

# **Maximising Value of Non-Performing Assets**

**Proceedings from the Third Forum for  
Asian Insolvency Reform – November 2003**



ORGANISATION FOR CO-OPERATION AND DEVELOPMENT

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## FOREWORD

Seven years after the financial crisis, Asian countries are continuing to grapple with the underlying behaviours and structural weaknesses that contributed to it. Most Asian jurisdictions have implemented extensive insolvency reforms, following legislation and restructuring techniques initially adopted in OECD countries. Yet, while post-crisis measures helped to stabilise the economy and the financial sector, Asian economies remain vulnerable. In effect, banks were recapitalised but not reformed and little restructuring of the debtors occurred. Moreover, an estimated US\$ 2 trillion of debt overhang in Asian countries adds to the urgency of insolvency reforms in the region. Asian governments have already spent sizeable resources to deal with non-performing assets. If another downturn were to occur, however, the ability to release the fiscal and monetary liquidity necessary to recapitalise the financial system again is questionable.

Equally important are indications that the resumption of growth and political changes have weakened the political resolve for continued insolvency reform. Such political will is essential, since governments have an important role to play in preventing a new crisis by strengthening the legal and regulatory environment for insolvency proceedings. Governments must also move with expediency to create transparent resolution practices, insisting on accountability, proper governance and professional management of the process, and leaving the private sector and market free to function within this framework. Moreover, improved liquidation proceedings and sound creditor rights systems remain important priorities for insolvency reforms in Asia.

These were among the main findings and conclusions from the Seoul meeting of the Forum for Asian Insolvency Reform, held on 10-11 November, 2003 in Seoul, Korea. The Forum, jointly organised with the World Bank, benefited from the support of the Japanese government and the Asian Development Bank. The Ministry of Finance and Economy and the Financial Supervisory Commission of Korea co-hosted it with the assistance of the Korea Development Institute and the Korea Asset Management Corporation. The OECD is grateful for their valuable support.

This publication provides comparative and country reports, focusing on *(i)* general developments in insolvency reforms and value maximisation of non-performing assets, *(ii)* the role of policy and incentives in insolvency reforms, and *(iii)* the development of the markets for non-performing assets. It is intended to provide policy makers, members of the judiciary, private sector experts, academics and students with a greater insight into the insolvency systems of the selected countries and to discuss policy options for further reforms.

The opinions expressed in this publication are those of the individual authors and do not necessarily represent those of the OECD, the governments of its Members or non-OECD Members. This volume is published under the responsibility of the Secretary-General of the OECD.



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Director, Directorate for Financial and Enterprise Affairs



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## The Changing Dynamics in Asian Non Performing Loans

by

*Lampros Vassiliou*<sup>1</sup>

### *The changing dynamics*

In the last year, many of the dynamics underpinning the approach in Asia to resolving and maximising value from non-performing loans (NPLs) have changed. The author's regional review for the second Forum for Asian Insolvency Reform (held in Bangkok, Thailand in December 2003) highlighted a number of areas of progress and some of the pitfalls in Asian corporate debt restructuring as well as providing a country-by-country summary of developments. This paper builds on that review and focuses on some of the evolving aspects of NPL resolution techniques and on shifts in approach to resolving Asia's estimated 2 trillion US dollars in NPLs.

### *Reworking the fictional rescheduling – the strategic double defaulters*

The author has often described the many so-called restructurings taking place in some of the Asian countries as fictional reschedulings, which have taken place without there being a realistic expectation that the debtor will be able to comply in full with the rescheduled timetable for repayment and without any serious attempts at operational restructuring or other real restructuring techniques. As defaults take place under these fictional reschedulings, reworking the workouts has already begun in many countries, with debtors commonly able to achieve a better deal the second time around. This odd phenomenon is partly due to the fact that the first round of fictional reschedulings rarely included a "haircut" of debt, as the banks' balance sheets could not, at that time, sustain the loss, and often ramped up interest rates after a few years of reduced rates or interest holidays. As time has passed since the 1997-2002 period when many of these deals were done, the economies in some of the so-called crisis economies such as Korea, Malaysia, Thailand, and, to a more limited extent, Indonesia have improved. As the economies have rebounded, often without any real change in fundamentals or in overall competitiveness of enterprises on a comparative basis, interest rates have fallen. Banks have been recapitalised and can now sustain the losses from writing off portions of debt which the bank really has almost no prospect of recovering, and are therefore now processing losses that really should have been processed in 1997.

In these changing environments, "strategic debtors" have again appeared. Strategic debtors is a term which was used in the period between 1997-1999 to describe debtors who were able to pay their debts but choose to use the Asian financial crisis as an excuse not to pay their financiers and commence restructuring negotiations in the hope of receiving some accommodation from their bankers. This tactic was very successful. As interest rates have fallen, and with banks' balance sheets now far better placed to take a hit, strategic double defaulters have sprung up. Requests for reduced interest rates and for haircuts are common requests and, commonly, the requests are agreed. The dynamic is also odd as (commonly) the debtor would have complied with its first restructuring plan for many years and then a default occurs (or a cynic would say is engineered) and the debtor is suddenly able to again achieve accommodations from its bankers. Some debtors, whilst acting cleverly and perhaps a little disingenuously, are not entirely to blame for this situation. If their bankers had, in the first round of restructuring, been less concerned with their own balance sheets and instead focussed on

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realistic financial restructuring and operational restructuring of the debtor, assessing the viability of the debtor's business and leaving it with a sustainable level of debt, the debtor may well have become more profitable and competitive in the interim period if it had not had to operate under the shadow of an overhang of unsustainable debt. In truth, the debtor's bankers never hoped to recover this unsustainable debt, but delayed writing it off.

The author has often quoted one banker as saying "we will do the rescheduling now and then do the restructuring next time they default". In reality, as things have turned out, the second round has involved either another rescheduling or a haircut and a reduction of interest rates. In other words, the second round of restructuring has resulted in a better result for the debtor. From the debtor's perspective "re-working the workouts works."

### ***The new wave of realistic restructurings***

There has also been a wave of new restructurings, which have generally been conducted in a realistic manner. Some of these cases have involved essentially good businesses or projects, often involving multinational sponsors. In many cases, these restructurings did not occur in the immediate aftermath of the 1997 crisis. These restructurings were delayed because the debtor often enjoyed a lengthy moratorium, either formal or informal, over the last six years, as its creditors realised that they really have no attractive legal recourse and have sat still, despite continuing to threaten the debtor in an unconvincing manner. As these cases have involved viable businesses with strong sponsors (who have often through relationships with the banks insulated or provided protection to the debtor from its bankers) it is not surprising that these deals have become the first bright spark as the Asian economies have started to rebound.

### ***The hole in restructurings***

One of the biggest misconceptions and risk areas in the financial sector in a number of Asian countries relates to restructurings of NPLs which have not been completed but which have been allowed to be reclassified as performing. In a number of corporate restructurings, the deals done between the debtor and its creditors are subject to a number of conditions precedent, such as the granting of new security or re-registration of pooled security to secure the combined restructured advances of the creditors. However, many of these conditions precedent have not been completely satisfied. For example, securities have not been properly perfected. Bankers have gone to their credit committees for approval to do restructuring deals on certain terms, including the satisfaction of these conditions precedent, but in reality the conditions precedent have never been completed. In the event of default, banks will not, in fact, be in the position that they and their credit committees think they will be in.

This has occurred partly due to the administration of restructurings by banks. Often, once the deal is agreed and debt-restructuring agreements signed, responsibility to finalise all remaining aspects of the deal is transferred to another department in the bank, such as the department that handles the security agent functions. The heat is off as the loan has been reclassified, and there is little incentive or pressure to force the debtor to complete all terms of the restructuring deal. Central bank requirements, at their best, require that the debtor make payments under the restructuring plan for a few months before the loan can be reclassified and, at worst, allow the loan to be reclassified on the hint of a restructuring such as the agreement of a non-binding term sheet. Few actually ensure that the deal is fully completed. Central banks have allowed the banks to reclassify the loans as performing and there has not been adequate investigation to see that all aspects of the proposed deal have in fact been documented and perfected.



### ***Restructuring drivers gone***

In addition, many of the drivers for restructuring which existed in the period between 1998-2002 have now gone. Committees such as the Corporate Debt Restructuring Committee (CDRC) in Malaysia and the Corporate Debt Restructuring Advisory Committee (CDRAC) in Thailand, which were established to promote the pace of restructuring, have ceased operations or downscaled. They no longer drive the banks into restructurings. Tax incentives instituted to facilitate restructuring have expired. IMF conditions have gone as loans as have been repaid. Banks have been recapitalised and do not feel the same pressure to deal with NPLs. Banks have become flush with cash and are now lending and therefore decreasing their NPL ratios by increasing total lending rather than decreasing NPLs. Crisis countries have endured, and have not collapsed or suffered unbearable downturns in standards of living or increases in poverty by not dealing with their NPL problems. Governments have realised that you can have GDP rates of 5%-7% whilst still carrying 10%-30% NPLs. Investors have returned, forgetting, at least at the institutional level, bad experiences in the past and are looking to the exotic East to make their bonuses as the US and other economies simmer. The overall result is that the pace of restructuring has slowed. Of greater concern perhaps is that it seems that some NPLs may never be resolved but will just sit quietly in the corner hoping not to be noticed as the party in Asia starts again.

### ***The withdrawal of blanket guarantees***

Many countries have implemented bank deposit guarantee or insurance schemes. These schemes avoided runs on the banks in the period after the 1997 crash and subsequently when uncertainties have arisen (often due to the discovery of a major fraud or significant misreporting in the operations of a particular bank). The depositors have known that the government guarantees their deposits with the banks. For example, the reason the Thai banking system did not collapse in the turmoil of 1997 was due to the bank deposit guarantee provided by the Thai government - it was the reason people kept banking with Thai banks such as Krung Thai Bank even after reports were leaked indicating that the bank's NPL ratio was at least 84%. These schemes vary in structure but have often involved full blanket guarantees of the entire amount deposited in certain types of accounts.

Banks have commonly been unable absorb losses from NPLs without risking clear insolvency and likely closure. Where bank deposits have a blanket government guarantee, there is little incentive for banks to realistically deal with their NPLs and undertake real restructuring. Transfer to asset management companies (AMCs) have restored banks' balance sheets, but the AMCs rarely go on to undertake real restructuring (financial or operational) of corporations. The result is that corporations are still burdened with unsustainable high levels of debt. There is no way around concluding that it remains a major problem.

However, some countries are now implementing programmes to remove or downscale these schemes. This is creating an interesting dynamic as the withdrawal of the blanket guarantee should provide a stimulus for finally dealing with some of the long standing NPLs in the banks. The fear is that if the banks do not deal with their NPLs by the time the deposit insurance is removed or downscaled, depositors may lose confidence in the banks. Japan and Korea are two countries that are leading the way in this respect, and their experience in the next few years should provide some interesting lessons as to how determinative this dynamic will be.

Korea had a full blanket deposit guarantee, which was reduced in 2001 by instituting a cap of 50 million Won. There is no plan to reduce this further at this stage. In Japan, there is a programme to reduce the level of deposit insurance provided by the Deposit Insurance Commission of Japan (DICJ). The full blanket guarantee was lifted in April 2002, with full protection now only being provided up to

a maximum of 10 million Yen plus interest. From April 2005, full protection will only be provided on accounts which bear no interest and are payable on demand. It is unlikely that this timetable for lifting the guarantee will be extended. This should provide a clear incentive to the Japanese banks to resolve their long standing NPLs so as to avoid bank runs by depositors and concerns about bank solvency.

### ***The disposal culture exposed***

In some countries, there has been an inability to move past the stage of disposal of NPLs (often through bulk sale or transfers to AMCs or special purpose vehicles (SPVs)) to the stage of undertaking real restructuring of the underlying loans or distressed assets. Whilst these transfers do reduce the NPL ratios on the balance sheet of the banks, a transfer alone has little overall positive impact on economic recovery at a micro or macro level. Some countries such as Chinese Taipei have continued to be strong markets for NPL bulk sales with almost all banks engaging in sales programmes, with a number of private AMCs, commonly funded by international investors, purchasing NPLs. However, there has been little or no subsequent restructuring of the NPLs or underlying distressed assets. Chinese Taipei must now move into real restructuring. In China, the four state-owned AMCs have begun sale programmes but these have generally been slow to complete and have faced a number of obstacles. China's NPLs market has been stagnant for a while but looks like it may be forced to revive shortly. The Japanese market looks like it is finally starting to move.

These and other developments are discussed below.

### ***The new markets – India at the head***

India is perhaps the largest new market, with new laws enabling the establishment of asset reconstruction companies (ARCs). ARCIL, one of the first ARCs, is acquiring loans from many of the major banks including ICIC Bank and SBI. Legal challenges have, however, delayed the implementation of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance (SRFAESI) under which ARCs are established. The proposed National Company Law Tribunal (NCLT), which replaces the existing Board for Industrial and Financial Reconstruction (BIFR), which handled cases under the sick industrial companies legislation, has also been delayed. It is hoped that the NCLT will speed the process of referring companies to rehabilitation although there are concerns as to whether it will be fully staffed with an adequate number of competent judges. There is also great need in India to develop a private profession of liquidators.

Whilst debtors abused the moratorium on legal actions under the sick industrial companies legislation, the removal of the stay in its entirety in the second amendment to the companies code is somewhat reactionary. A better solution would have been to provide for a clearly time bound stay on legal actions during the period of rehabilitation.

Stamp duty and taxation incentives are also required if the ARCs are going to become drivers of restructuring in India.

### ***The Philippine flop***

The Philippines suffers from significant NPLs and non-performing assets (NPAs) which have been acquired, mainly through settlement of NPLs by *dacion en pago* (debt for asset swaps) and subsequently been held for some time by local banks. Much of this collateral, both core and non-core assets of debtors, now sits idle on bank balance sheets as market prices fall below the net book value of the loans. Banks, hoping for improvement in economic conditions and hoping to avoid capital

write-downs, have held on to assets waiting for higher prices. As a result, assets and capital are not circulating in the economy and banks have become large inefficient holders of NPAs.

Given this background, domestic banks initiated discussions with foreign investors for the disposition of their non-performing portfolios. The Bangko Sentral (BSP) was supportive of these initiatives. However, investors were reluctant to proceed with investments and therefore it was considered that enabling legislation was required.

The Special Purpose Vehicle (SPV) Act of 2002 was enacted into law on 23 December 2002 and became effective on 9 April 2003. It was intended to help financial institutions dispose of their NPAs by waiving some of the taxes and reducing fees usually collected on the sale or transfer of assets. The SPV Law waived the documentary stamp tax, capital gains tax and other taxes, and reduced the applicable registration and transfer fees by 50%. In addition, losses suffered by the banks on the transfer can be amortised over seven years. The tax relief and other benefits under the SPV Law are only available until 8 April 2005.

Despite these incentives, no transactions have been completed. No financial institution has so far completed a bulk sale of NPAs to an SPV under the SPV Law. The SPV Law has been unsuccessful in achieving its aims to date. At least, there has not been the level of international investor interest that was hoped for.

The final version of the SPV Law differed significantly from earlier proposals that had been made by international investment banks and others. Senators in the Philippine Congress, whose families are also major debtors, inserted a number of debtor protections into the legislation such as mandatory rights granted to the debtor to restructure before the loan can be transferred to a SPV.

### ***Taiwan's 2-5-8 and more***

The "2-5-8" programme announced by the Ministry of Finance in Chinese Taipei in 2001-2002 aimed to reduce the NPL ratio to 5% and increase the capital adequacy ratio to 8% within two years. Financial institutions were encouraged to merge under the Financial Institution Mergers Act. They were also encouraged to form private AMCs under the Financial Holding Company Act. Various incentives were offered to encourage NPL disposals including deferred loss write-off provisions, which provide a breathing space of five years for the banks to absorb the losses from sales at discount.

In addition, the Financial Assets Securitisation Law of 2002 allows for the creation of Special Purpose Trusts and Special Purpose Companies as structures for asset securitisations to remove the legal barriers concerning the transfer of assets and provide tax incentives to promote asset-backed securities. The withholding tax on income from securitised securities was reduced to 6% to incentivise securitisations.

These measures have been successful with an unprecedented level of foreign investment and domestic investment in NPL portfolios coupled with an upward price movement. Purchasers have included Lone Star, Cerberus, Orix, Colony, the Taiwanese Asset Management Company or TAMCO and others.

### ***China's stalled NPL market***

Frustrations rage at the slow pace of development of the NPL market in China. After early sales in 2001 to Goldman Sachs and Morgan Stanley, China's four AMCs seem reluctant to sell or deal with their acquired NPLs. This is partly due to concerns by employees that if they do their job, they will

not have a job anymore, as their work will be done. Fear of causing a loss by selling under value (particularly to foreigners) has also restrained the eagerness of management of the AMCs to complete deals. Sales are also thwarted by branches of the AMCs and by local provincial governments seeking to impose taxes or charges on transactions.

Some transactions have, however, completed recently. Investors have included Morgan Stanley and GE Capital, who purchased a significant portfolio from Huarong AMC. There was also an unusual sale by Bank of China Hong Kong that transferred loans to a company in the Caymans, which sold them off at auction to Citigroup.

China's banks must be ready to face competition from international banks when they are granted full access to the Chinese banking sector in accordance with WTO provisions as is anticipated to occur in 2006. Many of the Chinese banks are planning major disposals of NPLs or settled assets (assets acquired through settlements with borrowers) this year. It remains to be seen if these deals reach completion.

### ***The residue NPLs***

An interesting and somewhat perplexing problem that has arisen as the NPL problem has been worked through in many countries is the problem of what to do with the "residue NPLs". Residue NPLs is a term the author uses to describe unresolved NPLs – commonly these are the balance of NPLs held by a national AMC after it has dealt with NPLs that it has been able to successfully resolve or after its statutory life has ended. Many of the national state-owned AMCs such as IBRA, Danaharta, TAMC and others have limited lives and some, such as Danaharta in Malaysia and IBRA in Indonesia, are at or close to their statutory limits. However, not all of the NPLs transferred to those national AMCs have been resolved. Indeed, one of the moral hazards associated with AMCs is the risk that the AMC is used as a warehouse in which NPLs are stored or hidden. This illustrates that some of AMCs in Asia at present house unresolved NPLs, irresolvable NPLs, NPLs where the loan was obtained by fraud, NPLs where the loan was obtained by inappropriate use of influence or power, NPLs where the loan was made as a result of state-directed lending or policy lending. Some of the NPLs housed in some of the AMCs would be embarrassing to high profile persons should they become public.

IBRA faces major issues with what to do with its residue NPLs as its statutory life ends. It may well be that the residue NPLs are transferred to another government agency. There are concerns that some of the NPLs may be left unresolved for years or perhaps simply left unresolved.

The experience of the Resolution Collection Corporation (RCC) in Japan will be instructive in dealing with the residue NPLs around Asia.

### ***The life and death of securitisation***

Securitisation in Asia has received much attention, although success has been limited. Many countries have implemented special legislation and taxation waivers or reductions to promote securitisation structures. There have, however, been few securitisations as investors and monoline insurers who provide the credit enhancement in these transactions have been reluctant to participate in transactions, or who, after testing the water in some jurisdictions by participating in a few transactions, are reluctant to engage in further transactions after having bad experiences. An example of this in Thailand, where the failure of some of the securitisations entered into in the 1996 – 1998 period, such as the SITCARS autos transaction, have left investors and monoline insurers doubtful that these complex structures can be understood and enforced by local courts.

It is only recently that some further securitisations have occurred. These have involved somewhat safer receivables such as secured housing loans. Some of the national AMCs have also engaged in securitisation programmes. Danaharta in Malaysia had one very successful securitisation, under which it securitised some of the best assets transferred to it. Despite this success, Danaharta has not to date engaged in further securitisations of lower quality assets. KAMCO in Korea is perhaps most famous for its securitisation programme, having engaged in numerous securitisations of good assets and distressed assets. However, securitisation has recently died in Korea after classification criteria for NPLs were tightened so that NPLs could not be removed from an originator's balance sheet if the originator retained any residual liability in respect of the NPLs by, for example, providing a guarantee to the vehicle to which the NPLs were transferred for any loss suffered on resolution of the NPL. After the tightening of the classification criteria, if the transaction could not be viewed as a true sale (or there was a guarantee provided, or a cash reserve or recourse clause) the transferring bank must now provision for the NPLs.

On a related point, loss-sharing arrangements, which have been a feature of the structure of some of the national AMCs or SPVs, are often forgotten when examining the position of banks in Asia. Under these arrangements, transferring banks still have contingent liability for losses on NPLs they transferred to other banks, AMCs or SPVs. Some of these loss-sharing arrangements are presently in the process of being crystallised and anticipated difficulties with the calculation of these losses have become obvious very quickly.

### ***The shift to and from DIP***

The battle continues to rage in many countries on the issue of the balance between interests of debtors and the interests of creditors in the formulation of rescue laws. In a number of countries such as Indonesia, Korea, Thailand and elsewhere, rescue laws were enacted in the period following the 1997 crisis. These laws were, on their face, said to be creditor friendly in that they provided creditors with rights to commence rehabilitation proceedings, appoint an administrator who is independent of the debtor and vote to approve rehabilitation plans. Despite this, the reality has been that in many cases these laws have resulted in quasi debtor-in-possession (DIP) systems. This has largely been due to the inability of creditors to appoint independent administrators in situations where the debtor is not co-operative. Debtors have frustrated their attempts to do so with endless vexatious litigation and other frustrating actions. The result has been that, even in countries where there are rescue laws which permit an administrator to be appointed, such appointments are rare and, more commonly, debtors are appointed to run the rehabilitation.

### ***Loopholes quickly exposed***

The debtors have quickly mastered these systems, identified and utilised loopholes in the laws and developed techniques such as the purchasing of debts through undisclosed trusts or nominees or other vehicles, so as to use the system to their advantage. In Thailand, for example, a debtor who is able to control 30%-40% of the debt is able to pass through a plan, which, in real money terms, returns almost nothing to other creditors. This is a result of the voting system, which allows one class of creditors to approve a plan provided that at least 50% of creditors in value voting on the plan vote to approve the plan. In a number of cases in Thailand, after lengthy delays with numerous amendments to the plan being proposed, creditor fatigue has set in and creditors have stopped attending creditors meetings or have agreed to transfer their debts at a severely discounted amount. This has allowed the debtor to obtain control of a sufficient majority of the debt and pass plans that provide for a stay on secured claims during the period of the plan and a minimal repayment to the creditors or otherwise provide creditors with a completely unsatisfactory result.

Despite this reality, a debate rages in many countries as to whether there should be a shift to a clearer debtor-in-possession system modelled on the US Chapter 11 system. This debate fails to acknowledge abuses of the existing laws and the reality that many so-called creditor friendly systems are really quasi debtor-in-possession systems. That said, if the systems end up being debtor-in-possession systems by default, they may as well be set up as such from the start. It is argued that a debtor-in-possession system is more suited to some of the Asian cultures as the system is less confrontational. This argument also ignores the reality of how many Chapter 11 proceedings play out in the USA, with lawyers representing all classes of creditors and lengthy legal proceedings. It also fails to acknowledge that the US Chapter 11 system is administered and closely supervised by a well-trained and experienced judiciary together with administrative and enforcement agencies, which will take years to adequately develop in many Asian countries. That said, the reality is that many of these systems will probably move to a clearer debtor-in-possession system in the next few years and, where that is the case, as much as possible should be done to ensure that creditor interests are safeguarded to the maximum extent possible. Even if the debtor remains in possession during a rehabilitation there should be protections to ensure creditors have access to information about the debtor's business and conduct to enable them to make fully informed decisions about restructuring plans proposed by the debtor.

### ***Pakistan's U-turn***

Pakistan's move to enact a new corporate recovery ordinance aimed at creating a balance between debtor and creditor interests seems to have stalled. Nowhere else in the world has there been such a tug of war on debtor versus creditor interests. The State Bank of Pakistan's position on the acceptability of write-offs of NPLs has also seen a swing in attitudes. In 1999, the general view was that NPLs should be recovered in full, as the debtor must have the money hidden somewhere. By October 2002, a directive was issued pushing aggressive settlement of NPLs. Some of the strongest creditor friendly laws (which, for example, allowed debtors to be imprisoned for non-payment) have made way to debt amnesty schemes, which make debtors who pay their creditors occasionally look foolish.

### ***Indonesia's new bankruptcy law***

Indonesia's new bankruptcy law was enacted in 1998 and since then only 103 bankruptcy petitions have been accepted together with 19 debt moratoriums and 22 creditor compositions. In light of the enormous number of NPLs, the 1998 amendments must be considered a failure. Reasons for the failure include corruption and improper influence in the Commercial Court, incompetent, unwilling, underpaid or untrained judges, and technical deficiencies and ambiguities in the law. Thus, a second new bankruptcy law is being debated which is intended to clarify much of the uncertainties in the existing law, but fails to reform the Commercial Court.

The author has often described the "implementation gap" in Asian insolvency law reform as being the gap between the letter of the law and actual practice, much of which is a function of the stage of cultural evolution and acceptance of insolvency procedures in a country. It is feared that this new bankruptcy law will also fall victim to the implementation gap.

### ***Hong Kong's provisional liquidation sidestep***

Remarkable as it is, Hong Kong still does not have a formal rescue procedure, as little progress has been made to enact the proposed provisional supervision procedure.

To overcome this deficiency, the Hong Kong courts have seemed to be willing to allow the provisional liquidation procedure to be used (or perhaps misused) to enable provisional liquidators to formulate restructuring plans. It remains notable that one of the efficient judicial systems in the region is prepared to be so flexible to overcome legislative gaps.

### ***Singapore's Omnibus***

Singapore is considering proposals for what is called the new Omnibus Insolvency Legislation. This legislation is modelled on the UK Insolvency Act of 1986, which introduced a new corporate voluntary arrangements procedure.

The insolvency of Asia Pulp & Paper (APP), which was incorporated in Singapore but had operations in Indonesia and China, displayed some of the problems with the existing insolvency system in Singapore. Two of APP's creditors sought to place it into judicial management, which was resisted by APP, who was otherwise engaging in out-of-court restructuring negotiations with creditors of the Indonesian and Chinese operations. The court, at first instance and on appeal, dismissed the petition and refused to order that APP be placed into judicial management, largely because the judicial management process might harm the on-going restructuring negotiations. The court considered preserving the engagement of the Widjaja family, the founders of APP, in restructuring negotiations more important than appointing independent judicial managers who would have a duty to protect all creditor interests and to unravel possible misdeeds, as well as prevent questionable transactions siphoning funds from the group. The court doubted that judicial managers could avoid the creditors ending up with bad debts.

After APP, the need for a new voluntary administration type procedure in Singapore should be clear: a procedure that is flexible in nature to help save viable businesses, that maximises returns to creditors, and also promotes good corporate governance.

### ***The new players***

The players around the restructuring table in Asia in a corporate debt restructuring have been diversified for some time now. They are not a group of conservative bankers sitting around the table with common agendas and considerations. Each bank has a different balance sheet position, varying abilities to accept a haircut and varying desires in terms of short, medium and long-term considerations in the formulation of a restructuring plan. In addition, there are national AMCs, whose staff might be reluctant to do a deal, as it makes their pending unemployment more likely and possibly exposes them to personal liability if the deal is questioned later. There are investment funds, distressed debt traders, vulture funds and others.

New arrivals around the table include government investment funds, credit default insurers or governments that have guaranteed NPLs transferred to another bank or AMC. However, these new players can be ghosts whose spirits and influence can be felt around the table, even if they are not physically present. They are changing the dynamics in many restructurings.

### ***Reckless lending again***

A wave of reckless lending has spread throughout the region. The author has noted new lending may sometimes be an indication of a reckless institution, and that it is odd that in many restructurings new money required for working capital is coming from the institutions that were (prior to their transfer to AMCs) the highest holders of NPLs. This phenomenon has continued and spread to the consumer finance area. Korea and Thailand are good examples where the availability of credit to

consumers has increased and defaults are already being experienced. Credit cards in Korea are probably one of the most serious risk areas. Housing loans have also increased as the property sectors have rebounded with new construction projects throughout many Asian cities. It should be feared that the increased level of household borrowing will not be sustainable when interest rates rise (as they will no doubt do) from the low levels prevailing at present.

There has also been a growth of a new area of NPL sales in the area of credit cards and personal loans in Korea, with credit card companies disposing of delinquent loans in order to meet the government mandated 10% maximum NPL ratio.

### ***SK Global's touted win for foreign creditors***

Fraudulent accounting at one of Korea's largest chaebols was recently discovered and a 3.7 billion US dollar black hole appeared. SK Global's restructuring seven months later has been touted as a success for foreign bankers, one of few following poor results in many of the large restructurings in Asia such as Asia Pulp & Paper and Thai Petrochemicals. The result achieved by foreign creditors produced a fully secured position with equity warrants and was obtained by threats to put international subsidiaries into liquidation and commence deeper fraud investigations. Some may regard that result as unsavoury. It is interesting that the result for foreign creditors in the restructuring of a Chinese GITIC recently was also obtained by concessions being made by the Chinese parties in order to avoid further investigations into fraud and improper practices.

