.  12-24 percent of Dubai GDP.		\$14.3 billion loans to large companies and \$1 billion to SME as of April 2010.  0.1 percent of GDP.		2.7 percent of GDP.  Includes the operational deficit of Naftogaz included in budget. (Additional contingent liabilities might arise from the \$1.6 of Naftogaz bonds guaranteed by government).	\$67 billion (net) in loans and equity investments, as of end October 2010.
Cost of banking sector support	1 percent of UAE's GDP.  AED 50 billion (\$13.6 billion) deposited in banks, some converted to Tier-1 capital.	4-8 percent of GDP for 2008-2011.	3.1 percent of GDP includes recapitalizations and asset swaps/purchases.	2 percent of GDP includes bank recapitalization and asset purchases as of December 2009.	3 percent of GDP in 2009  2.4 percent of GDP in 2010.	3.7 percent of GDP as of end June 2010, includes net cost of recapitalization schemes as well as asset purchase and lending by treasury (Table 1.3, IMF Fiscal Monitor, November 2010).

<sup>34</sup> The costs are gross. Some or all may be redeemed in future through repayment, dividends, sale of assets and divestments.