These results may well, in the short-term, result in an improved return in relation to the particular case involved, but it is to be questioned whether the negative implications for corporate governance are in the long-term worth the compromise.

### ***Japan's hope?***

Much hope has been placed in the new Industrial Revitalisation Corporation of Japan (IRCJ) to help revive the Japanese economy. It has been given government backing to the staggering amount of 10 trillion yen to purchase NPLs and revitalise corporations.

The IRCJ is conducting revitalisations of six debtor corporations, testing the water so to speak. Banks have to date been reluctant to transfer loans to the IRCJ as they fear its valuation standards on transfer will mean they have to book a loss. At present, there are no other incentives, such as amortisation periods for losses, tax incentives or provisioning incentives or other triggers such as forced revaluations of collateral. These other incentives have successfully encouraged banks in other countries to transfer their NPLs to national or private AMCs.

### ***Japan's Resona precedent***

The rescue of Resona Bank in Japan is viewed as a precedent for financial crisis management. In short, the Japanese government injected capital into Resona with the Deposit Insurance Corporation of Japan (DICJ) subscribing for shares. The transaction was unique in that the DICJ would usually buy preference shares but, in Resona's case, it purchased common stock and voted that stock to replace management. The DICJ borrowed some 1.96 trillion Yen from banks to purchase the common stock. This model is proffered as a precedent for the future in terms of replacing management and financing the acquisition of stock.



### ***The unresolved Thai Petrochemicals saga***

In Thailand's long running saga – the restructuring of Thai Petrochemicals Industry or TPI – new twists have developed. The plan administrators appointed by creditors were recently removed. After the Thai government became involved and after lengthy delays with no other feasible way to turn, the court appointed a team selected by the Ministry of Finance to become the new plan administrators. A restructuring plan has still not been put to creditors by this team and the stock market still spins on daily dramas in the restructuring.

Countless lawsuits still abound and creditor's money (or debtor's funds, depending on how you look at it) is wasted away on fighting what seems to be an endless battle. The Bangkok Post runs full-page advertisements by the founder of the company, Khun Prachai, reporting wins in defamation lawsuits, which the other parties then protest. The court issues rulings that 99-year leases of property to the public company with payment made in advance are entirely appropriate. The Prime Minister is pictured touring the plant with the founder and rumours spread that the Prime Minister or related interests are planning to acquire the company. Academics and economists speculate on whether the case remains a precedent case or whether it is so special that it does not set a precedent for others, as it is a one-off where special rules apply or can be accepted. Some suggest that it does not really matter what the final result is, as the market has already factored the case into decision-making and accepted that the worst could happen.

### ***The restructuring game***

Government interference in the turmoil of a distressed company is not necessarily a bad thing and, indeed, may at times be the only hope to resolve problems. However, the predictability of systems is sometimes more important than the particular result in one case. If the rules can change in the middle of the game because one player keeps breaking the rules, why should players have regard for the rules the next time they play?

The NPL restructuring game in Asia remains one where: the players are still learning the rules; the rules are changing; some prefer to cheat; and some pretend to play just for the benefit of the crowd. Only occasionally do you get to see a really well played match with a fair result.

The recovery in Asia has come too quickly, with economies rebounding without some of the underlying problems such as the NPL problem being realistically resolved. The corporate sectors and the finance sectors have marched on in many cases and simply ignored the pre-existing problems. It is almost as if the new economy had been reborn and the old economy left in sickness without ever really being brought back to health or allowed to pass away. Vietnam provides a wonderful example of this phenomenon, where the new free enterprise economy is striding forward, despite many problems in the state-owned sector, which continues without any visible improvement in existing NPLs.

### ***Fresh thinking***

No new or innovative approaches to restructuring or insolvency laws have really developed in Asia following the financial crisis. Most of the approaches have followed insolvency laws in other countries or restructuring techniques adopted elsewhere (for example, following the savings and loan crisis and the creation of the Resolution Trust Corporation in the US or the London Approach on out-of-court multi-creditor workouts). As yet, no innovative approach to restructuring has been developed that addresses the cultural issues in many Asian countries and produces an efficient system. What has become clear is that there is no uniform regional solution. Each country has a different background, different problems and a different stage of cultural evolution in dealing with insolvency matters and

therefore requires a different solution. What is also clear is that an insolvency law is only one piece in the puzzle. Effective systems, rather than just laws, need to be created that generate the right dynamics at a particular time in a country to resolve the NPL problem in a realistic way. It must be remembered that the efficient reallocation of resources is one of the main objectives of an insolvency system. The real challenge in many of these countries is to create an insolvency system that actually works in the prevailing environment, not just one which should work if everything else were fixed.

## Sociological Reflections on Insolvency Reforms in East Asia

by

*Terence C. Halliday and Bruce G. Carruthers<sup>1</sup>*

### 1) Introduction

Although every Asian country has its own distinct pattern of insolvency reforms, each country also exemplifies processes in common. The experience of the Republic of Korea with insolvency reforms provides a lens through which we may discern wider reform efforts in Asia. This article reflects on factors, which influence the success of law reforms, and on their implications for continuing reform efforts.

Korea's experience indicates three sets of what might be styled "ongoing conversations" about the form and functioning of insolvency regimes. First, there are conversations, or exchanges of views, within nation-states over various policy options that relate to insolvency reforms in the context of other policy commitments and commercial law reforms. These have the merit of embedding insolvency reforms in a wider policy matrix to produce consistency, coherence, and priority of enactment. Second, there are regional conversations among neighbours over the relative merits of differing solutions to problems such as non-performing loans or out-of-court restructurings. Sometimes these conversations are direct, when one country explicitly seeks information from another, and sometimes they are indirect and mediated, as in the cases of international financial institutions (IFIs) which bring the experience of an experiment in one country (*e.g.*, out-of-court workouts in Thailand) to another (*e.g.*, Indonesia). Third, there are global conversations between nation-states and global institutions, most importantly IFIs and international governance organisations such as the OECD.

Our research seeks to understand the dynamics of insolvency law making across the world *within* each of these conversations and *among* these conversations. We approach this problem from three angles: (1) we have undertaken a long-term statistical analysis of all nations' insolvency reforms from 1973 to 1998 in order to develop statistical models of the impact of economic, political and social changes on insolvency reforms<sup>2</sup>; (2) we have observed closely the reform initiatives undertaken by many international organisations, culminating in UNCITRAL's Legislative Guide on Insolvency which is reaching its final stages; and (3) we have studied intensively the insolvency reform programmes in three Asian countries - Indonesia, Korea, and China.

At the outset, let us make clear our perspective. First, we are independent—we are not affiliated to any global institution, national association, or national government that has a direct interest in the outcomes of insolvency reforms, although of course we are sympathetic to the general endeavour.

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<sup>2</sup> Bruce G. Carruthers and Terence C. Halliday (2003) "The Global Production of Law: The Diffusion of Corporate Bankruptcy Law, 1973-1998," American Bar Foundation Working Paper 2213.

Second, we undertake empirical research.<sup>3</sup> Some approaches to insolvency are driven by theory, or even ideology. We are aware of theory and we generate theory, but we rely ultimately on empirical evidence. We test or bring evidence to bear on any of the premises or doctrines on which insolvency system building is based, whether those premises emanate from international institutions, experts, or nation-states. Third, our approach is institutional or systemic. We specialise in the creation and functioning of institutions, in this case, insolvency institutions.<sup>4</sup> We seek to identify the conditions under which reforms will take place and take effect in one context, but not another. We uncover the taken-for-granted, invisible, and unobserved factors that explain differential success or failure. Put another way, we want to know not only about the substantive or institutional provisions of a restructuring regime, but also its supporting foundations, contexts, institutions, systems—that is, the determinative factors that facilitate or impede the translation of law on the books into effective law in practice.<sup>5</sup>

## 2) *Insolvency norm-making in the global arena*

National reforms of all sorts, including those in Asia, have been heavily influenced in one way or another by the major efforts of international organisations over the past 6-7 years. Some of these efforts began as technical assistance or as emergency interventions during the transitions from command economies after 1989 and were intensified in the wake of the Asian financial crisis in 1997. Subsequently, most leading multi-lateral organisations have sought to codify and systematise their perspectives and experience in formal templates or guides.<sup>6</sup>

Each multilateral initiative has its distinctive merits. The first initiative, undertaken by the Asian Development Bank, offers some 33 clear standards of substantive and procedural law and compares the compliance of 11 Asian countries to those standards.<sup>7</sup> By contrast, the EBRD Legal Transition Survey, which began in 1995, reports rankings of some 26 countries of the former Soviet Union and Central and Eastern Europe on not only the comprehensiveness of their substantive insolvency law, but it also reports evidence for the effectiveness of that law in practice.<sup>8</sup> While the EBRD reaches only into the countries of formerly Soviet Central Asia, its particular value lies in the systematic effort to measure the gap between law-on-the-books and law-in-action and, most important, to acknowledge that it is implementation not enactment which must be the ultimate test of successful reforms. Unlike the ADB, however, it does not publicise systematic standards.

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<sup>3</sup> Employing empirical evidence of several sorts partly controls for the inherent biases in any empirical methodology: primary and secondary analysis of quantitative data; systematic interviews and qualitative surveys; documentary and archival analysis; and participant observation.

<sup>4</sup> Bruce G. Carruthers and Terence C. Halliday, (1998), *Rescuing Business: Making Corporate Bankruptcy Law in the United States and England*, Oxford and New York, Oxford University Press.

<sup>5</sup> Explaining the gap between law-on-the-books and law-in-action is a central problem for scholarship on law and society. See: John R. Sutton, (2001), *Law/Society: Origins, Interactions, and Change*, Thousand Oaks: Pine Forge Press; Richard Lempert and Joseph Sanders, (1986), *An Invitation to Law and Social Science: Desert, Disputes, and Distribution*, New York, Longman; Roger Cotterrell. (1992), *The Sociology of Law: An Introduction*, London, Butterworths.

<sup>6</sup> Group of Thirty. (2000), *Reducing the Risks of International Insolvency: A Compendium of Work in Progress*, Washington, D.C.: Group of Thirty.

<sup>7</sup> Asian Development Bank, (2000), "Insolvency Law Reforms in the Asian and Pacific Region," *Law and Policy Reform at the Asian Development Bank*, vol. I, April 2000.

<sup>8</sup> EBRD, (1999) *Transition Report 1999: Ten Years of Transition*, London, EBRD; Anita Ramasastry, Stefka Slavova, Lieve Vandenhoeck, "EDRB Legal Indicator Survey: Assessing Insolvency Laws after Ten Years of Transition." *Law in Transition* Spring 2000, pp.34-43; Anita Ramasastry, (2002) "What Local Lawyers Think: A Retrospective on the EBRD's Legal Indicator Surveys," *Law in Transition* Autumn 2002, pp.14-30.

Three global institutions have led the way with normative models they advocate for all countries. In its *Orderly and Effective Insolvency Procedures*, published in 1999,<sup>9</sup> the IMF drew on its own experience and mustered a small group of international experts to present some broad conclusions on those elements of liquidation and reorganisation regimes, together with alternatives, that should be considered by national policy-makers, and especially by economic law-makers. Whereas the IMF focused principally on substantive law and offers no diagnostic instrument, the World Bank champions a systemic approach that embraces institutions, such as courts and professions, as well as substantive and procedural principles.<sup>10</sup> The Bank complements its normative model with two diagnostic instruments: one available for national self-analysis; and the other which is employed by Bank officials and consultants to appraise how well a country conforms to the Bank's Principles.

Arguably the climactic effort in global norm-making may culminate in 2004—a Legislative Guide on Insolvency produced by the Working Group on Insolvency Law of the United Nations Commission on International Trade Law (UNCITRAL). Developed in a global legislative forum, which is representative of nations from all stages of economic development, all regions of the world, and all legal families, together with leading INGOs and international professional organisations, the Legislative Guide offers law-makers the broad outlines of a statute with recommendations, some in the form of statutory language and others in the form of alternatives. A commentary for each chapter of the guide introduces a topic, presents policy alternatives where desirable, along with justifications for the choice of recommendations. Finally, the OECD has stimulated national engagement both with global normative templates and cross-fertilisation of experiences within regions through its peer oriented regional conferences. Thus a global division of labour among international institutions has developed from which have proceeded normative templates, a legislative guide, diagnostic instruments, survey instruments, and communication channels.

These initiatives simultaneously offer models to developing and transitional societies and present standards that are believed acceptable to prospective creditors whose lending, it is anticipated, will drive economic growth. They all proceed on the implicit, and occasionally explicit, theory that good insolvency (and other commercial law) will stimulate investment that will in turn produce economic development.

What is their general significance for Asian reforms?

There has been a general *substantive convergence towards rescue regimes*. All the global norms emphasise the necessity for insolvency systems to complement corporate liquidation regimes with corporate restructuring regimes. The emphasis on corporate rescue requires substantive law, often executive agencies, judicial competence, and expert professions. In Asia, however, it has been a consistent complaint of IFIs and expert observers that the most impressive restructuring framework will be of little value unless liquidation is a clear threat because creditors and courts ensure it happens in practice, a threat that seems to be hollow in many Asian countries.<sup>11</sup> How well out-of-court restructuring regimes have worked in countries from Indonesia to Thailand has been the subject of some doubt. Indeed, it is arguable in some instances, that these rescue mechanisms present one more way for debtors to stall effective financial or operational restructuring. Yet rescue regimes are

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<sup>9</sup> IMF, *Orderly and Effective Insolvency Procedures*, Legal Department, Washington, D.C., (1999).

<sup>10</sup> See World Bank, April 2001, "Principles and Guidelines for Effective Insolvency and Creditor Rights Systems."

<sup>11</sup> See the remarks of Lampros Vassiliou, OECD Forum on Asian Insolvency Reforms (FAIR), Seoul, Korea, November 2003.

attractive to governments because they appear to offer a backdoor method of softening otherwise hard budget constraints.<sup>12</sup>

From the earlier norm-setting initiatives of IFIs to the World Bank Principles and, most notably, the UNCITRAL Working Group on Insolvency, the *consultative process has broadened* radically. Earlier initiatives were principally designed by IFI lawyers and a small number of consultants.<sup>13</sup> The World Bank process, too, is drafted by the Bank itself, with the advice of many experts, but various drafts of the Principles have been widely discussed in regional forums.<sup>14</sup> UNCITRAL's process, however, represents a qualitative shift in process, for the Guide has been forged in a quasi-legislative forum where representatives of 30 to 50 countries, who represent all regions of the world and nations at all stages of economic development, work their way through the legislative instrument, section by section, seeking consensus among themselves and with the representatives of expert organisations, professional associations, and specialists from international institutions. The Legislative Guide is as close to a parliamentary product as it is possible to get in global norm setting.

These *global models are constructive*, that is, they seek to codify what has worked in advanced economies in the light of IFI experience with transitional and developing economies. They offer a clear point of departure, a theme around which variations may be woven. Herein, of course, lies a difficult problem: the value of single global standards can be subverted by their inflexible application to situations where they are singularly unsuited. The standards of "modern insolvency systems," or practices in "advanced countries", or "international best practices" may need considerable relaxation and adaptation in settings that have radically different institutional frameworks and whose economic and legal histories diverge sharply.

Progressively, *a global consensus has emerged* over the key features of an insolvency system and the law and institutions that are likely to deliver it. This consensus is not imposed by a particular country, or the product of a handful of powerful international financial institutions, or a particular legal culture. The UNCITRAL quasi-legislative process has demonstrated a degree of unanimity on nearly all issues that has surprised even its architects who, in 1999, never imagined that such convergence might occur. It is true that this consensus is achieved sometimes by recommendations at a higher level of abstraction that can apply in a statute, sometimes by giving countries alternatives, and sometimes by relaxing the statutory drafting language from "should" enact a measure to "may" enact it. Nevertheless, for bankruptcy law, which has long been considered to be too deeply embedded in national culture and institutions to allow a global model to emerge, the UNCITRAL achievement has been extraordinary. Moreover, it has occurred with the full participation of the developing and transitional countries, which are likely to be its most important consumers. These countries have effectively accepted the theory that efficient market economies require the transparency and calculability of formally rational law, although that correspondence is not without dispute, whether in advanced or developing countries.<sup>15</sup>

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<sup>12</sup> "Institutionalizing Markets, or the Market for Institutions? Central Banks, Bankruptcy Law and the Globalization of Financial Markets," Bruce G. Carruthers, Sarah L. Babb, and Terence C. Halliday, in *The Rise of Neoliberalism and Institutional Analysis*, edited by John Campbell and Ove Pedersen, Princeton, Princeton University Press, (2001).

<sup>13</sup> See IMF (1999), ADB (2000), EBRD (1999; 2002) op.cit.

<sup>14</sup> The World Bank states that some 700 public and private sector specialists from seventy-five countries have attended its regional forums (World Bank 2001, op.cit.)

<sup>15</sup> Bruce G. Carruthers and Terence C. Halliday. "Institutionalizing Creative Destruction: Predictable and Transparent Bankruptcy Law in the Wake of the East Asian Financial Crisis," Working paper, Department of Sociology, Northwestern University.

These *global models should be viewed as experimental or provisional*. It is early in the global reform cycle of insolvency institution building. We do not yet know which elements of advanced nations or which elements of global models will be fundamental, and which will be variable. For instance, the concept of “best practices,” which is widely used by international norm-makers is itself problematic. No practice is best everywhere. Thus, best practices can only be held to be “best” if the conditions under which they work well can be clearly specified. That is a very difficult condition to satisfy and no global norms do so. The constructiveness of the global norms, therefore, must be balanced by a restraint and flexibility in their application until such times as their contingencies are specified systematically by region, economic history, or commercial culture.

The reforms that followed the Asian financial crisis began in the absence of these global norms. While they may have been informally applied by IFIs, they do not appear until the mid-point of reform cycles in most countries. The first wave came from the IMF in 1999 and the ADB in 2000. The second wave has not yet crested. As of early 2004, the World Bank Principles have not been finalised although various versions have been circulating and the Bank has been conducting country appraisals based on the Principles. Similarly, UNCITRAL’s Legislative Guide is still in its final months of drafting and approval. Only since 1999, therefore, have Asian countries had available comprehensive norms of some sort against which national policy-makers could appraise the adequacy of their laws.

The forums hosted by the OECD in Asia advance the sophistication of models about restructuring regimes because they consider what seems to work and what seems not to work, what might be transportable from one economy or legal system to another, and what may not. Insofar as law and development scholars are vigorously debating the entire problem of so-called legal transplants, this conversation also helps inform the scholars who search for the conditions of law reform that will facilitate economic development.<sup>16</sup>

### 3) *Insolvency law-making in Asia: what we know and what we need to know*

To paint with very broad brushstrokes in this limited space, we limit ourselves to four general observations about patterns in common across Asian reform efforts. All of these reflect patterns that are found in research on developed economies,<sup>17</sup> although they take on a distinct character in Asian developing and transitional economies. Needless to say, significant variations occur on common themes among Asian countries.

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<sup>16</sup> There is a lively scholarship in law and finance and socio-legal studies on the contingencies of legal transplants. See also Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, Forthcoming; “Economic Development, Legality, and the Transplant Effect,” *European Economic Review*, Katharina Pistor, (1999); “The Evolution of Legal Institutions and Economic Regime Change,” Paper read at Bank Conference on Development Economics in Europe, Katharina Pistor, (2000); “Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies,” *European Business Organization Law Review* 1:59-108, Katharina Pistor, (2002); “The Standardization of Law and its Effect on Developing Economies,” *American Journal of Comparative Law* 50: 97-130; Katharina Pistor, Yoram Keinan, Jan Kleinhesiterkamp, and Mark West, (2002); “Legal Evolution and the Transplant Effect: Lessons from Corporate Law Development in Six Transplant Countries,” Unpublished paper, Katharina Pistor, Martin Raiser, and Stanislaw Gelfer, (2000). See also Nelken, David, “Towards a Sociology of Legal Adaption,” (2002). For a contrasting theoretical perspective, see David Nelken and Johannes Feest, Eds, *Adapting Legal Cultures*, Oxford, Hart Publishing.

<sup>17</sup> Carruthers and Halliday 1998, op.cit.

a) *Insolvency law-making follows recursive cycles*

In Asia, law making (and institution-building) has proved to be rapidly cyclical: laws are enacted on the books; problems arise during implementation; new laws are enacted or amended or institutions are modified. We call this the recursivity of law—cycles of reform from law-on-the-books to law-in-practice. Each cycle is intended to solve a problem that exists in the absence of law or in the gap that opens up between formal law and its actual practice.

At first glance, this seems to be stating the obvious. Yet not so long ago, in many advanced economies, bankruptcy laws stood un-amended for a half century or more.<sup>18</sup> Only in recent decades has the pace quickened, and in many Asian countries, some reforms are occurring almost annually. There are many reasons for this quickening of reforms cycles in developing and transitional countries. It may occur because there is no prior insolvency law so the first approximations work less well (*e.g.*, China). It may occur because laws-on-the-books have been unused so trial and error is required to find out what works when they are activated (*e.g.*, Indonesia, Korea). It may occur because a major crisis requires urgent reforms and mistakes can be made (*e.g.*, Indonesia, Korea). It may occur because in a financial crisis, tensions open up between IFIs and nation-states that produce unworkable tradeoffs or create resistance or there is a mismatch between IFI solutions and local implementation. It may occur because the economic and political stakes of insolvency law, especially those that shift discretionary power away from government officials, intensify political conflicts (*e.g.*, Indonesia). It may occur because the systemic implications of insolvency reforms reach to fundamental questions in the balance of power within the society as a whole.<sup>19</sup> Most of these reasons stem from an underlying dynamic—instability is built into the cycle at either the point of enactment or the point of implementation. This instability, which may also be seen as a contradiction or tension,<sup>20</sup> is likely to build up pressure for further cycles. Over time, if tensions are resolved and gaps narrow between enactment and implementation, then a slowing and settling into a stable regime will occur.

Several qualities recur in bankruptcy reform cycles across the region, qualities that precipitate further cycles of law making.

i) *Bankruptcy law reforms always have unanticipated consequences*: Bankruptcy reforms are always incomplete—issues are not anticipated, ambiguities occur. This is less a function of insolvency law itself than of all law. For this reason, all well-functioning legal regimes have “clarifying institutions,” such as courts, to reduce the ambiguity or settle meanings.<sup>21</sup> The problem of unanticipated consequences may be intensified in bankruptcy law because liquidations and reorganisations frequently require major redistributions of assets or control of corporations, setting into motion political and economic resistance which results in the distortion or emasculation of law. Unanticipated consequences may be even more frequent in regimes where law has had little capacity and little use, a recurrent problem in many parts of Asia, especially those that have followed a state development model in recent decades. Clarifying institutions are often poorly developed. However, just as courts may clarify ambiguous or incomplete statutes, so too statutes are often amended to correct court decisions or to bring orderliness into conflicting judicial interpretations. These

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<sup>18</sup> *Id.*

<sup>19</sup> Terence C. Halliday and Bruce G. Carruthers, (2003), “Foiling the Hegemons: Limits to the Globalization of Corporate Insolvency Regimes in Indonesia, Korea and China,” American Bar Foundation Working Paper 2212.

<sup>20</sup> William J Chambliss and Marjorie S. Zatz. (Eds.), (1993), *Making Law: The State, The Law, And Structural Contradictions*, Bloomington, Indiana, Indiana University Press.

<sup>21</sup> Katharina Pistor and Chenggang Xu, (2002), “Incomplete Law—A Conceptual and Analytical Framework and its Application to the Evolution of Financial Market Regulation,” Working Paper, Columbia University.



corrections or clarifications frequently turn on how much discretion is permitted to judges. It was precisely this problem of discretion, among other things, that prompted the officials of Korea's Ministry of Finance and Economy (MOFE) to act in the first wave of Korean reforms.<sup>22</sup> When the IFIs quickly appraised the problems of Korean insolvency law in late 1997 and 1998, they found that the laws were barely used.<sup>23</sup> Courts showed considerable reluctance to liquidate companies and they regularly exercised their discretion in favour of keeping companies alive, even when any hope of recovery seemed dim.<sup>24</sup> In the 1998 amendments to the Corporate Reorganisation Act, the government introduced a provision that would sharply limit judges' discretion. Following the recommendations of a leading economist, the amendment provided that each case filed under the Act would be subject to an Economic Criterion Test: if its going concern value is greater than its liquidation value, then a company could remain on the reorganisation track; if its going concern value is less than its liquidation value, the company would be liquidated.<sup>25</sup> The judge's decision, therefore, would be determined by a pure economic calculation, thereby removing a judge's flexibility and ignoring the wishes of creditors. The case of the Dong Ah Group demonstrates that this seemingly mechanical process could have disastrous effects. Once Korea's largest construction company, the Dong Ah Industrial Construction Company got into severe financial difficulty in 1998. When out-of-court restructurings failed, the corporation entered receivership under the Corporate Reorganisation Act. Judges obtained valuations and applied the Economic Efficiency Test. Since going concern value was less than liquidation value, the Seoul District Court felt bound to consign the company to liquidation, despite the fact that significant new creditors were prepared to come to Dong Ah's rescue and the Government strongly supported reorganisation. Thus was destroyed a company, and many others dependent upon it, that might have been restructured under court supervision.<sup>26</sup> As a result of a number of similar cases, the government felt compelled to back away from the strict economic test and to relax its application.

ii) *Bankruptcy reforms may be driven by professionals*: Professionals often drive reform cycles for two reasons. First, two major professions converge at the intersection of legal systems and the economy: lawyers and economists. Their training and epistemologies do not necessarily coincide and often conflict. They differ in their theories of how law and economies function. This conflict can drive reform cycles. In Korea, lawyers and economists have significantly divergent views of how law operates and what can be achieved through law.<sup>27</sup> Economists, including those in influential government departments, tend to think of law as more instrumental, portable, and independent of

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<sup>22</sup> For an interpretation of the Korean insolvency reforms, see Terence C. Halliday and Bruce G. Carruthers., Forthcoming, "Epistemological Conflicts And Institutional Impediments: The Rocky Road To Corporate Bankruptcy Reforms In Korea," In Thomas Ginsburg (Ed), *Korean Law Reform*, Routledge Press.

<sup>23</sup> In 1996, for instance, in all of Korea, 18 individuals and companies were liquidated under the Bankruptcy Act, 9 individuals and companies entered proceedings under the Composition Act, and 81 companies made use of the Corporate Reorganisation Act, (Il Chong Nam and Soogeun Oh, 2000. *Bankruptcy of Large Firms and Exit Mechanisms in Korea*. Seoul: Korean Development Institute, Table IV-1, page 37).

<sup>24</sup> Nam and Oh, (2000), op.cit.

<sup>25</sup> Soogeun Oh, (2003), "Insolvency Law Reform of Korea: A Continuing Learning Process," Paper presented at The Forum on Insolvency Risk Management, The World Bank, January 28, Washington, D.C., USA; Letter of Intent, Government of Korea to International Monetary Fund, 24 June 1998.

<sup>26</sup> "Dong Ah Construction To File For Court Receivership," 10/31/2000 Dow Jones International News; "Dong Ah Construction Faces Liquidation-Reports," 10/30/2000 Dow Jones International News; "Govt Asks Court To Place Dong Ah Under Receivership," 02/19/2001 Dow Jones International News; "Court decides to liquidate Dong Ah Construction," 2001.03.10 by The Korea Herald. ("We have learned from an accounting firm that Dong Ah's liquidation value (1.6 trillion won) is greater than its value as a going concern (1.2 trillion won). We have decided to liquidate Dong Ah Construction for the sake of national interest," the court said.)

<sup>27</sup> Halliday and Carruthers, "Epistemological Conflicts," forthcoming, Op.cit.

circumstances. They believe that law can be applied almost as easily as a change in macroeconomic policy and with a relatively predictable outcome. In this sense, their confidence in law's capacity for determinate economic change is high. Yet, at the present time, they also register doubt about the current capacity of courts to handle important economic cases and they hope for more certainty than they believe law currently offers in the hands of judges.

Many Korean lawyers take a different view: some are sceptical altogether that new laws are necessary to produce reform and believe that political misdirection of the economy is to blame; others believe that law needs time to settle, that quick cycles of reform will be counterproductive. Yet, others voice the opinion that the protectionism of the profession, by keeping its numbers so low, may inhibit the supply of skilled professionals to implement a new restructuring regime that draws corporate rescues into the courts or into the shadow of the courts. In general, Korean lawyers view law more organically, as part of a larger legal tissue, and as less manipulable. Moreover, lawyers are much less confident that the consequences of a legal change will be predictable.

In general, these differences in epistemologies and understandings of law can produce problems in both directions: economists bring a sense of efficacy and decisiveness, but impatience may not give time for law to settle; lawyers bring a sense of the seamlessness of law but their caution may lead to paralysis. Thus a dynamic pits activist economists eager to use law as a lever for rapid economic change, while lawyers resist the frequent changes of law or refuse to use it, or use it in unexpected ways. Their contest is reflected in successive cycles of law reform: economists at MOFE substantially drove the enactment segment of earlier reform cycles, while lawyers and judges substantially control the terms of its implementation. Without accord, each profession has a position of strength to frustrate the intent of the other—and thus generate further cycles. These differences in perspective will likely continue through the debate and implementation of the new draft bankruptcy law and may stimulate further waves of amendment beyond the major enactment of this law.

Second, a dynamic drives reform cycles when groups involved in reforms themselves come to recognise the recursivity of law. If major stakeholders in reforms—debtors, creditors, professionals, policy-makers—understand that insolvency law-making is an iterative game, they also know that what is lost in enactment may be gained back by impeding implementation; what is gained (or lost) in one round of enactment may be lost (or gained) in the next. Debtors (the corporate sector) in Indonesia, for instance, were not an important party to the reforms agreed between the IMF and the Government. Neither were trade creditors. It is not surprising that the debtors used every expedient at their disposal, from corruption of judges to frustration of debt-restructuring experiments, to frustrate reforms.<sup>28</sup> Put another way, stakeholders in reforms may have different levels of strength within different institutions. If stakeholders cannot win within the political process that leads to enactment of reforms, they may be considerably more successful on a battleground of their own choosing, *i.e.*, in the market and in implementation.

*iii) Bankruptcy reform cycles may be stimulated by external forces:* In transitional and developing countries, or countries in distress, cycles of reform may be fuelled by strong pressures from outside—from other countries, such as creditor nations, or from international financial institutions, or from major economic changes. External changes take two forms.

On the one hand, diffuse influences may be extended by international networks of scholars, by foreign aid programmes, by international conferences, and by participation in global forums, such as UNCITRAL's Working Group on Insolvency. In these cases, countries have significant freedom to

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<sup>28</sup> Halliday and Carruthers, 2003, "Foiling," *op.cit.*

choose which norms to follow and at what pace. China's law reforms reflect this pattern well, for its corporate restructuring reforms and draft laws since 1994 have been affected by consultations with the Asian Development Bank and the World Bank, by earlier aid from the World Bank Legal Department and more recently from the German Government's resident programme in Beijing on reform of commercial laws (GTZ), by international conferences held to review new drafts of the bankruptcy law, by the participation of China in UNCITRAL Working Groups, and by lessons learned from other countries, such as Australia, Japan and the United States.<sup>29</sup>

On the other hand, influence can be direct and accompanied by incentives or sanctions. These are best exemplified by the conditionalities built into the financial assistance packages negotiated between Indonesia, the IMF and World Bank.<sup>30</sup> However, significant influence was also brought to bear on Korea by the IFIs in late 1997 and 1998 to effect insolvency reforms. Although these were not included as conditionalities in formal agreements between the IFIs and Korea, clear understandings were reached that Korea would bring its bankruptcy law into line with "international best practices" and that the government would undertake "a thorough review" of its liquidation regulations and bankruptcy law.<sup>31</sup> Also agreed was a commitment by Korea to unify its three bankruptcy laws into a single, seamless law, a promise now being kept.<sup>32</sup>

China, Korea, and Indonesia therefore exist on a continuum where the least external constraint is brought to bear on China and the most has been directed at Indonesia. The extent and nature of external constraint matters. Paradoxically, while more constraint might seem to bring more results, just the opposite can occur, for nations under some duress to implement reforms as a condition of loans may comply reluctantly or little at all. A classic strategy will be to shift the resistance to their own ground, namely, in the complexities of implementation, and attempt to foil reforms that are unpalatable but could not be resisted at the moment of crisis-driven agreements.<sup>33</sup> There is little doubt that the pace and direction of reform cycles in Indonesia and Korea has been substantially influenced by the IMF and World Bank.

Driven by these and other forces, therefore, Asian insolvency reforms manifest a distinctively recursive character. In Korea, a series of amendments, new pieces of legislation, out-of-court restructuring schemes, changes in regulatory mechanisms - all have quickly followed each other in efforts to strengthen Korea's effort to implement a functioning insolvency system based in the law and the market rather than through government intervention.<sup>34</sup> Many of Korea's experiments have been successful, as increasing numbers of companies have proceeded through liquidation and reorganisation in shorter periods of time. Workouts seem to be occurring through implementation of the Corporate Restructuring Promotion Act. Yet, the Government has abandoned other experiments that did not catch on, such as the 1999 amendments to provide court-endorsed pre-packaged agreements that would allow fast-track reorganisations,<sup>35</sup> and it modified other measures, as we have seen with the strict economic criterion. Now the National Assembly has before it a comprehensive, unified

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<sup>29</sup> Terence C. Halliday and Bruce G. Carruthers. 2003. "Conformity, Contestation and Culture in the Globalization of Insolvency Regimes: International Institutions and Law-Making in Indonesia and China." American Bar Foundation Working Paper 2214.

<sup>30</sup> Memorandum from Government of Indonesia to IMF, 24 June 1998; Letters of Intent from Government of Indonesia to IMF 29 July 1998, 12 November 1998, 16 March 1999, 27 August 2001.

<sup>31</sup> Letter of Intent between Government of Korea and IMF, 32 October 1997; Memorandum to IMF from Government of Korea, 15 January 1998.

<sup>32</sup> Oh 2003, op.cit.

<sup>33</sup> Halliday and Carruthers, 2003, "Foiling," op.cit.

<sup>34</sup> Oh 2003, op.cit.

<sup>35</sup> Interviews 2294, 2282.

bankruptcy law.<sup>36</sup> If enacted, it is likely that it too, will stimulate further correcting cycles of statutory, court or administrative reform.

Indonesia has also gone through many cycles of reform and institution building, all of which have been influenced by conditions attached to the financing led by the IMF.<sup>37</sup> A series of initial enactments, followed by implementation problems, have led to legislative and administrative corrections. On the one hand, each new layer of law and each new administrative structure has opened up new possibilities, such as fighting corruption (*i.e.*, lack of autonomy from the market), or opening up court decision-making for scrutiny. On the other hand, the early decisions of the new Commercial Court shattered any hopes that the path to reform would be easy. Strong negative incentives for debtors to negotiate reasonable debt restructurings with creditors never took hold. Moreover, the evident successes of the JITF in obtaining MOUs will depend ultimately on whether they are realised in practice. If we apply a simple test of the quality of facilities for the courts, JITF, and IBRA, however, we might conclude that the priority of the government is with administrative rather than judicial solutions.

The Chinese situation is especially complicated for its current insolvency system comprises a complex mosaic of laws, regulations, and agencies. Cyclical reforms have proceeded along two parallel, almost independent, tracks. On the one side, the SETC (now SASAC) has conducted an ever widening set of experiments with SOEs, to get rid of debt overhang, and to liquidate or merge weaker SOEs without severely dislocating workers or communities.<sup>38</sup> On the other side, the FEC of the NPC has produced ever more refined drafts of a new comprehensive bankruptcy law. Now China, like Korea, has a comprehensive bankruptcy law “ready to go.”<sup>39,40</sup> There are many reasons why successive cycles of draft revisions have occurred: the most important is whether SOEs will be made subject to the law, and their restructuring taken progressively away from administrative control and placed in the courts. That debate remains unresolved.

Repeated cycles are not necessarily a bad thing—although they can reflect unrealistic aspirations, at one extreme, or lack of political will or capacity, at the other extreme. In undeveloped areas of law they may be expected, and after a period of time, in the best cases, the law and its institutions will settle at a new and higher equilibrium as nations produce laws and institutions that fit their context, and as implementation yields results. In the worst cases, either the reforms will die of exhaustion and unfulfilled promise, or somewhat more positively, substantive reforms will be put on the books but implementation will falter.

*b) Bankruptcy law-making produces conflicts among policy norms*

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<sup>36</sup> Soogeun Oh. 2002. “Drafting Of New Insolvency Law Of Korea.” Paper Read At FAIR Conference, OECD, Bangkok, Thailand, December.

<sup>37</sup> For sociological analyses of the Indonesian insolvency reforms see Halliday and Carruthers, (2003), “Foiling,” *op.cit.*; Halliday and Carruthers, (2003), “Contestation,” *op.cit.*

<sup>38</sup> World Bank, Bankruptcy of State Enterprises in China—A Case and Agenda for Reforming the Insolvency System, (2000). (Hereafter World Bank 2000), Nam and Oh, (2000).

<sup>39</sup> For analyses of the Chinese insolvency reforms, Halliday and Carruthers, (2003), “Foiling,” *op.cit.*; Halliday and Carruthers, (2003), “Contestation,” *op.cit.*

<sup>40</sup> Wang Weiguo, “Several Targets in the Current Drafting of Bankruptcy Law,” Paper delivered to Symposium on Reforming the Bankruptcy Law, sponsored by GTZ (German Ministry of Economic Co-operation and Development), (2001), Beijing; Wang Weiguo, this volume.

This is scarcely surprising to reformers. Nevertheless, it does complicate matters for global designers of insolvency systems because, for plausible institutional reasons, they seek a pure normative standard—most often that of “efficiency,” although it may be tempered by other values such as orderliness, effectiveness, and even fairness.

In Asian insolvency law making, we discover three values in tension—efficiency, equity, and stability (harmony). *Efficiency* emphasises insolvency regimes that produce quick, decisive action that will redistribute under-utilised or mismanaged resources to better equipped or better resourced managers. It is consistent with a purely economic view of insolvency and with law and economics theory. *Equity* concerns the breadth of stakeholders that are taken into account in insolvency law making and the relative priorities given to their voices and their economic interests. It may go beyond creditors, owners and managers to embrace the interests of communities, regions, states or provinces. *Stability* or harmony refers to the social and political repercussions of substantive and institutional features of bankruptcy regimes.

Implicitly or explicitly, these values encounter each other at the intersection of jurisprudence and policy-making. Reforms that do not take all three norms into account, and that do not hear the concerns of their advocates, may face a rocky road toward implementation. The negotiations among differing stakeholders who place different emphasis on these three values partly determine the frequency and dynamics of recursivity.

*Korea:* The tension between efficiency and equity norms has been debated among stakeholders in Korea. While the efficiency criterion has been advocated vigorously, most notably by the Ministry of Finance and Economy, two sets of parties have contested its distributive neutrality on grounds of inequity. Domestic and foreign credit institutions have each alleged inequities in respective laws. Before the Corporate Restructuring Promotion Act, domestic credit institutions complained that foreign credit institutions were holding restructuring agreements to ransom until foreign institutions were satisfied at a premium. After implementation of the Corporate Restructuring Promotion Act, foreign institutions complained that restructurings were forced on them in virtue of their minority creditors in most corporate financings. More generally, some elements of the legal profession maintain that short-term efficiencies in cram-downs of certain creditors—often trade creditors—will lead to long-term inefficiencies, because the inequity will cause harmed creditors to unsettle restructurings in which they had no voice.<sup>41</sup> In Korea, debtors and the corporate sector have been largely absent from the process of reform, a problem that recurs in most countries.<sup>42</sup>

*China:* However, the strongest limiting case for efficiency norms can be seen in what appears to be the Chinese government’s insistence that social stability is the primary political litmus test for passage of a comprehensive insolvency law. The New China created an “iron rice bowl” that China’s leaders promised its people in return for their labour and commitment. China’s social safety net was created around state-owned enterprises (SOEs).<sup>43</sup> With the slimming down of SOEs, a new social security system must be developed, but it is far from complete. If it is true that a very high proportion of SOEs are technically insolvent,<sup>44</sup> and if it is also true that firing workers from insolvent SOEs would also deprive them of their safety net and dignity, then a pure market-based insolvency regime

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<sup>41</sup> Halliday and Carruthers, “Epistemological Conflicts,” Forthcoming, op.cit.

<sup>42</sup> In the 1978 US reforms they scarcely appear. In the UK 1986 reforms, the corporate sector and debtors almost completely ignored the opportunities to participate in the reform process until they were shocked to learn of provisions that might hold directors personally accountable for their company failures. (Carruthers and Halliday 1998).

<sup>43</sup> Cao Siyuan, 1998, “The Storm over Bankruptcy (I),” *Chinese Law and Government*, January-February 1998.

<sup>44</sup> It has been estimated by a competent authority that as of 2001 almost all small and mid-sized SOEs were likely to be technically insolvent. (Interview 2001:101)

that strives only for efficiency might produce social unrest that could spill over into political disturbance. Some social unrest over displaced workers in the last year has underlined the potential danger. Thus, senior Chinese policy-makers are faced with a dilemma. On the one hand, drafters operating under the auspices of the National Peoples' Congress Committee on Finance and Economy have crafted an impressive insolvency law, which the World Bank, the GTZ, and numerous foreign experts have urged be enacted. Yet, enactment might introduce economic, social and political uncertainties. On the other hand, China's current mix of laws and regulations allows the government to maintain some administrative control, both from Beijing and locally, over potential dislocations in order to ease transitions to a socialist market economy. Stability trumps efficiency.

Since the designers of global insolvency norms have far more expertise and authority on the efficiency than the policy norms, they seek to bracket the latter<sup>45</sup> and to focus entirely on the substantive and procedural technical core of insolvency systems. This is defensible because they seek to generate global norms in an area of law where there is enormous cross-national variability in policy preferences and because their competencies and institutions are compromised the closer they come to political ideologies and national politics. Yet, national policy-makers cannot avoid confronting the value preferences inherent in bankruptcy law. The experiences of several Asian countries demonstrates that the effects of bankruptcy reforms can be so far-reaching, and penetrate so deeply into the economic, social and ethnic fabric of a society, that careful scrutiny must be given to the limitations of efficiency as a pure value in bankruptcy jurisprudence and practice.

*c) Insolvency systems are embedded in economic, political and social systems*

The systemic concept of insolvency regimes is a major advance. An implicit notion of insolvency *systems* motivated the major reforms of the US in 1978 and UK in 1986.<sup>46</sup> Reformers understood that an effective insolvency regime required a combination of public and private solutions, of structures and incentives, of officials and professionals, all integrated into a mutually sustaining system. The designers therefore integrated into their reforms substantive and procedural law, state agencies, and private professions. They encouraged synergies with business associations.<sup>47</sup> Similar approaches are now assimilated explicitly into global models, most notably that of the World Bank which even referred to its "systems approach" in earlier drafts. A systemic approach is implicit in both the models and actual technical assistance projects of other IFIs.

Yet, for all this, another step remains to be taken. Systems theory itself recognises, and national experiences demonstrate, that insolvency systems are embedded in other systems: in political systems (which incorporate the distribution of power in a society), in economic systems (which generate the distribution of wealth), and in social systems (which organise civil society, social support, interaction, and culture.) It is impossible to make significant changes to an insolvency system, let alone create a system *de novo*, without far-reaching implications not only for the insolvency system, but also for the other systems. If a new insolvency system threatens the distribution of power, wealth, and support in other systems, it will trigger, at least, intense negotiations among the leaders of each system, and, at most, conflict, resistance, and reversal. Many of the problems faced by reformed insolvency systems,

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<sup>45</sup> Often the bracketing is done by advising governments to handle distributive and welfare implications of bankruptcy in other areas of law or through administrative means, such as creating special unemployment funds.

<sup>46</sup> Carruthers and Halliday, 1998, *op.cit.*

<sup>47</sup> For example, the Institute of Directors ran courses for company directors to educate them about the steps they must take to avoid disqualification or seizure of their personal assets in the event that a court finds them culpable when their companies are in financial distress (Carruthers and Halliday, 1998, *op.cit.*)

therefore, lie less within the insolvency system itself, and more by the impact it has on other systems. Some brief examples illustrate the point.

*Political systems:* For Asia, and elsewhere, the fate of insolvency reforms will depend on how governments confront difficult questions: Has law historically exercised any restraint over executive power? Has law been an alternative centre of power in the society? Has business any experience with or confidence in definitive judgments by courts? Does law offer a substantial carrying capacity for market regulation? Has it carried any load of public administration? Has it been a preferred forum of dispute resolution? Are court rulings binding in practice or enforced?

This problem is acute for countries that have followed a state development model of economic growth. Institutional inertia produces a momentum that may take decades to slow down. Short of revolution, all countries demonstrate that it is exceedingly difficult for states to retract from active intervention in economies, for government officials to reverse their practices of intervening often or arbitrarily into industry development or even the decisions of particular corporations. This is compounded in countries where law has not been a prestigious occupation, judges may not be highly competent or authoritative, and courts have not been considered legitimate alternative centres of power.

For instance, many Korean reformers point to the major hurdles that are faced by initiatives to shift the locus of economic decision-making away from government agencies and into the markets and courts. This is partly because law is being asked to take on tasks substantially greater than in the past. Policy-makers and senior officials ask if lawyers and judges can be trusted with economic cases, especially of the largest corporations whose liquidation will have wide repercussions in the economy and beyond. Moreover, old habits die hard. A meritocratic technocracy has successfully brought Korea from a backward nation to one of the world's leading economies. The state has been successful in recruiting officials with world-class qualifications. The Ministry of Finance and Economy and its precursors have effectively guided Korea's development and its economist-officials have enormous experience in close market governance. While the shock of 1997 reduced their confidence, and the government of Korea has taken many steps to increase the autonomy of markets and the law from executive control, much of the law-making continues to be directly driven by MOFE and interventions continue, albeit at a reduced rate, even to the level of decisions about restructurings of particular firms.<sup>48</sup>

In China, the issue may be even more acute. China has no heritage of the rule of law.<sup>49</sup> Despite the immense volume of commercial law-making over the past fifteen years,<sup>50</sup> its legal system faces high hurdles to attain standards of fairness, efficiency, and certainty, especially in cases where substantial amounts of assets are at stake and local political interests are embroiled. The courts are not independent of state influence at the national or local levels. In the last two years, for instance, there is evidence that state authorities in Beijing have directed the courts arbitrarily to reduce the number of liquidations, a reduction apparent in trend statistics.<sup>51</sup> However, most importantly, to maintain political

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<sup>48</sup> While considerable advances appear to have been made in the retreat of government officials from direct intervention into the fate of particular firms, there is evidence that the government is still quietly intervening in certain bank decisions about restructuring, interventions that are made easier because the government is sometimes a major stockholder in banks. MOFE appears also to be directly involved in some high profile or politically sensitive restructurings or takeovers.

<sup>49</sup> Stanley B. Lubman, (1999), *Bird in a Cage: Legal Reform in Chicago after Mao*, Stanford, Stanford University Press.

<sup>50</sup> Randall Peerenboom, (2002), *China's Long March towards the Rule of Law*, Cambridge, Cambridge University Press.

<sup>51</sup> Statistics provided by Cao Siyuan Consultancy, (2003).

control the Party will find it exceptionally difficult to allow courts the autonomy that conventionally assures investors and commercial actors that their cases will be dealt with on their financial merits alone.<sup>52</sup> As a result, foreign lawyers and accountants have developed sophisticated techniques to avoid Chinese courts wherever possible. A new insolvency law, therefore, will be stunted at birth, or have symbolic value only, if the institutions on which it relies for implementation are not radically reformed—and that involves decisions that fundamentally affect the political system.<sup>53</sup>

*Economic systems:* Here the idea of an embedded insolvency system seems entirely obvious. It matters how closely the economy has been directed by the state, or what the characteristic patterns of ownership and control of corporations are, or how concentrated industry is, or how corporations have financed their operations. How prevalent are company towns and company-regions? Have courts historically played a central role in economic regulation? What social factors (ethnicity, region, religion) influence the organisation of the economy? It is not clear that we have models of insolvency regimes that are differentially adjusted to variations in the organisation of economic systems.

In Indonesia, many experts observe that both the political and economic system are organised partly around ethnicity—that the heights of politics are controlled by *pribumis* (ethnic Indonesians) and the heights of the economy are disproportionately controlled by Indonesians of Chinese ethnicity.<sup>54</sup> After the anti-Chinese pogroms of the 1960s, a “settlement” was concluded between the Chinese and *pribumi* leaders that effectively gave the Chinese free reign in the market so long as they remained out of politics. Over time, many politicians profited from association with major business groups, just as the Chinese conglomerates helped spearhead Indonesia’s economic development. The reforms negotiated by the IFIs and the Indonesian government, however, threaten to destabilise this long-standing settlement with repercussions that affect not only the economy but might conceivably trigger ethnic conflict.<sup>55</sup> Thus, it is not surprising that the Jakarta Initiative Task Force, set up to provide out-of-court restructurings for large corporations, has encountered stiff resistance by debtors. Given that the Task Force has a few positive incentives and very few negative incentives, to obtain any kinds of agreements creditors have had to take substantial “haircuts.”<sup>56</sup> The reasons are not difficult to understand for the Jakarta Initiative, while apparently involved only in financial or operational restructuring is, in fact, threatening the control of Chinese corporations. More importantly, the shift of control and ownership in corporate restructuring may be seen by Chinese business elites as a way of wresting control of much of the economy from their hands.

In the language of systems theory, this may entail deep systemic re-adjustments—even radical disjunctions—that disturb carefully negotiated settlements between ethnic communities that have led to delicate equilibriums among political, economic and social systems. If financial restructuring disguises the redistribution of wealth away from a powerful ethnic minority, this may produce severe disequilibriums in the economic and political systems.

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<sup>52</sup> Lubman, 1999, op.cit., p2,8.

<sup>53</sup> In fact, the situation is more complex than this. It is conceivable that China could push towards a system similar to that of Singapore, where the courts have high standards and appear largely independent on commercial matters, but are less so on political matters. It is also possible that Chinese courts might be more impartial and competent in cases where all the parties to the insolvency are Chinese. The government might even instruct the courts to be especially vigilant in matters that concern foreign enterprises, as it appears to have done with some government ministries that deal with foreign investors.

<sup>54</sup> Interview 2032.

<sup>55</sup> Interview 2267, Adam Schwarz, (1994), *A Nation In Waiting: Indonesia in the 1990s*. Boulder, Westview.

<sup>56</sup> Halliday and Carruthers, “Contestation,” op.cit.



*Social systems:* New insolvency regimes encounter deeply institutionalised ways of organising social life in countries. An effective insolvency system must deal with such questions as: does the social organisation of family and community provide an invisible safety net? How is inequity distributed over regions, ethnicities, and religions? How do people characteristically handle disputes? Are there cultural concepts, such as “face,” which might affect what kinds of insolvency regime will work in a region?<sup>57</sup>

China, which has already undergone one enormous social experiment from 1949 to the mid-1980s, is now undergoing another. China’s leaders are committed to a fundamental redefinition of the social contract the government has with society. Under the socialist social contract, the government committed to certain fundamental standards of living in return for limits on personal consumption, ceilings on personal aspirations, and compliance with the Party. “Pensions, health-care, disability benefits, housing - all came from lifetime employment.”<sup>58</sup> These were tied to jobs in state-owned enterprises.

With the growth of private enterprises and the drastic efforts to restructure the SOE sector, the old social contract is being replaced by a new contract whose terms are still being defined. The social safety net has been progressively shorn away from SOEs, workers are being pensioned off or thrown out of work—and a new safety net is not yet in place. While the government is valiantly endeavouring to erect a replacement safety net, the task is daunting, enormously expensive, and has a long way to go before it can offer anything like the scope of coverage that pertained during the pure socialist period.

To include SOEs in a new comprehensive insolvency regime, as many foreign observers are demanding, is tantamount to asking the Chinese government to take an extraordinary gamble that the law, in practice, will not lead to an avalanche of bankruptcies, will not throw a large number of workers into the street, and will not bring to a boil the social and political unrest that is likely to follow. To follow the law amounts to a retraction of government control of a potentially volatile social problem. What designers of insolvency systems, therefore, must put to one side (*e.g.*, how to deal with policy issues such as safety nets) may be fundamental for policy-makers—and insolvency regimes may be held hostage to changes in the social system.

In sum, putting an insolvency system into place will depend heavily on how much inertia there is in other systems, how much power, wealth, or social support needs to be surrendered by other systems, how difficult it is to re-equilibrate the political settlements with other systems, and how good the fit is between features of the insolvency and other systems. Sometimes the fit is good, sometimes less good. Institutional incongruence matters and effective law-making will increasingly require refined understandings of what type of insolvency systems fit with what types of economic, political and social systems.

One of the most difficult problems in insolvency law making, therefore, is that progress in the development of global norms has far outrun the specifications of the conditions under which regimes will work or not work. Insolvency designers have produced no contingent theories of fit between insolvency systems and differing configurations of economic, political and social systems. Thus, a

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<sup>57</sup> Gerry Meyerman, “The London Approach and Corporate Debt Restructuring in East Asia,” World Bank, Paper delivered to a conference on Emerging Markets in the New Financial System: Managing Financial and Corporate Distress; ADB Report, (2000); Halliday and Carruthers, “Contestation,” *op.cit.*, Interview 3002.

<sup>58</sup> Wenfang Tang and William L. Parish, *Chinese Urban Life Under Reform: The Changing Social Contract*, New York, Cambridge University Press, (2000), pp. 3, 35.

large gulf lies between the relative harmony found in IFI global standards and their effective implementation in enormously varying national contexts.

d) *Bankruptcy systems may vary by types of capitalism and commercial culture*

Political economists assert that at least two varieties of capitalism exist in advanced economies, at least in Europe and North America. While they share certain fundamentals in common, liberal market economies (e.g., Britain, United States, New Zealand) differ in important ways from co-ordinated market economies (e.g., Germany, France, Scandinavia): (1) in forms of corporate governance (a shareholding model versus a stakeholder model of the firm); (2) in the extent of a social safety net (with implications for how difficult it is to impose a hard bankruptcy law); (3) in the structure of financial markets (capital market-based versus bank-based). Moreover, liberal market economies rely on market-based co-ordination, where law is an integral part of the framework necessary for the effective functioning of markets, whereas co-ordinated market rely more on non-market based co-ordination, and the institutions which make that possible may or may not be enshrined in law or have formal legal standing. These two different types of economies may vary significantly in the extent to which formal commercial law is relevant to the creation and smooth operation of markets.<sup>59</sup> It is plausible to imagine that there may be further varieties of capitalism at the present time, or that new varieties are emerging.

Similarly, it appears possible that there are distinct differences in commercial culture across advanced countries. This is striking, for instance, in the sharp differences between sympathy for creditors versus debtors among British versus American insolvency practitioners. If this is so in advanced countries, it is plausible to expect it may vary all the more over civilisations or in countries making transitions from socialism or in Asia. Therefore we could anticipate that insolvency systems, and bankruptcy norms, might vary by type of capitalism and commercial culture.

In Asia, for instance, all three sets of reforms confront a style of capitalism where historically the state has played a commanding role in the economy. All three sets of reforms wrestle with a new equilibrium being negotiated between the market and the state. Oh<sup>60</sup> identifies three distinct attributes of Korea's economy that have influenced the direction and success of insolvency law-making: the government has intervened in the corporate exit mechanism; the government has led banking decisions, not based on profit-making but on policy grounds; and the government has believed the largest chaebols were "too big to fail." Clearly, Korea's many efforts at reform have attenuated these three patterns of state activity. Even then, it is likely that the Korean economy may continue to look more like a co-ordinated than a liberal market and this may involve the state much more in shaping the direction of corporate restructuring, at least at the policy level, than in liberal economies such as the UK, US or perhaps Hong Kong. Some co-ordinated economies, such as France, also expect judges to watch for infringements of a public interest much more.

Similarly, a lively debate exists among scholars about whether Asia displays a distinctly *relational* commercial culture compared to a *transactional* business culture that is often said to characterise many advanced economies. If it does, will it endure in a globalising world? A relational commercial culture depends on personal, family and ethnic ties, on trust, on business relationships that embrace more than business, and on a respect for harmony in social ties and avoidance of open

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<sup>59</sup> Peter A. Hall, and David Soskice, (2001), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*, New York, Oxford University Press.

<sup>60</sup> Oh, 2003, op.cit.

conflict.<sup>61</sup> One cannot simply imagine these away and pretend we all think and relate and dispute in the same way. If such differences exist, we will expect to see them in lending practices, in financing, in corporate ownership and control, in dispute resolution - and even in the development of insolvency practices.

#### 4) *Implications for Asian insolvency reforms - and beyond*

There are five implications of our analysis of reforms in Asia:

- a) *It is necessary to find a balance between global and local imperatives:* Global and regional multilaterals aggregate experience and expertise from advanced economies to offer a variety of standards, norms, and models that might contribute to economic development. National governments are on paths of development that incorporate a great deal of inertial force, *i.e.*, they are on trajectories that are difficult to re-direct. Successful institution-building requires, on the one hand, that insolvency designers recognise that the most elegant of models must be adapted to specific contexts; and on the other hand, that national reformers acknowledge the value to be found in global and regional models developed through a variety of expert and consultative processes.
- b) *Significant national variations must occur on global themes:* It is still too early in this new wave of insolvency system building to decide what is the irreducible core of insolvency attributes that will be universally salient. The international institutions have done the service of creating an array of standards. If it is true that there are varieties of markets and commercial cultures, then we should expect that a handful of normative alternatives would develop where their fundamental attributes are shared universally, and where other attributes are tailored to the region, history, and configuration of embedding systems in a given country. UNCITRAL's Legislative Guide is heading in this direction in its efforts to reflect this balance between universal recommendations and systematic variations, which it offers on issues where global differences recur.
- c) *It is imperative to learn from comparable situations:* Regional forums have the great merit of promoting learning from regional neighbours by cross-fertilising ideas and experiences. Experiments from the same region undertaken by countries with institutional attributes in common, may be far more valuable than those undertaken in distant places where the circumstances are radically different. Similarly, many attributes in the commercial culture and legal systems of advanced countries will simply not be present in developing and transitional societies. Direct transplants will not work unless those attributes are present. In their absence, alternative expedients may need to be found.
- d) *It is critical to identify institutional "conditionalities" and affinities:* It is impossible to learn from neighbours without identifying the soil out of which institutions spring. Two of

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<sup>61</sup> Compare, for instance, the scholarship on distinctively Chinese business relations and the debates over *guanxi*. ("Overseas Chinese Capitalism." In *Confucian Traditions in East Asian Modernity: Moral Education and Economic Culture in Japan and the Four Mini-Dragons*, edited by Wei-ming Tu. Cambridge: Harvard University Press; Gordon Redding, 1993, *The Spirit of Chinese Capitalism*. New York: Walter de Gruyter; 1996a; "Weak Organizations and Strong Linkages: Managerial Ideology and Chinese Family Business Networks." In *Asian Business Networks*, edited by Gary Hamilton. Berlin: Walter de Gruyter; Doug Guthrie, "The Declining Significance of *Guanxi* in China's Economic Transition," *China Quarterly* Vol. 154 (1998), pp. 31-62; Ethan Michelson, "Old Wine in New Bottles: Lawyers, Clients, and *Guanxi* in the Chinese Legal System." Unpublished paper, University of Chicago and American Bar Foundation (May 2002)).

the greatest weaknesses in current global movements for insolvency law reforms are, first, insufficient attention to the embeddedness of insolvency systems in other systems within a country, and second, insufficient identification and specification of the institutional conditions that produce success or failure in each situation. Unless it is possible to identify the contextual factors that influence success or failure, it may be useless or even harmful to simply lift an experiment from one context and drop it into another. The harm of failed experiments may come if nations that are not accustomed to law as a means of corporate restructuring experiment with a poorly adapted version of global models and it fails. That failure may have repercussions well beyond insolvency and undermine the confidence of a developing nation that law can work as promised by its advocates from advanced countries. The invisible factors - those taken-for-granted or unobserved conditions - that make the difference between success and failure must be systematically catalogued.

- e) *Expectations must be moderated:* In the long waves of legal and economic development, it is still early days for insolvency law making. Global models and standards have not been tested in the crucible of time and systematically evaluated over a variety of implementation contexts. Local conditions vary radically - as do competencies and political will. Bankruptcy institution building, like it or not, can be a highly contested field. Insolvency systems are deeply embedded in other institutions/systems. For all these reasons, we should expect advances and retreats, more and less successful experiments, and the prospect that imported norms may not work at all - or work in ways that are unanticipated.

Now that global norms have been established, and many nation-states have acted vigorously to enact reforms, a difficult task remains—to find out what works where. Put another way, the next stage in the global reform movement of insolvency systems is to develop a contingent analysis of insolvency law-making that demonstrates what kinds of insolvency regimes will thrive in what kinds of political, economic and social systems. That requires empirical research and institutional analysis. This new frontier calls for a co-operative venture that will pool the distinctive competencies of global architects of insolvency regimes, national law-makers, and social scientists to develop varieties of insolvency regimes, with certain universals in common, that will be well fitted to distinctive varieties of capitalism, institutions and culture.

## Facilitating Out-of-Court Workouts in a Crisis: Lessons From East Asia

by

*William P. Mako*<sup>1</sup>

As seen in the recent East Asia crisis, government responses to a “financial” crisis tend to focus on the resolution of financial sector distress. In fact, financial sector and corporate sector distress are intertwined – especially in cases where debt-fuelled over-investment by corporations in low-margin, loss-making, or cyclical businesses encouraged the crisis. Failure to resolve underlying corporate distress through adequate “operational restructuring” risks a diminution of long-term corporate competitiveness and a recurrence of acute corporate distress upon the expiration of crisis-related “financial restructuring” concessions from creditors.

Following an introductory discussion of corporate-financial sector linkages and issues in the operational and financial restructuring of distressed corporations (Section 1), this paper summarises approaches taken in the recent East Asia crisis to out-of-court workouts (Section 2) and corporate restructuring results through mid-2001 (Section 3). Subsequent discussion of lessons first considers process-related items that should be easy to implement, for example, the organisation and operation of creditors committees (Section 4). The paper concludes by highlighting difficult issues pertaining to the allocation of losses among debtors and creditors: the ability of creditors to impose losses on a debtor; the government’s readiness to force or induce creditors to recognise losses from corporate restructuring; and the resolution of inter-creditor differences on the allocation of losses and risk among creditors (Section 5). Failure to resolve these issues will cripple any out-of-court workout scheme.

### 1) *Corporate-financial sector linkages*

Corporate and financial sector restructuring are two aspects of the same problem. The amount of debt a company can sustain—and on which lenders can expect reliable debt service—is determined by the company’s cash flow (see Box 1). Indeed, a company cannot sustain interest payments in excess of its cash flow (*i.e.*, interest coverage of less than 1:1), let alone make any repayments on principal.

#### **Box 1. Measuring a Company's Sustainable Debt**

So long as management is not manipulating earnings and working capital (*e.g.*, by booking un-collectible receivables and revenues), a company’s earnings before interest, taxes, depreciation, and amortisation (EBITDA) is a reasonable measure of cash flow and indicator of sustainable debt. Using a 2:1 interest coverage standard and assuming a market interest rate of 8%, for example, a company with EBITDA of 100 million US dollars could sustain debt of 625 million US dollars.

An EBITDA/interest expense ratio of less than 1:1 is unsustainable; the company could not meet all its interest obligations, let alone repay any principal. Any ratio below 2:1 is worrisome. For example, Korea’s Dong-ah Construction was forced into receivership in 2000 despite 1999 interest coverage of 1.6:1.

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<sup>1</sup> Mr. William P. Mako, Senior Analyst, Private Sector Development Department, the World Bank.

There are a number of ways to resolve unsustainable corporate debt, some better than others. The best response would be for the company to raise new equity and/or undertake operational restructuring *e.g.*, discontinuation of less profitable or loss-making non-core businesses, layoffs of excess labour, and other cost reductions to increase the company's earnings and debt service capacity, plus sales of non-core businesses and assets (*e.g.*, real estate) to retire debt. If it appears that operational restructuring cannot reduce corporate debt to a sustainable level, financial restructuring becomes appropriate. For example, creditors could convert debt into equity or into lower-yielding convertible bonds. To avoid moral hazard, creditors should contemplate debt write offs only after having exhausted all other approaches and should retain some instrument (*e.g.*, equity, options, warrants) to participate in any recovery. Term extensions may be acceptable, so long as these do not have the practical effect of transforming debt into an equity-like instrument without also giving creditors the rights of equity holders. Reducing interest below the risk-adjusted rate may also be acceptable, so long as principal is repaid. Grace periods on debt service – especially on interest payments – usually just postpone the day of reckoning for nonviable companies. In cases where deferred debt service is re-scheduled into a large “balloon” payment due after several years, it is likely that the company will relapse into distress unless it uses this breathing space to address fundamental problems through operational restructuring.

Turning to the financial sector side, the creditor(s) of a corporation under restructuring should provision – and, as necessary, further reduce its capital – to reflect (i) the present value effects of any debt/equity conversions, rate reductions, term extensions, grace periods, and write-offs and (ii) appropriate provisioning of remaining corporate debt based on international standard forward-looking criteria. If these measures reduce a financial institution's risk-weighted capital below some ratio (*e.g.*, 8%), the government may decide to close and liquidate the institution, merge it with a stronger partner, insist on additional capital from current shareholders, or re-capitalise the institution and take control. Thus, corporate cash flow is linked to (i) the amount of sustainable corporate debt and (ii) the cost of re-capitalising financial institutions for losses in resolving the non-sustainable portion of corporate debt. In any case, where financial restructuring of a distressed corporation involves a debt/equity conversion, financial institution shareholders will also need to make arrangements for managing and eventually selling the converted equity.

Corporate debtors and financial institution creditors will naturally seek to minimise their losses from corporate restructuring. Losses may include, in addition to things of monetary value, diminutions of autonomy or prestige. For example, a corporation's management and controlling shareholders will seek to avoid outside interference, loss of control, dilution of their equity interest, or sale or closure of favoured lines of business and assets. A financial institution's management and controlling shareholders will seek to avoid losses on corporate debt restructuring that could necessitate capital write-downs leading to equity dilution, loss of control, nationalisation, forced acquisition, or liquidation of the institution.

The government will have to balance a variety of conflicting interests. These may include minimising the costs of bank re-capitalisation; protecting workers, suppliers, and subcontractors of failed companies and minimising ripple effects through the economy; minimising distortions to market competition through excessive debt-rescheduling concessions; avoiding labour strife; and – last but not least – dampening public criticism enough for the government to remain in office.

From the perspective of the distressed company itself (as distinct from its shareholders), it is reasonable to suggest time-phased restructuring goals.

In the *short-term* (3 months), it will be important to achieve some financial stabilisation in order to prevent the liquidation of viable albeit over-leveraged companies. Non-viable companies should be

allowed to fail and exit, through liquidation. In a systemic crisis, however, “strong swimmers” should not be dragged down along with the weak in the widespread “liquidity crunch” that typically occurs in a crisis.

In the *medium-term* (6-24 months), operational restructuring along the lines mentioned earlier should be undertaken to improve the company’s profitability, solvency, and liquidity.

Over the *longer-term*, it is important to deter a recurrence of imprudent debt-fuelled corporate investment. Such deterrence depends on a demonstrated quick and reliable ability by wronged creditors to foreclose on assets, liquidate non-viable companies, and seize viable but distressed companies from uncooperative shareholders/managers.

## 2) ***Recent approaches to out-of-court workouts***

Recognising that the resolution of hundreds or thousands of large corporate distress cases through insolvency law frameworks would quickly overwhelm local courts, Indonesia, Korea, Malaysia, and Thailand all adopted local variants of the “London approach” that the Bank of England had promulgated in the 1980s.

*Korea:* In July 1998, with encouragement from the Financial Supervisory Commission (FSC), 210 local financial institutions embarked on a contractual approach to out-of-court workouts as an alternative to unsupervised “bankruptcy avoidance loans” (bailouts) and court-supervised insolvency. These institutions signed a Corporate Restructuring Agreement (CRA) that provided for a 1-3 month standstill (depending on due diligence requirements), that could be extended for one month; a creditors committee led by a lead creditor, typically the chaebol’s lead bank; a 75% threshold for creditor approval of a workout agreement; a 7-person Corporate Restructuring Co-ordination Committee (CRCC), selected by signatories, to provide workout guidelines and arbitrate inter-creditor differences in cases where creditors could not approve a workout plan after three votes; and CRCC imposition of fines (up to 30% of a credit or 50% of the amount of non-compliance) for non-compliance with an arbitration decision.<sup>2</sup>

Other key factors included a strong creditor rights/insolvency system, the nationalisation of Korea’s largest banks, and an increasingly active role for the Korea Asset Management Company (KAMCO). In the Daewoo workouts, KAMCO bought 4.4 billion US dollars in debt from foreign creditors to smooth the way for agreement among domestic creditors.

*Malaysia:* A Corporate Debt Restructuring Committee (CDRC) was established in August 1998 with secretarial support from Bank Negara Malaysia (BNM) to provide a forum and framework for creditors and debtors to reach voluntary agreement. Either the debtor or its creditors could initiate a CDRC case. Eligibility for CDRC status was eventually raised to any case involving at least 100 million Ringgit in debt and five or more financial institution creditors. CDRC also provided for a creditors committee representing at least 75% of credits (later reduced to 50%) for each company; full information-sharing; creditor committee appointment of independent consultants to review or develop workout options; a standstill period of 60 days (extendable) to assess viability and financial needs; and 100% creditor approval for CDRC cases. Such a high threshold for creditor approval was consistent with the view of CDRC as a forum for facilitating purely voluntary agreements. But lower creditor approval thresholds for other types of cases – 75% for court-supervised reorganisations, 50% for workouts managed by the Danaharta public AMC – may have given creditors an incentive to reach agreement in CDRC proceedings. CDRC acted as an advisor and mediator between debtors and their

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<sup>2</sup> Financial Supervisory Commission, “Corporate Restructuring Agreement,” July 1998.

creditors. On at least some occasions, Danaharta bought out dissenting creditors. In addition, BNM reportedly used its influence on occasions to persuade holdout banks to accept workout banks supported by a majority of creditors.

Other key factors included a strong creditor rights/insolvency system; the powerful Danaharta AMC; and a thoughtful approach to segmenting corporate distress and linking corporate and financial sector restructuring. The largest corporate cases went to CDRC, while Danaharta handled mid-sized cases and smaller cases remained with the workout departments of individual banks. Banks were required to sell “excess” NPLs to Danaharta. Subsequently, the Danamodal agency would provide any necessary bank re-capitalisation and financial sector restructuring.<sup>3</sup>

*Thailand:* Thailand initially pursued a purely consensual approach, but soon adopted a contractual approach to out-of-court workouts. The Corporate Debt Restructuring Advisory Committee (CDRAC) was formed within the Bank of Thailand (BOT) in June 1998. CDRAC, which was chaired by the BOT governor, included representatives from creditor and debtor interest groups. CDRAC members identified priority cases, developed a set of principles and timeline to guide voluntary workouts (the “Bangkok Rules”), attempted to facilitate and monitor restructuring negotiations, and attempted to resolve legal and regulatory impediments to corporate restructuring. By end-1998, however, only about 3.5 billion US dollars in CDRAC case debt had been restructured.

This prompted BOT to play a more active role in monitoring and to promote a more contractual approach. BOT promulgated two model civil contracts: a Debtor-Creditor Agreement (DCA) to govern out-of-court agreements and an Inter-Creditor Agreement (ICA) to resolve differences among creditors. DCA signatories agreed on a 6-8 month schedule for developing and approving a restructuring plan; information-sharing; designation of a lead creditor or steering committee; and thresholds for creditor approval. Approval by 75% of creditors was necessary to ratify a restructuring plan—the same threshold as for a court-supervised reorganisation. In cases where creditor support was just 50%-75%, the plan could be amended and resubmitted for another vote. In cases where creditors could not agree on a plan, the DCA provided for cases to be forwarded to the courts for resolution under existing creditor rights/insolvency law. In cases of inter-creditor differences, the ICA provided for a three-person panel to arbitrate differences, but included an easy escape clause for concerned creditors. The DCA and ICA empowered the BOT to levy fines and reprimands to enforce creditor compliance, including requirements for creditors to file court petitions following a breakdown of the workout process.<sup>4</sup>

Other key factors included weakness in Thailand’s creditor rights/insolvency system; the government’s reluctance to nationalise or force the public re-capitalisation of Thailand’s biggest banks; and various legal/regulatory impediments to corporate restructuring.

*Indonesia:* Indonesia also initially pursued a purely consensual approach to out-of-court workouts, but later tried a more directive approach. While the Indonesia Bank Restructuring Agency (IBRA) AMC was expected to resolve corporate credits extended by Indonesia’s largely nationalised financial sector, the Jakarta Initiative Task Force (JITF) was established in September 1998 to resolve corporate credits from foreign banks. JITF’s initial focus was on advice, facilitation, and mediation and on the identification and removal of tax, legal, or regulatory impediments to corporate restructuring. The JITF was originally designed as a voluntary programme under the assumption that a new bankruptcy law would provide a remedy in cases where the parties could not negotiate a workout agreement in good faith.

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<sup>3</sup> R. Thillainathan, *The Malaysian Financial System*, December 2001, mimeo.

<sup>4</sup> World Bank, Bangkok office.



By the end of 1999 however, JITF debt workout agreements reached only 1.3 billion US dollars. Hence, in April 2000, JITF was given some ability to orchestrate regulatory relief or sanctions and to impose a time-bound mediation process. A debtor and its creditors were given an opportunity to agree on a mediation schedule. If the parties failed to agree, a mediation schedule could be set by JITF, which would monitor progress and mediate any disputes. If it determined that a party was behaving in an uncooperative manner or that progress could not be made, the JITF could terminate mediation and file a report with the government's Financial Sector Policy Committee (FSPC). In turn, the FSPC could refer an uncooperative debtor to the Attorney General for initiation of bankruptcy proceedings—an option that had not been used as of mid-2001.

Other key factors included the complete lack of any protection for creditor rights,<sup>5</sup> the dominant role of IBRA in many corporate restructuring negotiations, and various legal/regulatory impediments to corporate restructuring.

### 3) *Results*

The numbers of workout cases sometimes turned out to be small, for instance, less than 100 cases each in Korea and Malaysia. The size of Korean cases, however, was substantial, in particular the Daewoo workouts, which involved about 60 billion US dollars in distressed debt. Thailand was an anomaly in terms of more ambitious efforts there to pursue out-of-court workouts. In Thailand, the CDRAC process was applied to almost 15 000 cases, including almost 3 000 large corporations and 12 000 small/medium enterprises, for which a “lite” version of the Debtor-Creditor Agreement was developed (see Table 1). By mid-2001, restructuring agreements had been reached for more than three-quarters of the workout caseloads in Korea and Malaysia.<sup>6</sup> Completion rates were closer to one-half in Thailand and Indonesia. In Thailand, as of July 2001, it was expected that failed CDRAC cases would revert to the courts and that the courts would need seven or more years to resolve a combined backlog of over 65 000 NPL cases.

**Table 1. Overview of Workout Results (currency in millions of US dollars)**

	<b>South Korea</b>	<b>Malaysia</b>	<b>Thailand</b>	<b>Indonesia</b>
<b>Total credits assigned for resolution</b>	88 917	10 395	65 500	18 900
<b>Assigned cases</b>	83	54	14 917	n.a.
<b>Resolution: Cases</b>	68	46	6 345	n.a.
<b>% of assigned credits</b>	95%	77%	48%	56%
<b>Ratio of financial to operational restructuring</b>	5.1	40.5	n.a.	13.3
<b>New money</b>	3 667	n.a.	n.a.	n.a.

Sources: Financial Supervisory Commission; R. Thallianathan; World Bank Bangkok office; Jakarta Initiative Task Force; and staff estimates.

Notes: 1) Only includes Corporate Restructuring Agreement cases. Data as of June 2003. Financial operational restructuring ratio applies only to pre-Daewoo workouts agreed by 2 July 1999. 2) Corporate Debt Restructuring Committee cases, as of end-June 2001. Ratio of financial to operational is for end-1999 forward to formal legal documentation and implementation.

Focusing on completed workout cases, what was accomplished relative to the time-phased corporate restructuring goals suggested earlier?

<sup>5</sup> See article by PricewaterhouseCoopers in ADB volume, 2001.

<sup>6</sup> Practically speaking, Korea's completion rate was nearly 100%. Companies that dropped out of the workout programme typically converted into court-supervised insolvencies.

As the crisis developed, it became apparent that short-term financial stabilisation of distressed corporations was not an immediate operational issue, but was instead a longer-term “credit culture” issue. Probably no well-run large corporation in East Asia was driven out of business by the crisis-induced liquidity crunch.<sup>7</sup> Rather, the key issue was whether financial stabilisation resulted from a formal standstill supported and monitored by creditors or from do-it-yourself “strategic defaulting.” In Korea, a company’s acceptance into the CRA workout programme immediately led to due diligence and monitoring by creditors and their advisors. All too frequently in Thailand and Indonesia, debtor companies could indefinitely resist creditor entreaties to allow due diligence or supervision or to engage in good faith negotiations. While previous management and/or controlling shareholders may have remained in place at many such companies, reputations and company access to financing have presumably suffered. The alternative of formal creditor standstills, due diligence, and supervision is far preferable in terms of long-term support for the development of credit culture and business finance.

On the question of medium-term operational restructuring, it is impossible to say how much is enough without looking at individual companies. Four years after the start of the crisis, the bottom quartile of Korean corporations suffered from increasing losses, high debt, and increasingly negative cash flow. From available data on operational restructuring or other “self help” (asset sales, cost reductions, new equity) and financial restructuring concessions by creditors (debt rescheduling, debt/equity conversions), however, it does appear that operational restructuring played a bigger role in Korea’s corporate restructuring than in the other East Asia crisis countries. For the initial round of workouts agreed as of July 1999, the ratio of financial restructuring to operational restructuring was about 5:1. Subsequent workout agreements covering 56 billion US dollars in Daewoo debt seemed to focus almost exclusively on financial restructuring. In retrospect, however, it appears that the focus of creditors was on gaining near-term control in order to proceed with the follow-on sale or operational restructuring of Daewoo affiliates, which did in fact happen.<sup>8</sup> By contrast, ratios of financial restructuring to operational restructuring were higher for Indonesia’s JITF workouts (at 13:1) and for Malaysia’s CDRC workouts (at 40:1, as of end-1999). For JITF cases at the term sheet stage as of May 2001, 57% of the debt was to be rescheduled (with an average term of seven years and a 2.6 year grace on principal), 36% was to be converted into equity or convertible bonds, and 7% was subject to cash settlement or debt/asset swap.<sup>9</sup> In Malaysia, of 3.5 billion US dollars in debt restructured as of end-1999, promised asset sales and new equity amounted to only 85 million US dollars. Two large cases involving the conversion of 2.24 billion US dollars of short-term debt into seven-year zero-coupon bonds were especially controversial.<sup>10</sup> Such balloon payment arrangements appear to have featured prominently in Indonesia, Malaysia, and Thailand. The risk, of course, is that operationally

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<sup>7</sup>The same cannot be said for small/medium enterprises. In South Korea, for example, almost 19 000 small/medium enterprises failed in 1997/98. Kawai, Lieberman, Mako, “Financial Stabilisation and Initial Restructuring of East Asian Corporations,” p. 79. Greater attention should probably be paid to short-term financial stabilisation and liquidity for SMEs in a crisis.

<sup>8</sup> For example, Korea Investor Service data show that employment declined by 25-30% at Daewoo Heavy and Daewoo Motor Sales, 45% at Ssangyong Motors, and almost 60% at Daewoo Corporation between end-1996 and end-2001. Moreover, some affiliates have been sold, including Daewoo Motors’ sale to General Motors. Daewoo Corporation has been split into three companies (two good, one bad), as has Daewoo Heavy. These spin-offs of Daewoo Corporation’s trading and construction businesses and Daewoo Heavy’s shipbuilding and heavy machinery businesses were somewhat delayed – first by the need to legislate tax relief for spin-offs, and second by the need to negotiate preferential equity restructuring terms with public shareholders.

<sup>9</sup> JITF Quarterly Report, June 2001.

<sup>10</sup> These cases, involving engineering concern UEM/Renong, saw no change in management, dilution of existing shareholders, new equity, or asset sales. Indeed, it was reported in the press at the time that UEM/Renong actually acquired additional assets.

weak corporations will relapse into acute financial distress when grace periods expire and debt service demands resume. Indeed, corporate debt default recidivism has been an issue.

As for the long-term deterrence of imprudent debt-financed investment by corporations, Korea appears to have sustained its early success in addressing this moral hazard issue. Since 1996, at least 25 large companies involving 33 billion US dollars in debt have gone into court receivership.<sup>11</sup> In the Daewoo matter, creditors gained management control and displaced previous controlling shareholders in relatively short order. Following some waffling in late 2000, debt restructurings for three Hyundai companies (including Hynix Semiconductor) displaced family ownership interests and left creditors in control.<sup>12</sup> Thus, Korea has sustained the lessons that no chaebol is “too big to fail” and that imprudent debt-financed investment can result in a complete loss of ownership and control.

A credible and imminent threat of receivership inclined the management and controlling shareholders at other chaebols to co-operate in good faith with out-of-court workout efforts. While workouts typically imposed a loss on chaebol insiders (*e.g.*, from equity dilution, creditor supervision, forced asset sales), half a loaf was apparently better than none. In Thailand and Indonesia, where the lack of a credible immediate threat of total loss from liquidation, foreclosure, or receivership has made it easier for debtor companies to take advantage of their creditors, the lesson is mixed. The failed corporate manager/controlling shareholder may manage to hang on, but future access to market financing will presumably suffer for some unforeseeable period of time.

Discussion in subsequent sections will suggest that the above-mentioned differences in the quantity and quality of corporate restructuring have less to do with process or legal/regulatory impediments than with basic issues over the allocation of losses among the debtor and its creditors.

#### 4) *Easy lessons*

Recent experiences from East Asia workout regimes point to some easy items that need to be in place for a successful workout regime. These include appropriate principles and processes; resolution of tax, legal, or regulatory impediments to corporate restructuring; and responses to inevitable capacity constraints.

*Principles and processes:* In each of the four crisis countries, highly qualified professionals put a great deal of thought into appropriate principles and processes to guide out-of-court workouts. One example was the improved guidelines in Malaysia, which CDRC adopted in August 2001 after the previously mentioned controversy over some workout agreements (see Box 2). Another example is the standard model for memoranda of understanding for Korean workouts (see Box 3).

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<sup>11</sup> Kawai, Mako, and Lieberman, *op cit.*, p. 79 and Wonhyuk Lim, *Korea: Corporate Vulnerabilities and Restructuring*, mimeo, September 2002, pp. 29-30.

<sup>12</sup> Lim, *op cit.*, p. 14.

## **Box 2: Malaysia: Enhanced August 2001 Rules for CDRC Workouts**

### **Standstill Agreement**

- 90-day standstill binding on all creditors
- Allows for appointment of monitoring accountants and special audits
- Creation of special debtor accounts to ensure payment of operating expenses, advisors, and debt service
- Undertakings by debtor regarding information disclosure, inter-company lending, asset transfers, dividends, new borrowing, and investments
- Continued debtor use of collateral
- Creditors maintain credit lines; no increase in creditor claims; no acceleration; no change in creditor priorities, other than for new money; no set offs
- Standstill may be extended once

### **Financial Restructuring**

- Shareholders to take bigger "haircut" than creditors
- Debt to be restructured into equity, quasi-equity, and debt
- Common interest rate within same creditor class; maximum interest rate differential between classes of 1%
- Waiver of penalty interest
- Periodic payment of interest
- Usage of funds to be designated; financial covenants included in agreement
- Sharing of surplus from disposal of unencumbered assets
- All concessions clawed back in case of failure

### **Operational Restructuring**

- Changes in company management and board of directors, as appropriate
- Disclosure of related-party transactions
- Divestiture and/or liquidation of non-viable and non-core assets
- Asset sales to be agreed by creditors committee
- Implementation monitoring by accountants and special audits; regular reporting and establishment of operational covenants.

Source: R. Thillainathan, "The Malaysian Financial System," December 2001.

### Box 3: Korea: Typical Content of Workout Agreements

#### Commitments by Debtor

- 5-year management targets for debt reduction; sales; and operating income;
- Self rescue plan for asset sales, sales of businesses, workforce reductions, and other cost-cutting measures;
- Consent of labour union and controlling shareholders;
- Monitoring by management and creditors' Joint Management Team (JMT), including JMT approval of annual business plan; monthly un-audited financial statements; right of creditors to replace management for failure to meet performance targets; JMT control of cash management; and requirement for creditor approval of capital expenditures, dividends, rights offerings, or disposition of production facilities;
- Creditor's right to appoint outside directors and auditor;
- Equity write-downs or mergers

#### Commitments by Creditors

- Co-operation in implementation of agreed workout plans;
- Establishment of Joint Management Team
- Debt rescheduling
- New credits;
- Sanctions for non-compliance (foreclosure, penalty interest, management changes, suspension of new credits; acceleration or call of existing credits; suspension from workout programme; sale of converted debt and convertible bonds).
- Terms for graduation from workout and end to JMT monitoring

These examples, along with the earlier description of creditor approval mechanisms, provide many worthwhile ideas that may well be suitable for workout regimes for future crises. As the ineffectual Bangkok Rules showed, however, the challenge is not to identify appropriate principles and procedures but rather to make them stick.

*Legal/regulatory impediments:* East Asia's experience highlights the number and variety of tax, legal, or regulatory issues that can arise to impede corporate restructuring. For example:

- Gains to the debtor from financial restructuring may be treated as taxable income. Conversely, creditors may not be able to deduct losses from financial restructuring concessions to reduce their taxes. There may be value-added tax (VAT), stamp duty or other fees on asset sales or debt/asset swaps. Non-cash corporate reorganisations, such as mergers or spin-offs, may be treated as a taxable event. Opportunities to transfer tax loss carry-forwards to a corporate acquirer or new merged entity may be limited or non-existent.
- Corporate mergers or acquisitions may be constrained, for example, by a multi-month waiting period during which creditors may object and demand immediate repayment.

- Employees of state-owned financial institutions may be personally liable for agreeing to any corporate restructuring agreement that causes a loss to the financial institution.
- Banking laws or regulations may limit the amount of converted corporate equity that a financial institution can accept, or require its prompt sale.
- For a financial institution with diminished capital, acceptance of a restructuring agreement for an extra-large corporate credit may change a *de facto* legal lending limit violation into a violation more formally approved by the financial institution's management.
- The threat of local stock exchanges to de-list distressed corporations or any requirement to organise a tender to buy-out public shareholders may discourage debt/equity conversions. In addition, the ability of banks to hold converted corporate equity may be time-bound or subject to ceilings.
- Outsider public shareholders exercising their shareholder rights may oppose dilution of their equity and demand preferential terms in any debt/equity conversion.

All possible impediments should be identified at the outset of the crisis. In some cases, specific waivers (on legal lending limits) or permanent or time-bound general relief (on tax effects) may be appropriate. Alternatively, workout regime secretariats may pursue regulatory waivers for particular restructuring cases. While some such secretariats, the JITF in particular, heavily emphasised such waivers, there is no indication or reason to believe that such inducements ever encouraged debtor companies or financial institution creditors to take additional losses. While likely necessary, regulatory relief is not sufficient to induce restructuring. Public shareholder rights to oppose dilution through equity restructuring may be impossible to override in an out-of-court workout, as seen in the Daewoo spin-offs in Korea. To deal with perfectly valid protections for public shareholders, it may be necessary to link out-of-court workouts to efficient court-supervised processes, *e.g.*, “pre-packaged” reorganisations, to effect equity restructuring.

*Capacity constraints:* It is essential both to build implementation capacity and to design a resolution strategy around inevitable capacity constraints. Capacity needs are likely to include more and better bankruptcy judges and administrators, bank workout personnel, and a crisis resolution team for the government. Requirements for responding to systemic corporate and financial sector distress, however, can easily absorb all the accounting, legal, banking, and corporate turnaround expertise in a crisis country. Thus, it is also important to plan to work around likely capacity constraints. The assignment of almost 15 000 distressed companies to CDRAC in Thailand was probably unrealistic under the best of circumstances. Some segmentation of corporate distress – *e.g.*, large multi-creditor cases in out-of-court workout or court-supervised insolvency, medium-sized cases in an AMC, and small cases remaining with the originating bank—such as followed in Malaysia, seems to make the most sense. Limiting AMC mandates to the sale of un-restructured corporate debt (versus financial restructuring or follow-on operational restructuring) will lessen demands on AMC capacity and offer a higher chance of success. Joint ventures to induce professional private management of distressed corporate debt or converted equity, such as successfully used in Korea by KAMCO and corporate restructuring companies (CRCs), are another way of addressing capacity constraints.<sup>13</sup>

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<sup>13</sup> Holders of distressed debt/converted equity, however, will first have to agree on valuations with the private investor.

## 5) *Potential deal-breakers*

Workout principles and process, legal and regulatory impediments, and capacity constraints are the easy issues. Recent experience indicates that the success of an out-of-court workouts scheme – measured in terms of the quantity and adequacy of corporate restructuring – will ultimately depend on the ability of creditors to impose losses on a debtor; the government's readiness to force or induce creditors to recognise losses from corporate restructuring; and the resolution of inter-creditor differences on the allocation of losses and risk.

*Debtor losses:* Serious financial and operational restructuring of distressed companies will impose some losses on corporate managers and controlling shareholders, for example, through equity dilution, creditor monitoring, diminution of managerial discretion, or forced divestiture of favoured businesses and assets. Debtors involved in an out-of-court workout or court-supervised rehabilitation can be expected to resist such measures unless there is a credible timely threat of even greater loss, for example, through foreclosure, liquidation, or receivership.

Contrasts between Korea, and Indonesia and Thailand are instructive. While additional operational restructuring of Korea's bottom quartile of distressed companies is still needed, the 1989/99 workouts did impose significant losses on corporate insiders from equity dilution, management changes, creditor supervision, and forced asset sales. In Korea, a low performance threshold for receivership gave creditors a powerful threat.<sup>14</sup> The 1997 descent of 11 chaebols into receivership provided an incentive for other corporate debtors to agree in 1998/99 to lesser losses imposed by out-of-court workout agreements. In Indonesia, however, the absence of any credible threat to debtors has encouraged a dilatory and superficial approach to corporate restructuring. In Thailand, as seen in the infamous TPI case, the lack of a credible threat of foreclosure, liquidation, or receivership has produced the anomalous spectacle of prolonged debtor resistance to court-supervised rehabilitation.

To elicit sufficient debtor co-operation with either an out-of-court workout or court-supervised rehabilitation, creditors should have timely access to as many penalties (*e.g.*, foreclosure, liquidation, receivership) as possible. Commencement criteria should be performance-based (*e.g.*, non-payment of debt).<sup>15</sup> Procedures for converting an unsuccessful workout or court-supervised rehabilitation into receivership/liquidation should be simple, quick, and sure.

*Creditor losses:* Serious financial and operational restructuring of distressed companies is also likely to cause losses to financial institution creditors. For example, interest rate concessions or grace periods may reduce the present value of restructured debt, while a debt/equity conversion may leave financial institution creditors with illiquid and virtually worthless shares. In addition, operational restructuring sales of non-core assets or businesses may also precipitate losses for financial institution creditors. Sales proceeds may be insufficient to repay remaining debt on the asset, for example, or a corporate acquirer may refuse to assume all of the business' remaining debt. Such transactions may moreover indicate that all similar collateral is over-valued.

Finally, financial institution creditors may be reluctant to transfer restructured corporate debt and/or converted equity to a professionally managed joint venture on commercial terms if the negotiated price is below the carrying value of the credits/converted equity, in which case the transfer would force loss recognition. Such concerns seem to have discouraged some Korean banks from

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<sup>14</sup> In Korea, failure on two successive days to honour bills coming due is grounds for receivership.

<sup>15</sup> Experience from Thailand illustrates the undesirability of basing commencement criteria on the formal determination of accounting insolvency.

conveying distressed corporate assets to corporate restructuring vehicles (CRVs) for management by corporate turnaround professionals. Rather than risk losses and the diminished capital adequacy that could lead to regulator insistence on prompt corrective actions, equity dilution, or intervention, financial institution creditors may naturally settle for superficial financial restructuring (*e.g.*, balloon payments), discourage sales of non-core assets/businesses, and hang on to over-valued corporate credits/converted equity – thus leaving numerous feeble companies to depress corporate sector profits.

As noted at the outset, the resolution of unsustainable corporate debt is important for long-term corporate competitiveness. Thus, for the sake of the long-term health of the corporate sector, the government/financial supervisor should be prepared to force and/or induce adequate operational and financial restructuring of distressed companies. Reasonably realistic information on the financial position and performance of companies is a prerequisite for decision-making. This, in turn, highlights the importance of adopting international best practices in loan classification and provisioning according to forward-looking criteria. Thus informed, the authorities may intervene in financial institutions whose risk-weighted capital falls below an acceptable minimum or require sales of excess NPLs. In Malaysia, for example, any bank with an NPL ratio above 10% was required to resolve the excess promptly or else sell excess NPLs to the Danaharta public AMC.

But, what if the authorities lack the financial resources or political will to intervene additional financial institutions or force a “fire sale” of excess NPLs? In such cases, the authorities may provide regulatory forbearance as a way of encouraging capital-weakened financial institutions to resolve unsustainable corporate debt. Forbearance, which reduces the imminence of intervention risk, may be on loss recognition or capital adequacy (Box 4). Both were tried in the East Asia crisis.

#### **Box 4: Examples of Regulatory Forbearance**

##### **Loss recognition:**

- Redefinition of non-performing loans (from three months to six months of non-payment);
- Immediate reclassification of restructured corporate debt as performing;
- Relaxation of forward-looking criteria for restructured corporate debt;
- Ability to provision net of collateral;
- Multi-period recognition of losses from corporate restructuring and capital reductions; and
- Favourable accounting treatment for converted corporate equity.

##### **Capital adequacy:**

- Some opportunity for financial institutions, whose risk-weighted capital adequacy has fallen below some regulatory minimum ( 8%), to grow their way back to capital adequacy.



Forbearance may entail three risks. First, a financial institution may use the period of forbearance to engage in riskier lending to recover its capital position. As a result, if the institution ultimately fails, the costs will be higher. Hence, forbearance should only be allowed for financial institutions whose long-term viability seems reasonably assured, and progress toward time-bound capital adequacy goals should be closely monitored. A second risk is that some types of forbearance on loss recognition may encourage the over-valuation of restructured corporate debt/converted equity and thereby discourage follow-on operational restructuring.<sup>16</sup> It appeared that such forbearance on loss-recognition could discourage loss-averse financial institutions from taking more drastic steps (e.g., liquidation of non-viable companies, sale to strategic investors, transfer of converted corporate equity to a professionally-managed joint venture (JV), or forced sales of possibly-overvalued non-core assets/collateral. The third risk is that forbearance on loss recognition may impede private re-capitalisation of financial institutions. Investors may find it difficult to conduct due diligence and feel reluctant to invest in a financial institution characterised by murky loan classification and provisioning; overvaluation of restructured credits, collateral, and converted equity; and uncertain capital.

Some observers may suggest that there is always forbearance in a crisis. If so, the issues are how to minimise additional risks to the financial system and how to design forbearance to meet the broader goals of corporate/financial sector restructuring. Any forbearance should be limited in applicability and duration, as suggested above, and be carefully monitored. The above discussion also suggests that any forbearance should focus on capital adequacy instead of loss recognition.

*Inter-creditor differences:* Assuming a reasonably strong creditor rights/insolvency system, differences among creditors may be more difficult to overcome than debtor/creditor differences. Due to differences in type of credit, exposure, and capital adequacy, financial institutions may vary widely in terms of their willingness to make financial restructuring concessions, pursue follow-on operational restructuring, or provide new money. Both Korea and Thailand tried to bind creditors to inter-creditor arbitration. The *ex post facto* imposition of such arbitration could seem legally problematic. Disputes surfaced frequently. In Korea, for example, the CRCC provided arbitration decisions in 21 cases prior to July 1999, mostly on the allocation of losses from financial restructuring and additional risks from new money. Given close linkages with regulated financial institutions, it was perhaps natural for the financial supervisors in Korea and Thailand to play some role in enforcing inter-creditor arbitration decisions.<sup>17</sup> Such involvement, however, poses a conflict of interest with the financial supervisor's core function of preserving a sound financial system.

Experience with out-of-court workouts under Korea's initial CRA framework highlighted a significant "free rider" problem. In some cases, while major banks were attempting to agree on a workout plan without resorting to court receivership, non-bank financial institutions (NBFIs) held out for better terms—even though their credits were usually unsecured. If creditors could not reach at least

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<sup>16</sup> In Korea, for example, from mid-1998 until end-2000, restructured corporate debt was exempt from forward-looking criteria. Financial institutions received special dispensation to provision restructured debt at 2-20%. In many cases, however, financial data suggested that provisioning should have been at 50% or higher. The authorities allowed converted corporate equity to be carried at the lower of cost or market. This sounded reasonable. But, in fact, market floats were extremely thin (because the great bulk of converted equity was held by creditors, who were locked in for three or more years) and market prices were often based on speculative hopes of additional creditor concessions to elicit public shareholder acquiescence to planned equity dilution and debt/equity conversions.

<sup>17</sup> For example, Korea's Financial Supervisory Service (FSS) reportedly threatened to fine Hana Bank 6 billion Korean won if it failed to provide a promised 11.9 billion Korean won of emergency liquidity to Hyundai Petrochemical. *Korea Herald*, April 21, 2001.

75% agreement on a restructuring plan, creditors had to decide whether or not to put the company into court receivership. Court receivership, however, requires creditors to immediately make higher loan provisions for expected losses and raises the risks of supplier/subcontractor chain bankruptcies and employee layoffs. Knowing this, NBFIs sought to extract concessions from other creditors—many of which were large nationalised banks—interested in concluding a workout agreement. In many cases, large secured creditors relented and gave NBFIs a better deal in the financial restructuring of distressed companies.<sup>18</sup>

Difficulties in agreeing and implementing out-of-court workouts led to development of the Corporate Restructuring Promotion Law (CRPL), to replace the CRA approach to workouts. The CRPL came into effect in September 2001 and is to remain in force until 2006. Key features include the following:

- The CRPL applies to all financial institutions (including securities companies) plus the KDIC deposit insurer and KAMCO public asset management company (AMC), rather than just major banks and NBFIs.
- Creditors opposed to a restructuring plan can ask those in favour to purchase their claims and, if necessary, can go to court. If creditors ask to be bought out, their credits would be valued at liquidation value based on due diligence by an accounting firm hired by the creditors. Dissenting creditors cannot, however, just free ride and reap upside benefits without bearing downside risks—*e.g.*, from proportional participation in new credits.
- If creditors with a minimum of 75% of total credits cannot agree on a restructuring plan, the firm in question must proceed to court-supervised composition, reorganisation, or liquidation.
- To facilitate debt/equity conversions, the CRPL also lifts the ceiling on equity investments that can be held by financial institutions. Equity write-downs or write-offs, a normal step in debt/equity conversions in Korea, would still need to be approved by at least two-thirds of voting shareholders present at a shareholders meeting.

The CRPL has been used for restructuring of three Hyundai companies (including Hynix and Hyundai Engineering & Construction) and two Ssangyong companies.<sup>19</sup> Replication of a similar approach would better be adopted before a crisis in order to avoid any concerns about *ex post facto* imposition on financial institution creditors.

Other approaches to resolution of inter-creditor differences include suasion and linkages with the formal insolvency system. Reportedly, in Malaysia (as reportedly earlier in London) the central bank occasionally asked holdout creditors to reconsider their opposition to a particular workout arrangement. Out-of-court procedures in both Malaysia and Thailand mimicked creditor approval thresholds in the formal insolvency system. In Thailand, thresholds for creditor approval of a workout agreement were set at 75%, the same as for a court-supervised organisation. Thus, in any case where a 75% majority of creditors could not elicit the co-operation of a holdout minority, they had the option

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<sup>18</sup> Wonhyuk Lim, mimeo, September 2002.

<sup>19</sup> As of June 2002, the Hyundai restructurings had involved 5.4 trillion Korean won in debt/equity conversions, a 1.4 trillion Korean won debt write-off for Hynix, rate reductions and term extensions, and 658 billion Korean won in new credit for Hynix. Hynix creditors who were opposed to providing new credits accepted conversion of existing debt into equity or zero coupon bonds at a loss rate of close to 75%. Ibid.

of taking the agreement to Thailand's bankruptcy court for ratification and imposition on holdout creditors. In Malaysia, CDRC rules required 100% creditor approval of any workout agreement. But, lower approval thresholds in other cases—75% for Companies Act reorganisations and 50% for workouts managed by the Danaharta AMC—may have given creditors some additional incentive to reach agreement in CDRC proceedings.

#### **6) Conclusion**

Any out-of-court workout, proceeds in the shadow of the law. In at least two areas, strong linkages with formal creditor rights/insolvency law seem important for the efficient functioning of any out-of-court workout regime.

First, it seems essential for debtors to face a credible immediate threat of total loss (*e.g.*, from foreclosure, liquidation, and/or receivership) in order to elicit sufficient co-operation with out-of-court workout efforts.

Second, the ability to rapidly convert an out-of-court workout agreement into a court-supervised reorganisation seems the fairest and most expeditious method for dealing with holdout creditors or public shareholders. Careful attention should be given to absolute priority rules, availability of “cram down,” and thresholds for creditor approval—both in court-supervised insolvencies and, by extension, in out-of-court workout proceedings.



## India

### Developing the Asian Markets for Non-Performing Assets: Developments in India

by

*Sumant Batra*<sup>1</sup>

#### 1) *What is a non-performing asset?*

In India, an asset is classified as a Non-Performing Asset (NPA) if interest or instalments of principal due remain unpaid for more than 180 days. However, with effect from March 2004, default status would be given to a borrower if dues are not paid for 90 days. If any advance or credit facilities granted by a bank to a borrower become non-performing, then the bank will have to treat all the advances/credit facilities granted to that borrower as non-performing without having any regard to the fact that there may still exist certain advances/credit facilities having performing status.

#### 2) *Non-performing assets in India: An overview*

India has acquired an alarming number of Non-Performing Assets (See Table 1). As at 31 March 2003, the banks and financial institutions in India held NPAs worth approximately Rs. 1 100 000 crore<sup>2</sup> as against an aggregate gross NPAs of all scheduled commercial banks amounting to Rs. 63 883 crore at 31 March 2001.

**Table 1**

Distribution of NPAs Percentage to Total Assets as of the End of March 2003								
	2000		2001		2002		2003	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net
<b>All Scheduled</b>								
<b>Commercial Banks</b>	5.5	2.7	4.9	2.5	4.5	2.3	4.0	1.9
<b>Public Sector Banks</b>	6.0	2.9	5.3	2.7	4.8	2.4	4.2	1.9
<b>New Private Sector Banks</b>	1.6	1.1	2.1	1.2	3.8	2.1	3.6	2.2
<b>Foreign Banks</b>	3.2	1.0	3.0	0.8	2.4	0.6	2.4	0.8

A review of the figures of gross and net NPAs for the last four years shows an increase of Rs. 13 068 crore (more than 25%) (See Table 2)<sup>3</sup>.

<sup>1</sup> Sumant Batra is senior partner with a New Delhi based law firm of Kesar Dass B & Associates.

<sup>2</sup> One crore comprises 10 million Rupees.

<sup>3</sup> Source: Website of R. Kannan.

Table 2

<b>NPA Statistics - Scheduled Commercial Banks (Amount in crore)</b>	<b>Total Advances</b>	<b>Gross NPA</b>	<b>Net Advances</b>	<b>Net NPA</b>	<b>Percent of Gross NPA to Total Advances</b>	<b>Percent of Net NPA to Total Advances</b>
<b>Year</b>						
<b>1997-1998</b>	352 697	50 815	325 522	25 734	14.4	7.3
<b>1998-1999</b>	399 496	58 722	367 012	27 892	14.7	7.6
<b>1999-2000</b>	475 113	60 408	444 292	30 211	12.7	6.8
<b>2000-2001</b>	558 766	63 883	526 329	32 632	11.4	6.2

The apparent reduction of gross NPAs from 14.4% to 11.4% between 1998 and 2001 provides little comfort since this accomplishment is because of credit growth, which was higher than the growth of gross NPAs and not through any appreciable recovery of NPAs. There is neither a reduction nor even containment of the threat. The gross NPAs and net NPAs for public sector banks (PSBs) as at 31 March 2001 of 12.39% and 6.74% respectively, are higher than the figures for scheduled commercial banks (SCB's) at 11.4% and 6.2% (See Tables 3 to 5)<sup>4</sup>.

Table 3

<b>NPA of PSBs (Amount in crore)</b>	<b>Total Advances</b>	<b>Gross NPA</b>	<b>Net NPA</b>	<b>Percent of Gross NPA to Total Advances</b>	<b>Percent of Net NPA to Net Advances</b>
<b>Year</b>					
<b>1996-1997</b>	244 214	43 577	20 285	17.8%	9.2%
<b>1997-1998</b>	284 971	45 563	21 232	16.0%	8.2%
<b>1998-1999</b>	325 328	51 710	24 211	15.9%	8.1%
<b>1999-2000</b>	380 077	53 033	26 188	14.00%	7.9%
<b>2000-2001</b>	442 134	54 773	27 967	12.39%	6.74%

Table 4

<b>NPA of State Bank Group (Amount in crore)</b>	<b>Total Advances</b>	<b>Gross NPA</b>	<b>Net NPA</b>	<b>Percent of Gross NPA to Total Advances</b>	<b>Percent of Net NPA to Net Advances</b>
<b>Year</b>					
<b>1997-1998</b>	113 360	15 522	6 829	14.57%	6.98%
<b>1998-1999</b>	118 959	18 641	7 764	15.67%	7.74%
<b>1999-2000</b>	129 253	19 773	7 411	14.08%	6.77%
<b>2000-2001</b>	150 390	20 586	8 125	12.73%	6.26%

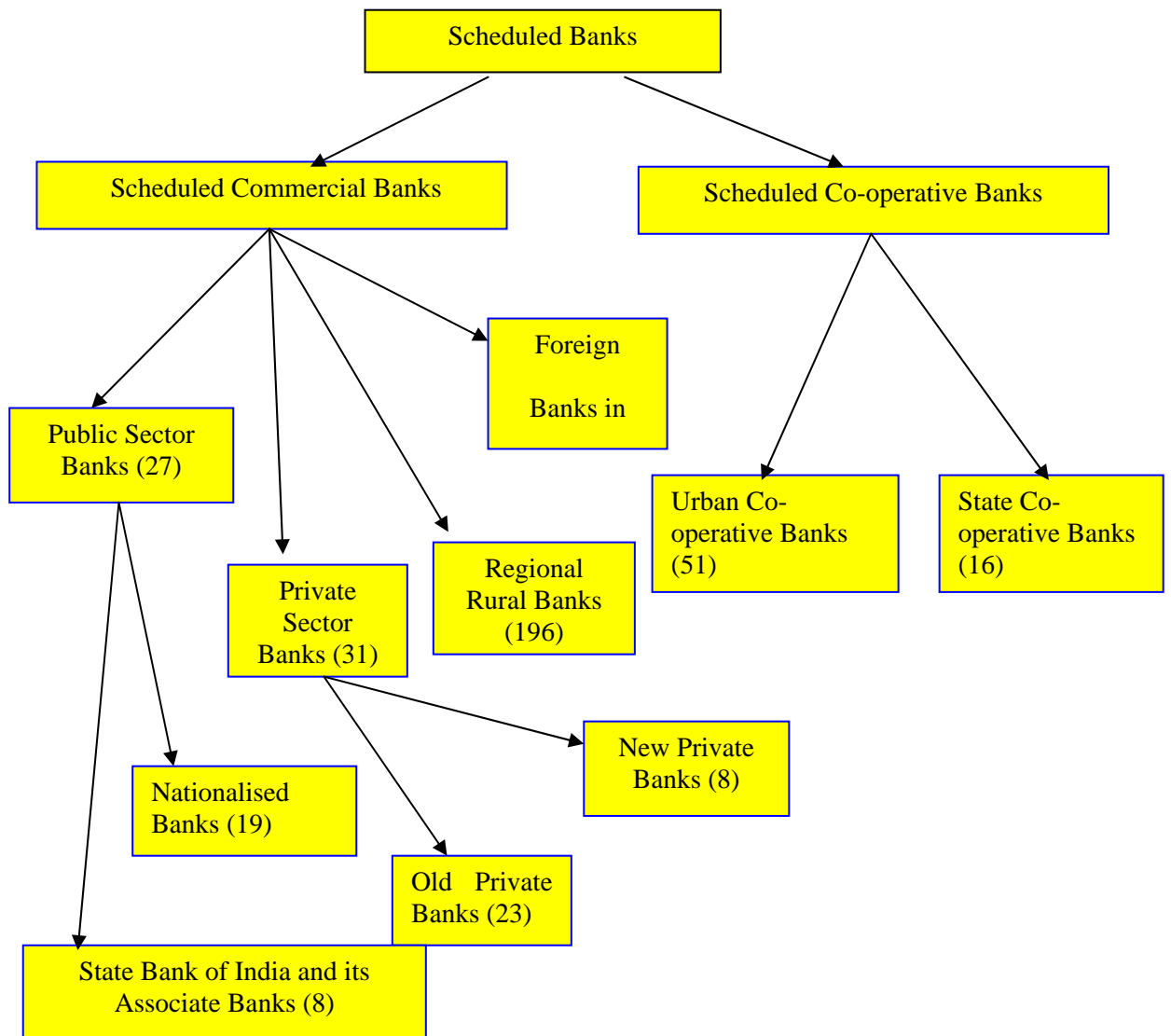
Table 5

<b>NPA of Nationalised Banks (Amount in crore)</b>	<b>Total Advances</b>	<b>Gross NPA</b>	<b>Net NPA</b>	<b>Percent of Gross NPA to Total Advances</b>	<b>Percent of Net NPA to Net Advances</b>
<b>Year</b>					
<b>1997-1998</b>	166 222	30 130	14 441	16.88	8.91
<b>1998-1999</b>	188 926	33 069	15 759	16.02	8.35
<b>1999-2000</b>	224 818	33 521	17 399	13.99	7.80
<b>2000-2001</b>	264 237	34 609	16 096	12.19	7.01

<sup>4</sup> Source: Website of R. Kannan.

The following is an overview of the structure of scheduled banks in India as on 31 March 2001.<sup>5</sup>

Figure 1



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<sup>5</sup> ADB.

### 3) *An analysis of factors contributing to NPAs*

An analysis of the contributory factors resulting in the emergence of NPAs on a large scale amongst commercial banks and financial institutions would lead to the following conceptualisation:

- PSBs performed creditably in respect of all parameters set for them. However, in the early 1990s, it emerged that PSBs were suffering from acute capital inadequacy and many of them had negative profitability. This is because the parameters set for their functioning were deficient and they did not project the paramount need for these corporate goals. Incorrect goal perception and identification led them to the wrong destination.
- The pre-reform era witnessed directed banking for PSBs which functioned under the overall control and direction of the Finance Ministry, which along with the Reserve Bank of India (RBI), decided/directed all aspects of the working of the banks, leaving little freedom to price their products in competition with each other, cater their products to segments of their choice, or invest their funds in their best interest as they determined.
- Since the 1970s, the SCBs of India functioned totally as captive capsule units cut off from international banking and unable to participate in the structural transformations, the sweeping changes, and the new types of lending products emerging in global banking institutions. Their personnel lacked needed training and knowledge resources required to compete with international players.
- Major policy decisions were taken externally by the Finance Ministry/RBI. The environment of receiving decisions from a political background as distinguished from a professional outfit prevented the best talents coming to occupy key positions.
- Audit and control functions remained under the control of executive officers, which were not independent and were thus unable to correct the effect of serious flaws in policies and directions of their superiors.
- The quantum of credit extended by the PSBs increased by about 160 times in the three decades after nationalisation (from around 3 000 crore in 1970 to 475 113 Crore on 31 March 2000). The Banks were not sufficiently developed in terms of skills and expertise to regulate such growth and manage the diverse risks that emerged in the process.
- The need for organising an effective mechanism to gather and disseminate credit information amongst the commercial banks was never felt or implemented. The archaic laws of secrecy of customer information prevented banks from publishing names of defaulters for common knowledge of the other banks in the system.
- Effective recovery from defaulting and overdue borrowers was hampered on account of a sizeable overhang component arising from infirmities in the existing process of debt recovery, inadequate legal provisions on foreclosure and bankruptcy and difficulties in the execution of court decrees. Legal remedies were beset with too many formalities and were very time-consuming.
- Effective corporate management was an alien concept. In respect of PSBs, the boards were ineffective and the only/main shareholder was the government of India. The government



exercised multiple roles and concerns, and the instinct to act as a watchful shareholder and increase shareholders value of banks and financial institutions was never felt or experienced.

- Credit management on the part of the lenders to the borrowers to secure their genuine and *bonafide* interests was not based on pragmatically calculated anticipated cash flows of the borrower's concern, while recovery of instalments of term loans was not out of profits and surplus generated but through recourse to the corpus of working capital of the borrowing concerns.
- Functional inefficiency was also caused due to overstaffing, manual processing of bloated operations and a failure to computerise the banks in India, when elsewhere throughout the world the system switched over to computerisation of operations.

#### 4) *Impacts of NPAs on the working of commercial banks*

NPAs affected the profitability, liquidity and competitive functioning of public and private sector banks, and finally the psychology of the bankers in respect of their disposition towards credit delivery and credit expansion.

##### *Impact on profitability*

Commercial banks incurred a total amount of Rs. 31 251 crore towards provisioning NPAs from 1 April 1993 to 31 March 2001. This has brought net NPAs to Rs.32 632 crore or 6.2% of net advances. The enormous provisioning of NPAs together with the holding cost of such non-productive assets over the years has acted as a severe drain on the profitability of the PSBs. Equity issues of nationalised banks that have already tapped the market are now quoted at a discount in the secondary market. This has alternatively forced PSBs to borrow heavily from the debt market to build Tier II capital to meet capital adequacy norms, thus putting severe pressure on their profit margins. It is worthwhile to compare the aggregate figures of the 19 nationalised banks for the year ended March 2001, as published by RBI in its Report on Trends and Progress of Banking in India (See Table 6)<sup>6</sup>.

**Table 6**

<b>Nationalised Banks Operational Statistics (Amount in crore) Performance Indicator</b>	<b>Year Ending March 2000</b>	<b>Year Ending March 2001</b>
<b>Earnings - Non-interest</b>	6 662.42	7 159.41
<b>Operating Expenses</b>	14 251.87	17 283.55
<b>Difference</b>	- 7 589.45	- 10 124.14
<b>Earnings - Interest Income</b>	50 234.01	56 967.11
<b>Exp.- Interest Expenses</b>	35 477.41	38 789.64
<b>Interest Spread</b>	14 756.60	18 177.47
<b>Int. on Recap Bonds</b>	1 797.88	1 795.48
<b>Operating Profit</b>	5 405.27	6 257.85
<b>Provisions</b>	4 766.15	5 958.24
<b>Net Profit</b>	639.12	299.61

<sup>6</sup> Source: Website of R. Kannan

### *Impact on the outlook of bankers towards credit delivery*

The psychology of the banks today is to insulate themselves with zero percent risk and turn lukewarm to fresh credit. This has adversely affected credit growth compared to growth of deposits, resulting in a low C/D Ratio of around 50% to 54% for the industry. It is evident that the existence of collateral security may at best convert the credit extended to productive sectors into an investment against real estate, but will not prevent the account turning into NPAs. Furthermore, blocked assets and real estate represent the most illiquid security and NPAs, in such cases, have the tendency to persist for a long duration. Nationalised banks have reached the dead end of the tunnel and their future prosperity depends on an urgent solution of this lingering threat.

### *Excessive focus on credit risk management*

The most important business implication of NPAs is that they lead to credit risk management assuming priority over other aspects of the bank's functioning. The bank's whole machinery is thus pre-occupied with recovery procedures rather than on expanding business. A bank would be forced to incur carrying costs on non-income yielding assets. Other consequences would be a reduction in interest income, high levels of provisioning, stress on profitability and capital adequacy, a gradual decline in the ability to meet steady increases in costs, increased pressure on net interest margins, thereby reducing competitiveness, a steady erosion of capital resources and increased difficulty in augmenting capital resources.

The less appreciated implications are reputational risks arising out of greater disclosures on quantum and movement of NPAs, provisions, etc. The non-quantifiable implications can be psychological, like risk aversion, lower morale and disinclination to take decisions at all levels of staff in the bank.

### *High cost of funds due to NPAs*

Quite often genuine borrowers face difficulties in raising funds from banks due to mounting NPAs. Either the bank is reluctant to provide the requisite funds to genuine borrowers or, if the funds are provided, they come at a very high cost to compensate the lender's losses due to NPAs. Therefore, corporations often prefer to raise funds through commercial paper where the interest rate on working capital charged by banks is higher.

### *Impact of banks scrips on stock exchanges*

The RBI has included stock market behaviour of bank scrips in its annual review of the banking sector. As per a RBI Report, despite the various reforms being carried out in Indian stock exchanges, many bank scrips remain illiquid and thinly traded. In fact, of 25 banks traded on the National Stock Exchange (NSE), the share of the top five banks in turnover and capitalisation constituted 96% and 83% respectively during 1998-1999.

### *Excess liquidity-lending-default*

The banks in India are faced with the problem of increasing liquidity in the system. Further, RBI is increasing the liquidity in the system through various rate cuts. Banks can get rid of their excess liquidity by increasing lending, but often shy away from such an option due to the high risk of default. However, almost all of the banks are facing the problem of bad loans, non-performing assets, thinning margins, etc. as a result of which, they are reluctant to grant loans to corporations. As such, when the RBI announces a rate cut, the news is no longer warmly greeted by bankers.

### *The importance of credit ratings in assessing the risk of default for lenders*

Banks rely on credit rating agencies to measure credit risk and assign a probability of default. However, credit rating is not foolproof. Besides, there may be conflicts of interest, which a credit rating agency may not be able to resolve in the interest of investors and lenders. Stock prices are an important, but not the sole indicator of the credit risk involved. Stock prices are much more forward-looking in assessing the creditworthiness of a business enterprise.

### *Usage of financial statements in assessing the risk of default for lenders*

For banks and financial institutions, both the balance sheet and income statement have a key role to play by providing valuable information on a borrower's viability. However, the approach of scrutinising financial statements is a backward looking approach. This is because the focus of accounting is on past performance and current positions. The key accounting ratios generally used for the purpose of ascertaining the creditworthiness of a business entity are the debt-equity ratio and interest coverage ratio. Highly rated companies generally have low leverage. This is because high leverage is followed by high fixed interest charges, non-payment of which results in default.

### **5) Current status of NPAs and Indian banks: A statistical introspection**

Indian banking in 2002 represents a sea change from where it was in the preceding decade. There has been a decade of professional banking moving towards global standards. Banks, in general, performed extremely well in 2001-2002 and onwards.

In 1992-1993, the profitability of the PSBs as a group turned negative with as many as twelve nationalised banks reporting net losses. By March 1996, the outer time limit prescribed for attaining capital adequacy of 8%, eight public sector banks were still short of the prescribed limit. The public sector banks which suffered losses of Rs.3 293 crore in 1992-1993 and Rs. 4 349 crore in 1993-1994, *i.e.* in the initial years of introduction of prudential norms, ended the year 1997-1998 with a net profit of Rs.5 027 crore. Net NPAs of public sector banks formed 8.2% of the net advances and 3.3% of the total assets as at the end of March 1998. Corresponding figures as at 31 March 2002 are 5.82% and 2.42%. PSBs recorded an aggregate net profit of Rs.8 301 crore in 2001-2002 (See Tables 7 and 8)<sup>7</sup>.

**Table 7**

<b>Non-Performing Assets as Percentage of Total Assets –All Scheduled Commercial Banks</b>									
<b>Sr No</b>	<b>Bank name</b>	<b>Gross NPAs/Total Assets</b>				<b>Net NPAs/Total Assets</b>			
		<b>1998-1999</b>	<b>1999-2000</b>	<b>2000-2001</b>	<b>2001-2002</b>	<b>1998-1999</b>	<b>1999-2000</b>	<b>2000-2001</b>	<b>2001-2002</b>
<b>1</b>	<b>Nationalised Banks</b>	6.83	6.0	5.44	5.21	3.26	3.15	2.95	2.16
<b>2</b>	<b>State Bank Group</b>	6.52	5.88	5.11	4.39	2.94	2.60	2.35	2.00
<b>3</b>	<b>Total PSBs</b>	6.71	5.95	5.31	4.89	3.14	2.94	2.72	2.42
<b>4</b>	<b>Private Sector Banks (Old)</b>	5.78	5.22	5.14	5.20	3.56	3.27	3.28	3.22
<b>5</b>	<b>Private Sector Banks (New)</b>	2.26	1.60	2.05	3.91	1.59	1.08	1.18	2.10
<b>6</b>	<b>Foreign Banks</b>	3.10	3.16	3.04	2.43	1.10	1.03	0.77	0.82

<sup>7</sup> Source: *Trends and Progress in Indian Banking*, RBI, (2002).

6) *Measures taken to deal with NPAs*

The Government of India, RBI and other related agencies have been hectically engaged in introducing banking and financial sector reforms (See Figure 2).

Figure 2

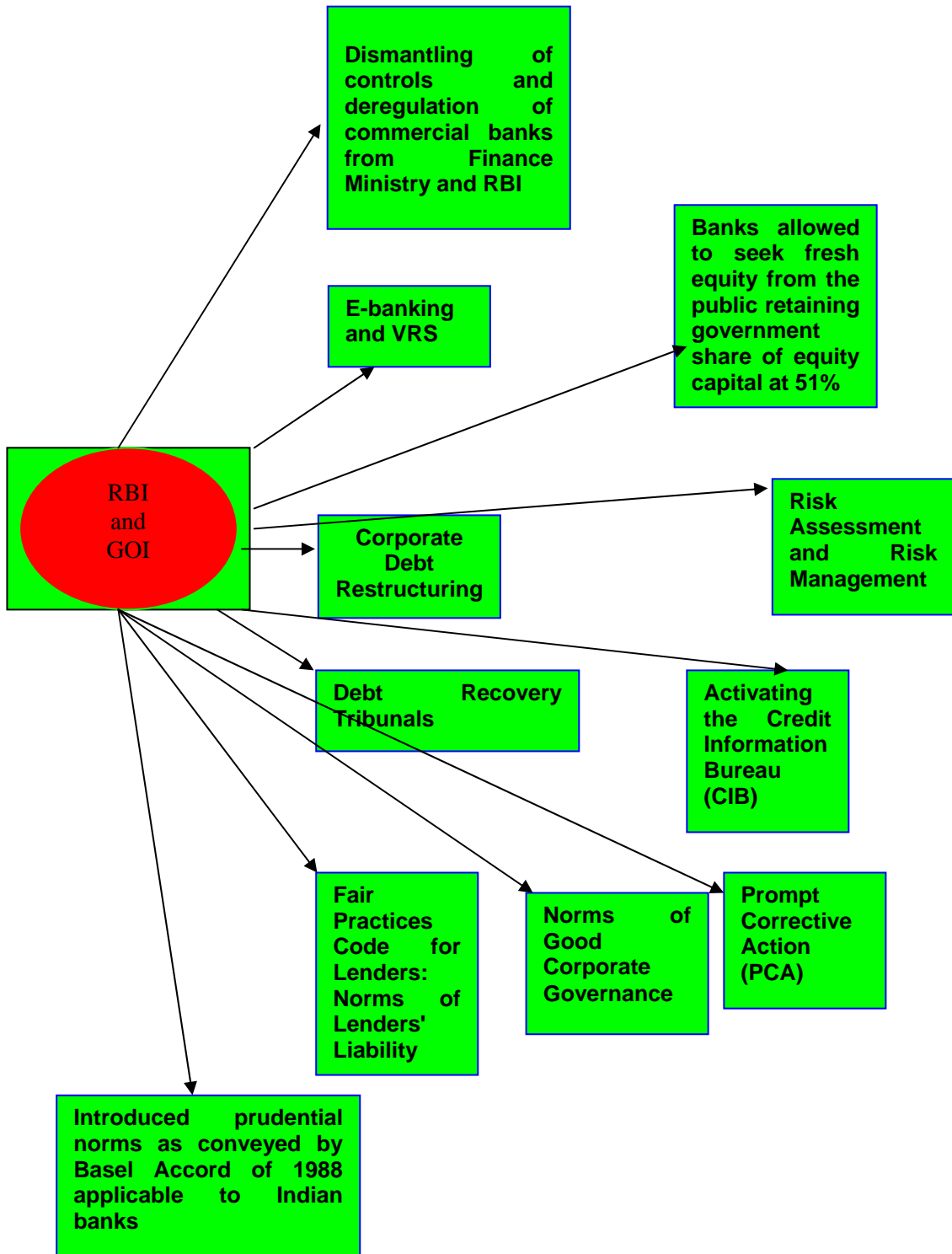


Table 8

Non-Performing Assets as Percentage of Total Advances –All Scheduled Commercial Banks									
Sr No	Bank Name	Gross NPAs/Total Advances				Net NPAs/Total Assets			
		1998-1999	1999-2000	2000-2001	2001-2002	1998-1999	1999-2000	2000-2001	2001-2002
1	Nationalised Banks	16.02	13.91	12.16	11.01	8.35	7.80	7.01	6.01
2	State Bank Group	15.67	14.08	12.73	11.25	7.74	6.77	6.27	5.45
3	Total PSBs	15.89	13.98	12.37	11.09	8.13	7.42	6.74	5.82
4	Private Sector Banks (Old)	13.06	10.78	10.94	11.01	8.96	7.06	7.30	7.11
5	Private Sector Banks (New)	6.19	4.14	5.13	8.87	4.46	2.88	3.09	4.94
6	Foreign Banks	7.59	6.99	6.84	5.38	2.94	2.41	1.82	1.89

**These reforms are discussed below:**

- *Dismantling of controls and deregulation of working of commercial banks*, permitting entry of new private sector banks and permission for foreign banks to open more branches. This had the effect of opening Indian banking to global standards by making them function efficiently in a competitive environment. This was the initial step to create a structural framework for the PSBs to enable them to adjust to the new environment and turn into dynamic and self-reliant operating units.
- *The process of deregulation* freed the banks from the control of the Finance Ministry and RBI. The RBI, hereafter, acts as a regulator. In the year 1994, RBI further fine-tuned the process by constituting a separate Board of Financial Supervision (BFS) with the objective of segregating the supervisory role from the regulatory functions of RBI. Banks now operate independently in a competitive financial market, but have to comply with prudential norms and safeguards essential for their wellbeing.
- RBI made *prudential norms*, as conveyed by the Basel Accord of 1988, applicable to Indian banks. These included standards relating to capital adequacy, income recognition, asset classification and provisioning for non-performing assets. This had the effect of providing much-needed transparency about the state of affairs of each bank and enabled instant corrective measures to be executed.
- *Banks were permitted to seek infusions of fresh equity* from the public with the government retaining a 51% share of equity capital. A number of PSBs entered the market and raised Tier I and Tier II capital accordingly. This has created a new class of stakeholder (albeit shareholders) vitally interested in the wellbeing of the banks and qualified/empowered to question the Board of Directors at the appropriate forum.
- *Governance*: RBI emphasised the paramount importance of accepting norms of good corporate governance by banks. While the Securities Exchange Board of India (SEBI) has introduced a general set of norms applicable to all companies including banking companies, RBI has further covered the special needs of banking companies by bringing out an appropriate set of standards.

- The Credit Information Bureau (India) Ltd.:* In order to expedite credit and investment decisions by banks and financial institutions, and curb the accretion of fresh NPAs, the Credit Information Bureau (India) Ltd., (CIBIL) was set up by the State Bank of India in association with HDFC in August 2000. CIBIL was to be technology driven to ensure speedy processing, periodic updating and availability of error-free data at all times in the system. As a first step towards activating the CIBIL, it was decided to initiate the process of collection and dissemination of some relevant information within the existing legal framework. The RBI accordingly decided to constitute a group drawing representation from CIBIL, the Indian Banks' Association (IBA), select banks and FIs to examine the possibility of the CIBIL performing the role of collecting and disseminating information on the list of suit-filed accounts and the list of defaulters, including wilful defaulters, which is presently handled by the Reserve Bank. The group is also expected to examine other aspects of information collection and dissemination, such as the extent, periodicity and coverage, and the feasibility of supplying information on-line to members in the future.
- Norms of lenders' liability:* RBI has come out with broad guidelines for framing the Fair Practices Code with regard to lenders' liability to be followed by commercial banks and financial institutions, emphasising transparency and proper assessment of borrowers' credit requirements. RBI has issued a draft of the model code and has advised the individual banks to adopt model guidelines for framing their respective Fair Practices Codes with the approval of their Boards. This is a balancing measure. It imposes a self-discipline on the part of the banks, which will only indirectly prevent accounts turning into NPAs on account of the bank's own failures or wrong actions.
- Risk assessment and risk management:* Since the year 1998, the RBI has been making serious efforts towards evolving a suitable and comprehensive model for risk-management by the banks and to integrate this new discipline in the working systems of banks. The RBI has identified risk-prone areas in asset-liability management, credit management, changes in market conditions and counter-party and country risks and has evolved suitable models for managing all such risks. RBI has also evolved a system of Risk-based Supervision of Banks. It also advised banks on a parallel scheme for carrying out internal audit based on risk perception.
- E-banking and VRS:* The influence of these areas of banking reforms may not appear directly relevant to a reduction of NPAs. However, computerisation provides for data-accuracy and operational efficiency and results in a better Management Information Service (MIS). VRS rationalises the work force, which in turn results in better productivity and operational efficiency.
- RBI has also cautioned banks on the use of gains from the sale of investments:* It has advised banks to follow a more prudent policy for utilising the gains realised on sales of securities arising from a decline in interest rates and also for building up adequate reserves to guard against any possible reversal of the interest rate environment due to unexpected developments. Accordingly, banks are required to build an investment fluctuation reserve (IFR) of a minimum of 5% of all investments in the "held for trading" and "available for sale" categories within five years. As on 31 March 2002, the IFR of all the banks put together stood at Rs. 3 223 crore or 0.71% of the total investment of Rs. 4 540 000 crore. Of the total investments, the State Bank of India group alone accounted for Rs. 1 850 587 crore against which it has set aside Rs. 1 228 crore in IFR, or a coverage of 0.66%.

- *RBI Guidelines on Fair Practices Code for Lenders* are applicable to SCBs/AIFIs (excluding RRBs and LABS): According to the Fair Practices Code, which is at the core of lender liability, the lenders must treat their borrowers fairly, and when they do not, they can be subject to litigation by the borrower for a variety of reasons, *inter alia*, breach of contract, breach of fiduciary duty, fraud and misrepresentation, and negligent loan processing and administration.
- *Compromise settlement schemes*: Banks are free to design and implement their own policies for recovery and write-off incorporating compromise and negotiated settlements with the approval of their Boards, particularly for old and unresolved cases falling under the NPA category. The policy framework suggested by RBI provides for setting up of independent Settlement Advisory Committees headed by a retired judge of the High Court to scrutinise and recommend compromise proposals. Specific guidelines were issued in May 1999 to PSBs for one time non-discretionary and non-discriminatory settlement (OTS) of NPAs of the small enterprise sector. The scheme was operative up to September 30, 2000. (Public sector banks recovered Rs. 668 crore through compromise settlement under this scheme). Guidelines were modified in July 2000 for recovery of the stock of NPAs of Rs. 5 crore and less, as on 31 March 1997. (The above guidelines which were valid up to 30 June 2001, helped the public sector banks to recover Rs. 2 600 crore by September 2001). An OTS scheme covering advances of Rs. 25 000 and below continues to be in operation and guidelines in pursuance to the budget announcement of the Honourable Finance Minister providing for OTS for advances up to Rs.50 000 in respect of NPAs of small/marginal farmers are being drawn up.
- *Circulation of information on defaulters*: The RBI has put in place a system for periodic circulation of details of wilful defaults of borrowers of banks and financial institutions. This serves as a cautionary list while considering requests for new or additional credit limits from defaulting borrowing units and also from the directors/proprietors/partners of these entities. RBI also publishes a list of borrowers (with aggregate outstanding of Rs. 1 crore and above) against whom banks and FIs have filed suits for recovery of their funds, as on 31 March every year. These measures serve as a negative basket of steps shutting off fresh loans to these defaulters.<sup>8</sup>
- *Recovery action against large NPAs*: RBI advised public sector banks to examine all cases of wilful default of Rs. 1 crore and above and file suits in such cases, and file criminal cases in regard to wilful defaults. Boards of Directors are required to review NPA accounts of Rs.1 crore and above with special reference to fixing of staff accountability.
- *Special mention accounts*: In a recent circular, RBI has suggested to the banks to have a new asset category or “special mention accounts” for early identification of bad debts. This would be strictly for internal monitoring. Loans and advances overdue for less than one quarter and two quarters would come under this category. Data regarding such accounts will have to be submitted by banks to the RBI. However, special mention assets would not require provisioning, as they are not classified as NPAs. An asset may be transferred to this category once the earliest signs of sickness/irregularities are identified. This will help banks look at accounts with potential problems in a focused manner right from the onset of the

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<sup>8</sup> See: RBI circular on wilful defaulters and action thereagainst, numbered DBOD. No. DL(W).BC. /110 /20.16.003(1)/2001-02), 30 May 2002 which can be seen on schedule 13 or from the RBI’s official website.

problem, so that monitoring and remedial actions can be more effective. Once these accounts are categorised and reported as such, proper top management attention would also be ensured. Borrowers having genuine problems due to a temporary mismatch in funds flow or sudden requirements of additional funds may be entertained at the branch level, and for this purpose, a special limit to tide over such contingencies may be built into the sanction process itself.

- *RBI guidelines on classification of bank advances:* The Reserve Bank of India (RBI) has issued guidelines on provisioning requirements with respect to bank advances. In terms of these guidelines, bank advances are mainly classified into:
  - *Standard Assets:* Such an asset is not a non-performing asset. In other words, it carries not more than normal risk attached to the business.
  - *Sub-standard Assets:* It is classified as non-performing for a period not exceeding 18 months.
  - *Doubtful Assets:* An asset that has remained an NPA for a period exceeding 18 months is a doubtful asset.
  - *Loss Assets:* Here loss is identified by the banks concerned, by internal auditors, by external auditors, or by the Reserve Bank India upon inspection.

## 7) **Legal Reforms**

Various legal reforms have been undertaken by the government to improve the legal framework (See Figure 3).

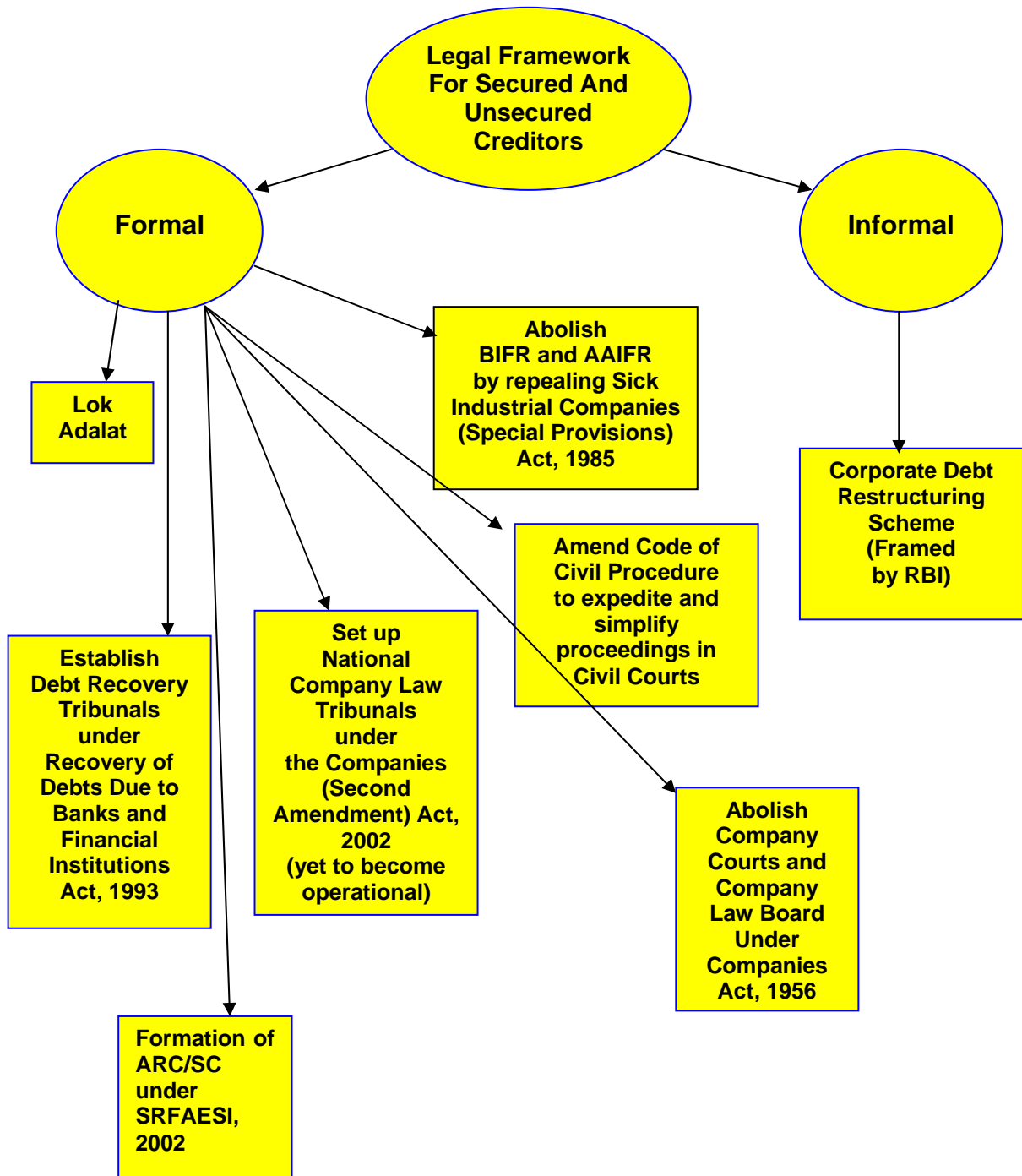
### *Formal framework*

The banks and financial institutions can enforce their securities by initiating recovery proceedings under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (DRT Act) by filing an application for recovery of their dues before the Debt Recovery Tribunal (DRT) constituted under the said act in various states in India. Once their claim is adjudicated, a Recovery Certificate for the amount found due and payable is issued by the DRT. Based on the Recovery Certificate, execution proceedings are initiated by the Recovery Officer appointed for facilitating recovery of money under the Recovery Certificate.

The DRT Act and the rules and regulations framed there under provide for a self-contained mechanism and procedure for execution of Recovery Certificates. The sale is carried out by an auctioneer or a receiver appointed by the Recovery Officer under its supervision. DRT has adequate powers to grant injunctions against the disposal, transfer or creation of third party interest by debtors in the properties charged to the creditor. The DRT has the power to pass attachment orders in respect of charged properties. The power to appoint the receiver or remove any person from possession or custody of the property is also vested with the tribunals. The execution proceedings before the tribunals involve attachment of charged properties and sale thereof by way of public auction. The power to appoint the receiver for the properties is also available. In case of non-realisation of the decreed amount by way of sale of the charged properties, the personal properties of the guarantors/sureties of the debtor company can also be attached and sold.



Figure 3



For claims below one million rupees, the banks and financial institutions are required to initiate proceedings under the Code of Civil Procedure of 1908, as amended, in a civil court. The execution is carried out under the Code of Civil Procedure. Under the Code of Civil Procedure, the courts are empowered to pass injunction orders restraining the debtor through itself or through its directors, authorised representatives, agents etc. from disposing of, parting with or dealing in any manner with the subject property. The courts are also empowered to pass attachment and sales orders for subject

property before judgment, in case necessary. The procedure for execution of judgments/decrees is also very well laid down in the code. In execution proceedings, the powers for arrest or deposit of the security amount are also been given to the courts. The procedure for sale of subject property has also been well laid down. The sale of subject property is normally carried out by way of open public auction subject to confirmation of the court. The provisions for appointment of the receiver and foreclosure, sale or redemption of mortgaged property by the court, and the procedure thereto have also been laid down in the code.

The foreclosure proceedings, where the DRT Act is not applicable, can be initiated under the Transfer of Property Act of 1882 by filing a mortgage suit where the procedure is the same as laid down under Code of Civil Procedure.

The secured creditors, other than banks and financial institutions, have to approach the Civil Court for enforcement of security by way of an ordinary suit for recovery or by filing a mortgage suit. In such cases, the provisions of the Code of Civil Procedure are invoked.

#### **8) *Recent significant developments in law making***

In December 2002, the Indian parliament passed the Companies Act of 2002 (Second Amendment) to restructure the Companies Act of 1956 (the 1956 Act) leading to a new regime of tackling corporate rescue and insolvency. The provisions of the Second Amendment are, however, yet to be notified. The Sick Industrial Companies (Special Provisions) Act of 1985 (SICA), that presently deals with the revival and rehabilitation of companies, has been repealed by passing of the Sick Industrial Companies (Special Provisions) Repeal Bill of 2001 by the Parliament, which has yet to be notified.

In the same month, the Indian parliament passed another significant item of legislation, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act of 2002 (SARFESI) to regulate, for the first time, the securitisation and reconstruction of financial assets. SARFESI also deals with the enforcement of secured interests by secured creditors without the intervention of court.

##### *a) The Companies Act of 2002 (Second Amendment): A critical analysis of the main provisions*

The Companies Act of 2002 (Second Amendment) proposes amendments to the provisions of the 1956 Act and the setting up of a National Company Law Tribunal (NCLT) and its Appellate Tribunal. Under the proposed legislation, NCLT will have:

- the power to consider revival and rehabilitation of companies (a mandate presently entrusted to BIFR under SICA);
- the jurisdiction and power relating to winding up of companies presently vested in the High Court. The winding up proceedings pending in High Courts shall be transferred to the tribunal; and
- the jurisdiction and power exercised by the Company Law Board under the 1956 Act. The Company Law Board will stand abolished.

A composite law will, therefore, deal with the reorganisation and liquidation of companies. The Second Amendment is a sound attempt towards creating a balance between reorganisation and liquidation. However, it still remains to be seen as to how effective it proves in providing an orderly

exit mechanism for failed enterprises, ending unproductive uses of business assets and transferring them to more efficient market participants.

*i) The composition of the NCLT, qualifications of members and its benches:*

NCLT will consist of a President and such number of Judicial and Technical Members not exceeding sixty-two in number. The President of NCLT will be a former judge or any person qualified for appointment as a High Court Judge. The Principal Bench will be located at New Delhi and Benches may be constituted at other places. Each of the Benches of the NCLT will comprise at least a Judicial Member and a Technical Member. The winding up and reorganisation matters will, however, be handled by Special Benches having three or more members comprising at least one Judicial Member, Technical Member and Member appointed under the labour-related category.

While the Judicial Member will be a person who has the prescribed experience as a judicial officer or as a member of Indian legal services or Indian Company Law Services or has fifteen years experience as a practitioner, the Technical Member will be a person who has requisite experience as a Chartered Accountant, a Cost and Works Accountant, a Company Secretary etc.

No such qualifications are provided under SICA for appointment of Members with the result that BIFR has become a rehabilitation centre for retired bureaucrats. There is no permanent Judge presiding over the Liquidation Court and the Chief Justice designates a High Court Judge as a Company Court Judge by rotation of roster.

The Second Amendment seeks to improve upon the standards to be adopted to measure the competence, performance and services of a bankruptcy court by providing specialised qualifications for the appointment of members to the NCLT and a transparent process for their selection and appointment. However, the quality and skills of judges, newly appointed or existing, will need to be reinforced by continuing appropriate training. No provision has been made for appropriate procedures to evaluate the performance of judges based on the standards.

*ii) Commencement: applicability, accessibility and the test for determining sickness*

The Second Amendment seeks to provide easy, convenient, inexpensive and quick access while providing adequate safeguards against misuse of the provisions by defaulting and dishonest debtors as experienced under SICA. The Second Amendment requires that when an industrial company has become a sick industrial company<sup>9</sup> the Board of Directors of the said company shall make a reference to NCLT, and prepare a scheme for its revival and rehabilitation and submit the same to NCLT for determination of the measures that may be adopted with respect to the company. The reference would be accompanied with a certificate from an auditor from a panel of auditors appointed by NCLT certifying the causes of the net worth being 50% or less, or default in repayment of debt.

The trigger point under SICA is different. SICA requires the Board of Directors of a sick industrial company to make a reference to the BIFR within sixty days from the date of finalisation of the duly audited accounts of the company for the financial year at the end of which the company has become a sick industrial company. A sick industrial company under SICA means an industrial

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<sup>9</sup> Section 46AA of the Companies Act of 2002 (Second Amendment) defines a sick industrial company as an industrial company which has at the end of any financial year accumulated losses equal to 50% or more of its average net worth during four years immediately preceding such financial year or failed to pay its debts within any three consecutive quarters on demand for its repayment by a creditor or creditors of such company.

company (being a company registered for not less than five years and employing fifty or more workers), which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth.<sup>10</sup> If the Board of Directors has sufficient reasons, even before finalisation of the accounts, to form an opinion that the company has become a sick company, it shall, within sixty days after it has formed such an opinion, make a reference to the BIFR.

*iii) Inquiry by NCLT and declaration of sickness*

On receipt of a reference, the NCLT may make an order as to if the said industrial company has become a sick industrial company and such an order shall be final. NCLT may make such inquiry as it considers fit for determining whether the industrial company has become a sick industrial company. NCLT may require an Operating Agency<sup>11</sup> (OA) to enquire and make a report with respect to such matters as may be specified by it.

Similar provisions exist under SICA except that now it has been provided that the order of NCLT in this regard shall be final and, further, that the definition of OA is limited to public financial institutions, banks or any other person which may be specified as OA by BIFR.

*iv) Preparation and sanctions of the scheme:*

- If, after making an inquiry about the sickness of the company, NCLT is satisfied that a company has become sick, the NCLT shall decide whether it is practicable for the company to make its net worth exceed the accumulated losses or make the payment of its debt within a reasonable time. If NCLT decides that it is practicable for a sick company to make its net worth exceed the accumulated losses or make the payment of its debt within a reasonable time, it shall give the company, such directions as it may deem fit to do so.
- If NCLT decides that it is not practicable for a sick industrial company to make its net worth exceed the accumulated losses within a reasonable time and it is necessary to adopt remedial measures, it may direct an OA to prepare a scheme providing for such measures in relation to such company as it considers necessary from out of the parameters laid down under the Second Amendment.
- The OA shall prepare a scheme providing, *inter alia* for any one or more of the following measures: the financial reconstruction of the sick company by change in or takeover of management; the amalgamation of the company with any other company; the sale or lease of a part or whole of any industrial undertaking of the sick company; the rationalisation of managerial personnel; such incidental, consequential or supplemental measures as may be necessary; change in the Board of Directors, etc.
- The creditors of the company may also prepare a scheme for revival and rehabilitation (if approved by at least three-fourths of creditors) and submit it to the NCLT.

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<sup>10</sup> The definition of “net worth” under SICA has been retained under the Second Amendment and has been defined as the sum total of the paid up capital and free reserves. For the purposes of net worth, “free reserves” means all reserves credited out of the profits and share premium account but does not include reserves credited out of re-valuation of assets, write-back of depreciation provisions and amalgamation.

<sup>11</sup> Section 31AA of the Companies Act of 2002 (Second Amendment) defines Operating Agency as a group of experts consisting of persons having special knowledge of business or industry in which the sick industrial company is engaged and includes public financial institutions, banks or any other person which may be specified as the Operating Agency by NCLT.

Similar provisions exist under SICA, except that the time frame has been defined or redefined for various stages, and it has been added that the ability of the company to make the payment of its debt within a reasonable time will also be required to be seen by the NCLT. Though a specific provision has been made for creditors to file a scheme, there is no bar against filing a scheme under SICA.

*v) Circulation/sanctions of the scheme and its binding effect*

The Second Amendment provides that where the scheme prepared by the OA relates to preventive, ameliorative, remedial and other measures with respect to any sick industrial company, it may provide for financial assistance by way of loans, advances or guarantees or relief or concessions or sacrifices from the central government, state government, any scheduled bank or other bank, a public financial institution or state-level institution or any institution or other authority to the sick industrial company.

Every such scheme must be circulated to every person to provide financial assistance for its consent within a period of sixty days from the date of such circulation. If no consent is received, it is deemed that consent has been given and NCLT shall sanction the scheme, and from the date of such sanction, the scheme shall be binding on all concerned. However, if the consent so required is not given, NCLT may adopt such other measures, including the winding up of the sick industrial company, as it may deem fit. Therefore, every such creditor has a right to veto the scheme. Little discretion lies with the Court in the matters of approval of the scheme. Similar provisions exist under SICA.

The Second Amendment provides a number of broad guidelines to the OA to prepare the scheme. All the options are made available. The most common types of plans that are framed are based on haircut by creditors and sale of surplus assets, or one time settlement of dues of creditors. However, the law does not address the manner in which the priority has to be accorded to classes of creditors. The parties are left to negotiate the best deal between them based on a realistic scenario.

*vi) Implementation, modification and the binding effect*

Under the Second Amendment, once sanctioned, the scheme has a binding effect on all concerned by operation of statute. A scheme based on one time settlement of dues deals with the discharge of creditor(s). The implementation of the sanctioned scheme will be monitored by court and, if required, can be modified. Any person aggrieved by the sanction of the plan can challenge it before the Appellate Tribunal or seek review of the order.

*vii) Winding up of sick industrial companies*

Where the NCLT comes to the conclusion that the sick industrial company is not likely to make its net worth exceed the accumulated losses within a reasonable time while meeting all its financial obligations, and that it is not possible to revive the company in future, and that it is just and equitable that the company should be wound up, it shall record its finding and order winding up of the company.

Under SICA, the BIFR does not have the jurisdiction to order winding up of the company. If the BIFR concludes that it is not possible to revive the company and that it is just and equitable that the company should be wound up, it records its opinion and forwards the same to the concerned High Court which, on the basis of this opinion, may order winding up of the company and may proceed and cause to proceed with the winding up of the sick industrial company in accordance with the provisions of the 1956 Act.

*viii) New time frame*

The new time frame requires:

- Reference to be filed within 180 days from the date on which the Board of Directors has come to know the causes of making a reference, or within 60 days of adoption of final accounts.
- Enquiry by the OA to determine whether the company is a sick industrial company within 21 days, which is extendable to 40 days.
- Time for the OA to prepare the scheme is 60 days extendable by 90 days.
- Sanction within 60 days from receipt of suggestions/objections to the draft scheme.
- Consent of creditors required to give financial assistance in any form is 60 days.

*ix) Appellate Tribunal*

There will be a National Company Law Appellate Tribunal (NCLAT) to hear appeals from the orders of the NCLT. The Chairperson of NCLAT will be a retired Judge of the Supreme Court of India or a Chief Justice of a High Court. The appeal from the order of NCLAT will lie with the Supreme Court of India.

Under SICA, there is an Appellate Authority for Industrial and Financial Reconstruction (AAIFR), which comprises a retired High Court Judge as its chairman. The AAIFR hears appeals from the parties aggrieved by the orders of the BIFR. There is no appeal from the order of AAIFR though the High Court can entertain writ petitions under Article 226/227 of the Constitution of India against the orders passed by the AAIFR.

*x) Suspension of legal proceedings and contracts*

The Second Amendment does away with the infamous provision under SICA which provides that where, in respect of an industrial company, an inquiry is pending or any scheme is under preparation or consideration, or a sanctioned scheme is under implementation or where an appeal is pending, no proceedings for the winding up of the industrial company or for execution, distress or the like against any of the properties of the industrial company or against its guarantor or for the appointment of a receiver shall lie or be proceeded with further, except with the consent of the BIFR or as the case may be, the Appellate Authority. This provision is one of the major causes for the failure of SICA as legislation. However, taking away the provision altogether appears to be a reflex reaction.

*xi) Misfeasance proceedings: fixing liability*

The Second Amendment requires that if, in the course of scrutiny or implementation of a scheme, NCLT finds that any person has misapplied, retained, become liable or accountable for any money or property, or has been guilty of any misfeasance, malfeasance or non-feasance or breach of trust, it may direct him to repay or restore the money or property or order such compensation as it may deem appropriate. Identical provisions exist under SICA.

*xii) Formation of the Rehabilitation and Revival Fund*

The Second Amendment introduces a provision for levy and collection for the purposes of rehabilitation or revival or protection of assets of the sick industrial company at such rate not less than 0.005% and not more than 0.1% on the value of turnover of every company or its annual gross receipts whichever is more. It also requires the creation and setting up of a Rehabilitation and Revival Fund. The sources from which amounts will be credited to this fund have also been specified. The fund will be transferred to the Consolidated Fund of India and the amount released to NCLT from time to time for the purposes specified in the Second Amendment. Good companies view this provision as a premium on good businesses.

*xiii) Cases in which the company may be wound up by the court*

Apart from the existing grounds,<sup>12</sup> the following additional grounds for winding up a company have been added by way of the Second Amendment:

- If the company has acted against the interest of the sovereignty and integrity of India, the security of the state, friendly relations with foreign states, public order, decency or morality.
- If the company has defaulted in filing with the registrar its balance sheets and profit and loss account or annual returns for five consecutive financial years.
- If the NCLT comes to the conclusion that the sick industrial company is not likely to make its net worth exceed the accumulated losses within a reasonable time while meeting all its financial obligations, and that it is not possible to revive the company in the future, and that it is just and equitable that the company should be wound up.

*xiv) Test for insolvency*

The test followed in insolvency proceedings is the liquidity test. Liquidity is based on cash-flow criteria and relates to a debtor's inability to service its debts as they come due. A balance sheet test is also applied. However, there is no automatic stay against the debtor's transfer, sale or disposition of assets or parts of the business without court approval, except to the extent necessary to operate the business. However, such an order can be passed on an application made by the petitioning person and if, in the opinion of court, sufficient grounds are made for injunction.

*xv) Commencement: applicability and accessibility*

The Second Amendment clearly identifies the entities to which it applies. All enterprises or corporate entities including state-owned corporations are subject to the same insolvency law as private

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<sup>12</sup>The court may wind up a company if: the company has by special resolution resolved that it be wound up; if the company does not commence its business within a year from its incorporation, or suspends its business for a whole year; or if it is unable to pay its debts. A company shall be deemed to be unable to pay its debts if: a creditor to whom the company is indebted for a sum exceeding one lakh, has served on the company a demand by registered post at its registered office requiring it to pay the sum so due and the company has for three weeks thereafter neglected to pay the sum; or if execution or other process issued on a decree or order of any court in favour of a creditor of the company is returned unsatisfied; or if it is proved to the satisfaction of the court that the company is unable to pay its debt; if a default is made in delivering the statutory report to the registrar or in holding the statutory meeting; if the number of members is reduced in the case of a public company below seven and in the case of a private company below two; or if the court is of the opinion that it is just and equitable that the company should be wound up.

corporations. An application to the NCLT for the winding up of a company can be presented by way of a petition by:

- the company;
- any creditor or creditors, including contingent or prospective;
- any contributory or contributories;
- the Registrar of Companies; and
- In a case of falling under Section 243 of the 1956 Act, by any person authorised by the central government in its behalf.

Financial institutions and insurance companies are dealt with under the Banking Regulations Act though liquidation, and, if initiated under the said act, end up before the ordinary liquidation court. The provisions provide easy access to creditors and debtors.

*xvi) Power of the court on hearing petitions*

The provisions in this regard have not been changed under the Second Amendment. On hearing a petition, the NCLT may dismiss it or adjourn it conditionally/unconditionally or make any order of winding up or pass any interim order or make any other order as it may deem fit. However, it has been added that in case the grounds for filing the petition is the non-filing of a statutory report, the NCLT may direct that such a report be filed and impose costs instead of winding up.

*xvii) Disclosure of information*

The Second Amendment provides for a specific provision for debtors to disclose relevant information in liquidation proceedings. It has further been provided that where a petition for winding up is opposed, that the company shall file its statement of affairs, last known addresses of all directors and the company secretary, details of the location of assets and their value, details of debtors and creditors with addresses, details of workers/employees and of the amount outstanding to them and such other details as may be specified. The court has inherent power to seek information on the causes of the debtor's financial difficulty and a review of past transactions that may be avoided under the avoidance provisions of the insolvency law.

*xviii) Governance: management, creditors and creditors' committees*

Under the 1956 Act, there is an OL attached to every High Court, which acts as a liquidator. The OL is an employee of the government and represents a highly inefficient and bureaucratic department. The Second Amendment provides for appointment of court appointed professionals as liquidators who will be capable and competent of handling insolvency proceedings much more efficiently. It provides for the OL to be appointed from a panel of chartered accountants, cost accountants, lawyers and company secretaries. This is a star feature of the Second Amendment.

In rehabilitation proceedings, the debtor remains in possession and administers the company. The OA, appointed by BIFR, acts as an extended arm of BIFR and assists in the discharge of its functions which are confined to holding inquiries into the sickness of the company, preparation of a scheme and its monitoring. There is no drastic curtailing of the powers of management and only a



close watch is maintained. This is another area where adequate provisions will need to be introduced by further amendment and/or the drafting of new rules.

There is no creditors' committee. Creditors protect their interests through participating directly in the proceedings or through the liquidator. There is adequate participation by creditors at every important stage of the proceedings.

*xix) Administration: collection, preservation, disposition of property*

Though the Second Amendment provides for obtaining information on debtors assets, it only slightly improves upon the provisions for the collection, preservation and disposition of all property belonging to the debtor, including property obtained after the commencement of the case. There is a need to make provisions to deal with some of the complex issues that sometimes arise in the course of proceedings.

Though a transparent system for disposing of assets exists, it is neither flexible nor efficient. Private sales are virtually out of question. The law allows for sales free and clear of security interests, charges or other encumbrances, subject to preserving the priority of interests in the proceeds from the assets disposed. Often, certain assets of an enterprise will be subject to a security interest, pledge, mortgage or other collateral interest in favour of one or more creditors.

Where a winding up order has been made or where a provisional liquidator has been appointed, the liquidator shall take into his custody or under his control all the property, effects and actionable claims to which the company is or appears to be entitled. All the property and effects of the company shall be deemed to be in the custody of the court as from the date of the order for the winding up of the company.

*xx) Voluntary winding up*

A company may be wound up voluntarily when the period, if any, fixed for the duration of the company by the articles has expired or the event, if any, has occurred on the occurrence of which the articles provide that the company is to be dissolved and the company in its general meeting passes a resolution requiring the company to be wound up voluntarily or if the company passes a special resolution that the company be wound up voluntarily. The provisions under this heading remain unchanged under the Second Amendment.

*xxi) Commencement: moratoriums and suspension of proceedings in liquidation proceedings*

The Indian law prohibits the un-authorized disposition of the debtor's assets if requested, and suspends actions by creditors to enforce their rights or remedies against the debtor or the debtor's assets by operation of law. There is wide discretion on granting injunction. The law does not provide a statutory moratorium on repayment of debts but stays enforcement of creditors' rights in liquidation proceedings.

When a winding up order has been made or the OL has been appointed as the provisional liquidator, no suit or legal proceeding can be commenced, or, if pending at the date of the winding up order, can be proceeded with against the company except by leave of the NCLT, and subject to such terms as the court may impose. However, after the coming into effect of the Recovery of Debts Due to Banks and Financial Institutions Act of 1993, the Supreme Court of India, while interpreting its various provisions, has held that the banks and financial institutions do not require the leave of the Company Court for initiating proceedings under the said act.

The NCLT, which is winding up the company, shall have jurisdiction to entertain or dispose of any suit or proceeding by or against the company, any claim made by or against the company. Secured creditors, however, can choose to stay outside the winding up proceedings. Any suit or proceeding by or against the company which is pending in any court, other than that in which the winding up of the company is proceeding, may be transferred to and disposed of by that court.

*xxii) Recognition of creditors' rights and preferential payments*

The provisions under this heading remain unchanged under the Second Amendment except that the remuneration of the OL shall be treated as first charge on the realisation of the assets. The Indian law recognises the rights and priorities of creditors established prior to insolvency under commercial laws.

In the winding up of a company, worker's dues and debts due to secured creditors, to the extent such debts rank *pari passu* with such dues, shall be paid in priority to all other debts. The debts payable shall be paid in full unless the assets are insufficient to meet them in which case they shall abate in equal proportions.

*xxiii) Directors and officers liability*

This issue has been part of the national debate on corporate governance. A number of provisions already exist in the 1956 Act and SICA in this regard. A few more amendments were introduced earlier in the year 2002 in the 1956 Act to make the provisions more stringent.

Another significant provision had been added by the Second Amendment in this direction which provides that if, in the course of winding up, NCLT finds that any person has misapplied or retained or become liable or accountable for any money or property or has been guilty of any misfeasance, malfeasance or non-feasance or breach of trust, it may direct them to repay or restore the money or property or order such compensation as it may deem appropriate.

*xxiv) Fraudulent or preferential transfers*

Any transaction with a creditor entered into by a company in preference of other creditors within six months prior to the date of commencement of winding up is to be deemed a fraudulent preference of its creditors and is accordingly invalid. But if a company makes payment to a creditor who is pressuring the company with a threat of a suit and attachment of property, then such a payment cannot be called fraudulent provided the debt was really due.

*(1) Voluntary transfer*

Under Section 531A of the 1956 Act, a transfer of property whether movable or immovable or any delivery of goods by the company within a period of one year prior to the presentation of a winding up petition is void as against the liquidator, unless the transfer/delivery was made in the usual course of company business, and the transfer was in favour of a purchaser or encumbrance in good faith and for real and valuable consideration.

*(2) Transfer of shares*

When a company is undergoing voluntary winding up, any transfer of shares or changes in the status of members of such proceedings after commencement is void, unless a prior permission of the liquidator is given. The same position prevails in case of winding up by court or under supervision of

the court, with the difference that such a transfer is valid if permission of the court is obtained either before or after the making of the transfer.

*Transfers for benefit of all creditors to be void*

Any transfer or assignment by a company of all its property to trustees for the benefit of all its creditors is void.

*(3) Effect of floating charge*

Where a company is being wound up, a floating charge on the undertaking or the property of the company created within the twelve months immediately preceding the commencement of the winding up, is invalid unless it is proved that the company, immediately after the creation of the charge, was solvent, except to the amount of any cash paid to the company at the time of, or subsequent to, the creation of, and in consideration for, the charge, together with interest on that amount at the rate notified by the central government in this behalf.

*(4) Disclaimer of onerous property in the case of a company that is being wound up*

Where any part of the property of a company which is being wound up consists of (a) land of any tenure, burdened with onerous covenants; (b) shares or stock in companies; (c) any other property which is un-saleable or is not readily saleable, by reason of its binding the possessor thereof either to the performance of any onerous act or to the payment of any sum of money; or (d) unprofitable contracts, the liquidator of the company may, with the leave of the court, by writing signed by him, at any time within twelve months after the commencement of the winding up or such extended period as may be allowed by the Court, disclaim the property. The court may make an order rescinding the contract on such terms, or otherwise, as the court thinks just and any damages payable under the order to any such person may be proved by him as a debt in the winding up.

The Court may make an order for the vesting of the property in, or the delivery of the property to, any person entitled thereto or to whom it may seem just that the property should be delivered by way of compensation for such liability as aforesaid, or a trustee for him, and on such terms as the court thinks just, and on any such vesting order being made, the property comprised therein shall vest accordingly in the person therein named in that behalf without any conveyance or assignment for the purpose provided that the property disclaimed is of a leasehold nature.

*(5) Pre-bankruptcy period within which transfers may be reviewed and are subject to avoidance*

Any transaction with a creditor entered into by a company in preference of other creditors within six months prior to the date of commencement of winding up is to be deemed a fraudulent preference of its creditors and is accordingly invalid. Under Section 531A of the 1956 Act, a transfer of property, whether movable or immovable, or any delivery of goods by the company within a period of one year prior to the presentation of a winding up petition, is void.

*b) Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFESI)*

SARFESI provides for the enforcement of security interests in movable (tangible or intangible assets, including accounts receivable) and immovable property without the intervention of the court, by way of a simple, expeditious and cost-effective process. Where any borrower makes any default in

repayment of secured debt or any instalment thereof, and his account in respect of such debt has been classified by the secured creditor as a non-performing asset, then the secured creditor may call upon the borrower, by way of a written legal notice, to discharge in full his liabilities within 60 days from the date of the notice, failing which the secured creditor would be entitled to exercise all or any of the rights set out under SARFESI. The notice must contain details of debt and secured assets.

Any bank or public financial institution or any other institution or non-banking financial company as specified by the central government or the International Finance Corporation or a consortium thereof can invoke the provisions of SARFESI relating to security of interest.

#### *The main provisions relating to enforcement of security interest*

SARFESI provides that where any borrower makes any default in repayment of secured debt or any instalment thereof, and his account in respect of such debt has been classified by the secured creditor as a non-performing asset, then the secured creditor may call upon the borrower by way of a written legal notice to discharge in full his liabilities within 60 days from the date of the notice, failing which the secured creditor would be entitled to exercise all or any of the rights set out under SARFESI. The provisions of SARFESI relating to security of interest can be invoked by:

- any bank;
- public financial institution under Section 4A of the Companies Act of 1956;
- any institution specified by central government under sub clause (ii) of clause (h) of section 2 of the Recovery of Debt Due to Banks and Financial Institutions Act of 1993;
- any other institution or non-banking financial company as specified by the central government; or
- the International Finance Corporation or a consortium thereof.

#### *Taking possession of assets*

On the expiry of 60 days, if the debt is not fully paid by the borrower, the officer(s) so authorised can enter the premises where the secured asset is lying and take its possession. If there is resistance or there is likely to be resistance from the borrower and/or its agents in the taking over of the possession, such officer may write a request to the Chief Metropolitan Magistrate (CMM) or the District Magistrate (DM) in whose jurisdiction such secured asset is situated to take possession.

#### *Takeover of management of secured assets*

Another option available under SARFESI is to take over the management of the secured assets. The manner and effect of takeover has been set out under SARFESI. While in possession of the borrowers business, the secured assets can be sold simultaneously to recover the dues.

#### *Appointment of a manager for the secured assets*

The duties and responsibilities of the manager are not defined anywhere in SARFESI. However, it appears that the function of a manager would be confined to managing the asset and not to sell or transfer the asset. The manager would be a custodian of the assets and will otherwise have full control over the assets to the extent empowered. Managers can be assigned the responsibility to manage the

asset but cannot be empowered to sell unless the manager is also acting under clause (a) of sub-section (4) of section 13 of SARFESI.

#### *Procedure in case of takeover of co-financed assets*

In case of financial assets by more than one secured creditor, or joint financing of a financial asset by secured creditors, no secured creditor shall be entitled to exercise any of the rights conferred on him unless exercise of such rights is agreed upon by the secured creditor representing not less than three-fourths of the amount outstanding as on the record date and such action shall be binding on all secured creditors

#### *Appeal before the Debts Recovery Tribunal*

Any person (including the borrower) aggrieved by any of the measures referred to in sub-section (4) of section 13 taken by the secured creditor or his authorised officer under this chapter, may proffer an appeal to the Debts Recovery Tribunal having jurisdiction in the matter within 45 days from the date on which such measures had been taken. However, such appeal shall not be entertained unless the borrower has deposited with the Debts Recovery Tribunal 75% of the amount claimed in the notice. Any person aggrieved by any order by the Debts Recovery Tribunal under section 17 may proffer an appeal to an Appellate Tribunal.

#### *Protection of secured creditors*

No suit, prosecution or other legal proceedings shall lie against any secured creditor or any of his officers or manager exercising any of the rights of the secured creditor or borrower for anything done or omitted to be done in good faith under SARFESI. However, any offence by the company during the time the directors of the secured creditor are holding appointment would be treated as would an offence committed by a company in a normal case.

#### *Jurisdiction of civil court barred*

No civil court will have jurisdiction over any of the matters under SARFESI.

#### *Asset Reconstruction Companies (ARC)*

Chapter II of SARFESI provides for the setting up of reconstruction and securitisation companies for securitisation *i.e.* acquisition of financial assets from its owner, whether by raising funds by such Securitisation or Reconstruction Company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise. SARFESI deals with the registration of these companies, their pre-requisite qualifications etc.

#### *Measures for asset reconstruction*

The measures that securitisation or reconstruction companies can take for the purpose of asset reconstruction are:

- Takeover of the management of the business of the borrower.
- Sale or lease of a part or whole of the business of the borrower.
- Rescheduling of payment of debts payable by the borrower.

- Enforcement of security interest in accordance with the provisions of the act.
- Settlement of the dues payable by the borrower.
- Taking possession of secured assets.

Additionally, such companies can perform the following functions:

- Acting as an agent for any bank or financial institution for the purpose of recovering their dues from the borrower on payment of such fees as may be mutually agreed.
- Acting as a manager.
- Acting as a receiver.

An ARC can acquire financial assets by issuing a debenture or bond, or any other security in the nature of a debenture, for consideration agreed and by incorporating such terms in the agreement, or entering into an agreement for the transfer of such financial assets to such company on such terms and conditions as may be agreed.

The terms and conditions of acquisition can be negotiated and agreed between the parties. However, such terms and conditions would have to be in consonance with the guidelines framed and directions issued by the Reserve Bank of India.

#### *Legal consequences of acquisition*

ARCs shall be deemed to be the lender and all rights of the lender shall vest in the ARC in relation to such financial assets.

All contracts, deeds, bonds, agreements, power of attorney, grants of legal representation, permissions, approvals, consents or no objections and instruments relating to financial assets existing before the acquisition of financial assets by the ARC shall have full force and be enforced as if they had been issued in favour of the ARC or as the case maybe.

No suit, appeal or proceedings shall abate or be discontinued for the reasons of acquisition of financial assets by the ARC. However, the appeal may be continued, prosecuted and enforced by or against the ARC. However, such company, in respect of which an ARC carries out acquisition of assets, can file no reference.

#### *Procedure for acquisition: Notice of acquisition*

Though no procedure, as such, has been laid down under SARFESI, a notice of acquisition may be sent to the obligor (generally speaking, the borrower) or to any other concerned person (such as, co-lenders, statutory authorities etc.) and the registering authority in whose jurisdiction the asset is located. Such notice is not mandatory. The notice is not of proposed acquisition but of the acquisition already carried out. If any payment is received from the obligor after acquisition, the same shall be in trust and be forwarded to ARC.

#### *Resolution of disputes*

Disputes relating to non-payment of any amount due, including interest arising amongst banks, FIs, ARCs and qualified institutional buyers shall be settled by conciliation or arbitration as provided in the Indian Arbitration and Conciliation Act of 1996.

#### *Enforcement of secured rights*

SARFESI was enacted only a few months ago with its implementation having been stayed partly by the Supreme Court of India. Therefore, it is difficult to comment on how effective its enforcement will be. The provisions of SARFESI appear to provide an efficient, inexpensive, transparent and predictable method for enforcing a security interest in property. It provides self-contained and comprehensive provisions for enforcement of security interest including its management and sale.

The rules framed under SARFESI deal with procedures such as making of inventory, the auction process etc. There is still much to be done as SARFESI is still in its infancy.

SARFESI provides adequate safeguards to the debtor by court involvement, though debtors do not agree.

#### *Recording and registration of secured rights*

Though there exists a cost-effective and simple process for publicising secured interests in movable and immovable assets by registration, the system is quite inefficient. There is no centralised registration and every state has its registration office, which are not inter-linked. The department responsible for registrations lacks transparency, is over-burdened and unorganised. Though access to the registry is inexpensive and open to all for recording and search, the record is hard to locate and information difficult to get. Electronic filing has not yet started, though computerisation of registries is proposed and things are expected to improve in the future. Registry officials do not review filings for accuracy or legality.

#### *Enforcement of unsecured rights*

This issue does not seem to be very high on the agenda of reforms. However, unsecured creditors do have a remedy in the form of an expeditious and summary recovery mechanism before Debt Recovery Tribunals. Nevertheless, the procedure followed by Debt Recovery Tribunals lacks efficiency, transparency, and reliability and is largely unpredictable. They are not of much assistance in recovering debt, including seizure and sale of immovable and movable assets and sale or collection of intangible assets such as debts owed to the debtor by third parties. There is no efficient enforcement of judgments, particularly for unsecured credit.

### **9) *Informal framework***

#### *The Corporate Debt Reconstruction (CDR) system*

Not all customers who have defaulted on commercial banks and contributed to the burgeoning NPAs of these banks are wilful defaulters. Quite a few are described as “sunset” industries. Others have become weak due to changes in the external environment, delays in execution of the project, cost escalations or on account of the time needed to develop an optimum share for the product. These accounts are classified as NPAs no doubt, but these pertain to a different category where hasty coercive action or forced recovery measures cannot be justified. Lenders have an obligation to consider the genuine difficulties of borrowers. If this principle is not accepted, the purpose of bank

financing industries and other sectors of the economy loses the definition “development finance” and becomes reduced to mere money lending.

Successful reconstruction of an ailing unit that has defaulted, and bringing it back to standard assets, is also a strategy for dealing with NPAs without causing pain to the defaulted borrower. The process is primarily rescheduling the debt portfolio of the borrowers among its creditors to help the borrowers in the revival of projects and continue operations through reductions in the existing debt burden and establishment of new credit lines under the implied assumption that the lender would prefer reduction in risk to optimisation of returns. The objective of the CDR is to ensure a timely and transparent mechanism for restructuring of the corporate debts of viable corporate entities affected by internal and external factors, outside the purview of BIFR, DRT or other legal proceedings, for the benefit of all concerned.

The legal basis for the mechanism is provided by the ICA (Inter-Creditor Agreement). All participants in the CDR mechanism must enter into a legally binding ICA with necessary enforcement and penal clauses. It is a voluntary system based on debtor-creditor agreement and inter-creditor agreement. The scheme does not apply to accounts involving only one financial institution or one bank. Instead, it will cover multiple banking/syndication/consortium accounts with outstanding exposures of Rs. 20 crore and above by banks and institutions. The CDR system would only be applicable to standard and substandard accounts, with potential cases of NPAs getting a priority.

Banks and financial institutions have been gripped by a corporate debt restructuring (CDR) frenzy. Until 31 July 2003, 45 CDR proposals worth Rs. 44 204 crore had been cleared. The Rs. 9 863-crore Essar Oil CDR cleared in last July is, perhaps, the latest and biggest example. Nevertheless, one wonders how this will help clean up India's Rs. 100 000 crore bad loan problem.

#### **10) Conclusion: Some general observations on the new laws**

*Second Amendment and SARFESI: Do they provide an effective and compatible enforcement system?*

The Second Amendment and SARFESI are a leap forward in the direction of providing an effective and compatible enforcement system. However, there is a lot more required to make the said laws predictable, transparent and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system. The Second Amendment does little to expedite and simplify insolvency procedures. Unfortunately, no definite time frame has been provided for various stages during the liquidation proceedings. It is hoped that with professionals acting as liquidators, the proceedings will be conducted in a professional fashion maximising the value of assets and improving the efficiency of the entire process, which presently suffers from delay and inefficiency. It is now for the administrators of NCLT to enforce the provisions of law effectively and meaningfully.

SARFESI is a bold and firm initiative in the direction of providing a final and equitable debt collection mechanism for creditors and in improving the enforcement of creditor rights to expand credit flows. But, the legislation, however well intended, has holes leaving scope for further dispute and litigation rather than providing an efficient vehicle for resolving individual disputes between creditors and debtors.

*Need for effective implementation*



The essential features governing a model formal restructuring process in any part of the world are common if not alike, though they may be structured differently. SICA, in India, is structured, more or less, on the above principles. The question which arises for consideration, is why SICA has failed to work. Any sound legislative framework is dependent upon a predictable and effective judicial process coupled with efficacious enforcement mechanisms for its success. In India, one needs to focus and improve upon the implementation and execution mechanism. In addition, there is a need for a more creative and commercial approach to corporate entities in financial distress and attempts to revive them rather than applying the more traditional and conservative approach of liquidation or bankruptcy. As such, socio-economic needs dictate that, before liquidating financially distressed companies, some attempt must be made towards corporate rescue operations.

#### *Tribunalisation of justice and an over-burdened tribunal*

Though tribunalisation of justice is now a recognised trend, the Indian experiment with tribunals has been nothing to boast about. They have largely failed to serve the purpose for which they were set up. Flowing from such diverse dimensions of judicial functions, NCLT would be burdened with a workload of enormous magnitude and, in the process, would be likely to lose focus on revival and rehabilitation of sick entities. Change in eligibility criteria for making a reference would itself generate a greater workload. In the process, the objective of expedient disposal of the matter may become a casualty, leaving aside matters which NCLT would have to decide relating to its other two functional roles. Though the number of members has been fixed at 62, past performance has shown that even under SICA, with the number of members fixed at 15 (including the Chairman), the BIFR has never worked with a full contingent and even now is functioning with less than 50% strength for the last two years.

#### *Suspension of proceedings*

The Indian experience with rehabilitation has been so disappointing that there has been a reflex reaction by taking away the moratorium provision, which, under SICA, sounded the death knell for many creditors. Hopefully, there will be a re-thinking and a brief moratorium would be provided to give the debtor time to negotiate a consensual business solution. SICA failed on the implementation front and it is hoped the new regime will be continuously monitored to ensure that it is being implemented in accordance with the policies and purposes of its design.

#### *Defective trigger point for reorganisation*

In the existing provisions of SICA, it was experienced that the entry level for seeking ameliorative measures by the sick unit was too late owing to the criterion of 100% erosion of net worth. Under the Second Amendment, 50% erosion in average net worth for the last four years of the reference year or three successive defaults in paying instalments to the creditors becomes the deciding factor for entry-level eligibility of a sick unit. However, the objective of bringing into purview of the NCLT a case of incipient sickness would be defeated considering the period of 180 days and a further extension of the time period by a further 90 days provided for filing a reference.

Redefining net worth is a very good development though the proposed definition may also suffer from the same problem which besets the present legislation and that is to prevent and curb the flair for creative accounting by changing the accounting policies to feign sickness. This could have been curbed by making the definition of “erosion of net worth” and “accumulated losses” more clear and unambiguous. The new dispensation could have provided for a water-tight definition, which could be linked to delegating the powers to the judicial forum put into place to implement the rescue legislation,

to notify the accounting policies on the basis of which net worth/accumulated losses would be worked out for determining sickness.

#### *Certification by auditors*

The new provisions provide for establishing a panel of auditors to give a certificate with regard to the parameters of sickness represents progress. However, it may turn out to be duplicative as, under the present dispensation, statutory auditors are required to give their opinion on the sickness of a company under the Manufacturing and Other Companies (Auditors Report) Order of 1988. It is not clear as to how this duplication would help as the auditors on the panel will come from the same stream of chartered accountants and may be liable to the same failings as the statutory auditors of the company except that the auditors out of the panel maintained by the NCLT will be giving the certificate.

#### *No comprehensive bankruptcy code and roadmap*

The Second Amendment stops short of providing a comprehensive bankruptcy code to deal with corporate bankruptcy. In the fast changing scenario of growing cross-border investment, trade and commerce, cross-border insolvency problems are bound to increase and a comprehensive bankruptcy code alone can address such issues taking into consideration international practices. It does not introduce the required roadmap of the bankruptcy proceedings viz. application for initiating bankruptcy proceedings; appointment of a trustee; empowerment of the trustee; operational and functional independence; accountability to the court, including the power of the court to remove the trustee in case of mismanagement; relationship with current management; monitoring or substitution; day-to-day operation, etc; time bound restructuring/recognition plan; who should submit; procedure of acceptance; mechanism to sell off; pro-active initiative of the trustee; number of time-bound attempts for restructuring; decision to pursue insolvency and winding up; and strategies for realisation and distribution.

#### *International insolvency in India*

Unfortunately, the Second Amendment ignores the recommendation of Eradi Committee and fails to provide a framework for cross-border insolvencies, with recognition of foreign proceedings. The Government of India though proposes to deal with the issue in the near future.

In this area, the recommendations of Eradi Committee have been ignored in the bill. Indian insolvency laws do not have any extra-territorial jurisdiction, nor do they recognise the jurisdiction of foreign courts in respect of branches of foreign banks operating in India. Therefore, if a foreign company is taken into liquidation outside India, its Indian business will be treated as a separate matter and will not be automatically affected unless an application is filed before an insolvency court for winding up of its branches in India. At present, thankfully, the government is considering the adoption of the UNCITRAL Model Law on Cross-Border Insolvency to meet the demands of globalisation and to deal with international insolvency. This will radically change the orientation of Indian law and make it suitable for dealing with the challenges arising from globalisation and increasing integration of the Indian economy with the world economy. While drafting the substantive and procedural rules of bankruptcy, international standards for both national and cross-border insolvency should be taken into consideration which, based on the Indian situation, should be suitably incorporated.

#### *Need for an effective out-of-court restructuring mechanism*

Presently, the Corporate Debt Restructuring (CDR) Scheme of the Reserve Bank of India deals with out-of-court workout in India. The CDR Scheme has not been very effective and is hardly invoked by debtors. The CDR Scheme is presently under review. The INSOL Global Principles have been made available to the concerned authorities for their consideration and adoption.

*Bankruptcy proceeding for banks and financial institutions*

Bankruptcy proceedings against banks and financial institutions have a very special significance as they affect the domain of the monetary system, management and financial stability. In several developed countries, there is a separate bankruptcy code for banks and financial institutions. In India, this is primarily the responsibility of Reserve Bank of India. The new law and procedures should be structured to handle the bankruptcy proceedings in the case of banks and financial institutions in consultation with the Reserve Bank of India.

## Developing the Asian Markets for Non-Performing Assets

by

*Ashwani Puri*<sup>1</sup>

### 1) *Developing NPL markets*

The Asian Currency Crisis severely crippled the financial system in most Asian countries and brought to light the magnitude of Non-Performing Loans (NPLs) at Asian financial institutions. Driven by the need to proactively tackle the soaring NPL levels, the respective governments embarked upon a programme of substantial reform. This process involved the establishment of asset management companies (AMCs) for resolving the impaired assets held by banks and financial institutions. AMCs in countries such as Indonesia, Korea, Malaysia, and Thailand were initially structured as centralised government-owned entities, though banks in countries like Thailand subsequently set up their own individual entities to resolve distressed assets. Taiwan has gone a step further with large-scale portfolio sales and a number of foreign investor-owned AMCs dominating the NPL market. The process of establishing AMCs was often supplemented with the creation of out-of-court debt restructuring mechanisms in these countries. A number of factors influenced the successful resolution of NPLs in these countries. Some of these key factors and experiences hold significant lessons for emerging NPL markets and are discussed below.

#### a) *Willingness to transfer*

Lenders are often reluctant to sell or transfer assets at values lower than their book value to prevent a hit to their financials and avoid the risk of criticism for having undersold. Banks in Malaysia were encouraged to transfer their assets to Danaharta by providing them with upside sharing arrangements and the facility to defer the write-off of financial losses on transfers for five years. These incentives, coupled with the directive of the Central Bank to make adjustments in the book values of the assets not transferred to Danaharta (after Danaharta identifies them), were sufficient to ensure effective acquisition. In Taiwan, the increasing number of NPL auctions by banks was facilitated by the regulatory requirement to reduce their NPLs to 5% by the end of 2003, and the flexibility to amortise financial losses over a five-year period.

#### b) *Ease of implementation of recovery strategies*

##### i) *Enforcement of creditor rights*

A significant dimension influencing NPL resolution and investor participation is the ease of implementation of recovery strategies. Certainty and the timing of the ability to enforce creditor rights is key to success in resolution. AMCs, like Danaharta, have been provided with a strong platform to affect the resolution of NPLs with clearly laid down creditor rights. Danaharta has been allowed to foreclose property without reference to the Court and thus has been able to dispose of collateral swiftly by using the tender route. Special resolution mechanisms that have involved minimal intervention of the Court have also served to attract investor interest in the NPL market in certain countries like Taiwan. On the other hand, the operations of the Thailand Asset Management Corporation, the government owned AMC, have been hindered by deficiencies in Bankruptcy Law provisions.

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<sup>1</sup> Mr. Ashwani Puri, Executive Director, Corporate Finance and Recovery Services, PricewaterhouseCoopers Pvt. Ltd, India.

ii) *Effective restructuring implementation*

Most Asian countries adopted out-of-court restructuring mechanisms to minimise court intervention and speed up restructuring of potentially viable entities. However, this process has yielded mixed results. In Korea, for example, while most chaebols and corporate entities entered into workout arrangements, this often did not lead to far-reaching restructuring of these entities. While debt restructuring was generally implemented quickly, delays were witnessed in asset reduction programmes, and improvement in operating performance was slower and lower than expected. Similarly, in Thailand the majority of restructuring arrangements have typically involved extension of grace periods or concession arrangements, and it is widely held that adequate financial and operational restructurings have generally not been effected.

In Malaysia, however, Danaharta has been able to exercise considerable influence over the restructuring process through the appointment of special administrators that have prepared workout plans and have exercised management control over the assets of the borrower during plan preparation and implementation stages. The restructuring process effected by the special administrators has been facilitated by the automatic moratorium that comes into effect at the time of the administrator's appointment.

c) *Foreign Direct Investment (FDI) policy*

Domestic and foreign institutional investors require a regulatory and tax environment conducive to entering the NPL market. Flexibility in ownership, collaborations, transaction structures, remittances and the issue of financial instruments are key elements of this framework apart from tax issues. For instance, Taiwan's willingness to allow foreign ownership of AMC's has helped attract investor interest. While the profit that the AMC generates from the disposal of the NPLs is subject to the current 2% business tax rate applicable to banking institutions, foreign shareholders are accorded certain tax benefits in the form of a lower withholding tax rate of 20% (as opposed to the 35% rate generally applicable) on the dividend remitted by an AMC that has secured Foreign Investment Approval status from the Ministry of Economic Affairs. The bank-based AMC's in Thailand have been subject to a payment of 30% corporate income tax charged on net profit generated, but only after the cash on the NPLs is collected.

2) *The emerging Indian market*

The process of resolution of NPLs has only just been initiated in countries like India. Banks and financial institutions in India are faced with the task of dealing with NPLs, which are reportedly worth around 20 billion US dollars as on 31 March 2002. While the NPL situation in India may not be as grim as some other Asian countries at the height of the Asian crisis,<sup>2</sup> it is significant enough to warrant urgent attention. The total distressed assets are considerably higher than the reported NPL numbers, and it is widely believed that NPLs could be double the reported figure if more stringent international classification norms are applied in India.

Creditor rights have historically been difficult to enforce in India, often involving long-winded court procedures. Furthermore, in India defaulting borrower companies have often misused the shelter provided by the mechanism<sup>3</sup> of the Board for Industrial and Financial Reconstruction (BIFR). A company entering the purview of BIFR was protected through a moratorium on lender actions during

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<sup>2</sup> The ratio of reported net NPLs to net advances is 5.5% for banks and 8.8% for financial institutions in India.

<sup>3</sup> The Indian equivalent of the US Chapter 11 proceedings.

the course of its proceedings. Proceedings often took very long to complete on account of systemic deficiencies in the workings of the BIFR.

A consortium lending approach has typically been followed in India. While development financial institutions<sup>4</sup> have typically provided term loans to borrowers, the commercial banks have typically been working capital lenders. The resulting inter-creditor issues, and lack of an effective platform for resolution of the same, often caused delays by lenders in responding to borrower issues.

*a) Steps taken by the government of India*

Over the past year or so, the government of India has taken several steps to help create an enabling environment for NPL resolution. Notable among these are:

- i) The enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SRFAESI) in December 2002, which lays down the legal basis for the formation of asset reconstruction companies (ARCs) and provides lenders and ARCs with the powers to enforce security interest (if 75% by value of the secured creditors agree) and sell the assets of the borrower without court intervention. Furthermore, SRFAESI empowers lenders to remove a company from the purview of the BIFR. ARCs are also allowed various measures for asset reconstruction, including change of management of the borrower's business though guidelines for implementing this are still awaited.
- ii) An out-of-court restructuring mechanism called Corporate Debt Restructuring (CDR) has been set up, which provides a platform for resolution of inter-creditor and debtor-creditor issues.
- iii) A National Company Law Tribunal (NCLT) is being set up to replace the BIFR. NCLT is, *inter alia*, envisaged to perform BIFR's functions more effectively.

*b) Development of the Indian NPL market*

Pursuant to the SRFAESI Act, a number of ARCs have applied to the Reserve Bank of India<sup>5</sup> for setting up operations. Asset Reconstruction Company (India) Limited (ARCIL) and Asset Care Enterprises Ltd. have been promoted by groups of Indian lenders and are among the first ARCs in India. The process of acquisition by ARCIL of the first lot of assets is currently underway.

A number of issues could however hamper effective development of the Indian NPL market:

*i) Legal challenges*

A tremendous outcry has been raised against the provisions of the SRFAESI Act by borrowers who have termed it as being against the principles of "natural justice". A number of petitions are currently pending before the Supreme Court that challenge the right of lenders to take over and sell the borrower assets with limited opportunity of borrowers to challenge the action in a court of law. The Supreme Court judgment on this issue could profoundly affect the efficacy of this act.

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<sup>4</sup> *E.g.* IDBI, IFCI.

<sup>5</sup> India's central bank.

*ii) Valuation issues*

Provisioning requirements against NPLs allow Indian banks an extended time frame and banks can carry NPLs on their books almost indefinitely. Different Indian lenders typically have differing provisioning levels for the same asset and, often, these levels are low, even more so in view of the resolution time frames and costs under the prevailing Indian framework. Given that no amortisation of financial losses is permitted upon transfer of NPLs (RBI guidelines suggest transfer of assets to ARCs at market values), and given that no regulatory fiat that forces lenders to transfer their NPLs has been issued, success in overcoming the reluctance of lenders to transfer their NPLs at market prices is key to the development of the Indian NPL market. Apart from the ability to absorb the loss arising from a sale or transfer of NPLs, there are strong concerns about possible criticism for having undersold, particularly among public sector lenders who form well over 70% of the banking system.

*iii) Tax and regulatory issues*

The high level of transaction costs in the form of the stamp duty,<sup>6</sup> payable on the transfer of financial assets by way of assignment, is a significant deterrent to the acquisition process except in the case of some progressive states.

While the government appears keen to encourage both foreign and domestic investors, the need for specific policy, regulations and tax provisions responsive to their requirements has still to be addressed.

*iv) Restructuring implementation*

The CDR process has dealt with and approved a large number of restructuring cases in the past few months in a time bound manner. Inevitably, concerns have been raised regarding the quality of restructuring packages in cases where it was felt that more stringent or innovative operational and financial restructuring was needed to facilitate early recovery. The CDR cell is increasingly seeking to involve professionals in the co-ordination, implementation and monitoring of restructuring cases.

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<sup>6</sup> Varying from 3-14% in the various states of the country.





## Indonesia

### The Role of Policy and Incentives in Maximising the Value of Distressed Assets

by

*Bacelius Ruru*<sup>1</sup>

This paper has been prepared as an attempt to address the question of public policy as it relates to the value of distressed assets. The Asian financial crisis, as we all know, resulted in large amounts of non-performing corporate loans (NPLs), many of which ultimately wound up in the hands of the government. Though many of these distressed loans have since been sold and/or restructured, the policy issues they left behind are with us still. The question remains: how should the public sector go about dealing with systemic economic collapse within the corporate sector?

The panel discussion for which this paper was prepared couches the question in terms of maximising the value of distressed assets. This particular articulation of the issue raises a host of public policy questions and, it can be argued, carries with it a series of implicit assumptions, which must be examined one by one. This paper is largely devoted to examining these assumptions. In its final sections it suggests various policy options for consideration.

#### *1) Maximising the value of whose assets?*

The most fundamental question to be addressed in dealing with the panel topic is (assuming that the public sector has a role in the business of value maximisation) in whose hands must distressed assets be imbued with maximum value? This is, in fact, more than a merely rhetorical question. In our experience in Indonesia, we have seen three main players actively involved with distressed assets, and their interests frequently diverge wildly.

The first candidate for value maximisation is, of course, the existing owner of over-indebted corporations. This interest group will obviously desire to retain their ownership and control over said assets, which represent a future stream of income to them. Consequently, the value of the assets in the hands of this group will be maximised by policies (formal and informal) that permit current owners to retain control. In this regard, the interests of the existing owners will obviously differ from the second key group of stakeholders, which are the lenders (both original and through the secondary market), who hold claims against the distressed assets.

With respect to this group, value will be maximised by policies which permit lenders to seize corporate assets quickly and inexpensively, and which permit a vibrant secondary market for distressed assets to be sold. As we have seen, the consequential effect of such policies are increased secondary market prices for distressed assets, and it is assumed that it is this group, with its emphasis on asset price and portability, that is referred to in this panel topic when distressed asset value maximisation is discussed.

In addition to original owners and lenders, there is a third interest group inevitably involved in the asset value equation, namely, the government of the emerging economy in question (and, assuming the government represents the interests of its electorate, the people of the economy themselves). With respect to this interest group there are two, perhaps conflicting considerations. On the one hand, the interests of the government will be maximised to the extent that seized assets can be sold for top

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<sup>1</sup> Mr. Bacelius Ruru, Chairman, The Jakarta Initiative Task Force, Indonesia.

dollar. This of course implies the use of policies that increase the market value of distressed assets and, in this regard, the interests of the government are not that much different than those of common creditors. As discussed below, however, an interesting side issue arises here, in that the timing of government asset sales can have an impact on recovery. Quick asset sales dumping large quantities of corporate assets onto an already depressed market may work to further depress prices, while a more measured, cautious disposal strategy can arguably avoid the “buy high, sell low” syndrome seemingly built into the boom and bust corporate cycle.

This more cautious approach is, however, at odds with the second consideration facing emerging market governments. In addition to the interest of the government in maximising the value of its own assets, it will also have an interest in seeing a robust, vibrant corporate sector that maximises tax revenue and employment for its citizens. With respect to this consideration, much more concern is placed on the rapid disposal of corporate assets and policies to ensure that they wind up in the hands of those most able to put them to productive use. There may, of course, be nationalistic arguments involved, with objections being expressed that rapid asset sales may result in a wholesale transfer of corporate assets to foreign concerns, and more discussion on this topic will appear below. But, returning to the original issue, to the extent that the goal of the emerging market government is to foster long-term economic growth, the proper response would seem to encompass policies encouraging quick transfer of corporate assets in a manner consistent with macro stability.

## 2) *Maximising value over what time frame?*

Closely related to the previous question of whose asset values are to be maximised is the issue of the period over which value is to be measured. As discussed in the preceding paragraphs, a certain tension exists between relatively rapid asset disposals (which arguably contribute to long-term corporate health at the expense of short term government recovery) and the slower approach that advises the government to hold distressed assets until their price recovers (thus increasing short-term recovery at the arguable expense of long-term corporate health).

Although a definitive policy position on these issues is beyond the scope of this paper, it can be suggested that while a tension between the two approaches certainly exists, there is in fact less inconsistency between them than there might at first seem. Even if a rapid divestment approach is followed, there are few who could credibly argue that assets should be disposed at such a pace as to deny buyers sufficient time to fully assess their value (or otherwise restrict the ability of the government to take adequate marketing steps). This, of course, will inevitably take time.

Similarly, there may well be a significant number of assets in need of stabilisation before sale. Such stabilisation may involve the process of wresting control from existing management (a process that the public sector can arguably manage more effectively in emerging markets than can the private sector). Alternatively, the stabilisation process may simply involve short-term financial and operational measures, such as securing short-term working capital lines to ensure that suppliers and employees are paid. In either case, it will take time to stabilise the assets in question, such that the “fire sale” scenario feared by those taking the wait-and-see approach is less likely to materialise.

From the wait-and-see perspective, it is unlikely that any could rationally argue for an indefinite ownership over effectively nationalised corporate assets. Although there is ample evidence that too rapid divestment can, indeed, create market instability and encourage rent seeking, there is a similar wealth of evidence demonstrating that the private sector can, in general, operate most corporate concerns much more efficiently than can the public sector. In this light, the wait-and-see approach should be viewed less as an attempt to maximise government asset recovery by sitting on assets

indefinitely, and more of an undisguised attempt to maximise government recovery over the short term.

Thus, the issue of short-term versus long-term asset value maximisation is, in fact, less of a choice between two conflicting options as it is a process of assessing the probable “present value” of any particular divestment regime. Various assumptions must be made regarding the likely recovery to the government as a result of asset sales, the disruptions caused by the sales, and the long-term impact of quick versus slow divestment in terms of overall corporate health. Based on how these factors are assessed, the scheduling of divestment can be undertaken. Those arguing for all-or-nothing “sell fast” or “go slow” approaches, it is suggested, are likely doing so based either on ideological concerns or from a desire to benefit their own specific interests. On the other hand, a well-reasoned, prudent distressed asset divestment scheme is likely to fall somewhere between the two extremes.

### **3) *Recommendations: Let the markets work, but watch them closely***

As promised at the outset, this paper will now turn to practical considerations in connection with the asset-value maximisation topic. As discussed above, we must begin our practical analysis by answering two key questions: 1) whose interests are we to maximise through public policy, and 2) over what time frame are we to act? For the government of an emerging market economy, there can be only one answer to the first question: the government must act to maximise asset prices solely to benefit the interests of its citizens. This, of course, is largely uncontroversial, as no special interest group would ever admit that the proper role of government is to maximise its own interests. Rather, the controversy arises where debtor and creditor interest groups seek to identify their own interests with those of the common citizen.

In this regard, owners of distressed corporate concerns (who may be seeking to retrieve their assets from the government or who may be arguing in favour of policies that will otherwise allow them to hold on to their companies) will raise nationalistic objections to the supposed fire sale of national assets. On the other hand, international investors will point to the purported benefits of foreign direct investment (FDI), and will argue that systems allowing for quick asset disposal will encourage future trade and investment and will bring expertise into the country. However, as discussed below, neither of these arguments is completely persuasive.

As to the investor argument, it is certainly the case that investment-friendly policies encourage additional investment, and it is also probable that long-term FDI is beneficial to the growth of an emerging economy. However, the jury is still out on the effects of short-term FDI (including, if one study is to be believed, bank lending). As such, arguments that fire-sale divestment regimes are justified by FDI concerns are simply not credible when advanced by those providing the sort of FDI that is of uncertain value in the first instance. On the other hand, the concerns of long-term investors should be taken seriously, and should be factored into any divestment strategy. However, given the longer-term nature of such investors’ return horizons, it is unlikely that such investors will be much interested in seeing fire-sale divestments taking place.

On the other hand, the arguments inevitably raised by the owners of distressed corporate assets are similarly suspect. There is no obvious reason why local businessmen must own most assets, and to the extent that there is such a reason, it does not justify a conclusion that the same businessmen should continue to control precious corporate assets. Bringing in new entrepreneurial talent and technical expertise, be it domestic or foreign, helps to ensure that asset values are maximised and that companies are run as profitably as possible. It is the position of this paper that it is this argument, more than all the others, which carries with it the definitive policy recommendations for the public sector to follow.

The creative destruction of the capital markets is, in fact, essential to ensuring crisis situations are not repeated. Only by ensuring that entrepreneurial success is rewarded and failure is punished over the long run can the real sector be made internationally competitive. Under circumstances where limited corporate assets remain locked within tightly controlled family dynasties regardless of entrepreneurial merit, other (local) entrepreneurs are denied opportunities to compete and the health of the entire economy suffers.

Of course, seizing and dumping corporate assets in too quick a fashion, without the opportunity to stabilise and market the assets being sold, is not an optimal solution. As discussed elsewhere, the costs and benefits of various timing approaches must be weighed, but this argument does not justify an indefinite nationalisation of distressed assets. In answering the second question posed above, this is neither a strictly short-term nor a long-term approach, but rather one which balances the immediate concerns of the day with longer-term issues of growth and economic health.

At this point, the reader may still be unsatisfied. It is fine to argue that the government must plan divestment programmes to maximise the long-term health of its economy, but it is quite another thing to specify how policy is to accomplish this. Is it not, as has been suggested above, the solution to encourage policies that allow for ownership of corporate assets to be transferred more readily in the event of default, so as to permit new entrepreneurial talent and initiatives to be introduced?

The answer is, of course, yes. In the final analysis, the creative destruction of the markets is best encouraged by policies that encourage quick, efficient transfer of ownership of corporate assets where existing management has failed to perform. This requires efficient and transparent insolvency systems, and government policies (including asset divestment policies) that send the signal to the markets that the cost of entrepreneurial failure is a loss of control, so that assets can be recycled for the next entrepreneur in line to take their turn. This process must, of course, be carefully co-ordinated in the event of systemic economic failure so that the markets are not distorted. In the end, the process must proceed.

#### **4) *Conclusion: But what about the rest of us?***

As a concluding matter, a final question must be answered. What does any of the above have to do with the value of distressed assets? Of course, policies that encourage the quick transfer of ownership will maximise the market value of distressed assets and, to the extent the government or local banks hold such distressed assets, they will be beneficiaries. But in this regard, it must be mentioned that this is only a secondary effect of the policy. There is no reason, in fact, that the government ought to be concerned with the value of distressed assets as an end in itself. Policy should be, as discussed above, inwardly focused on the best interests of the citizenry, and it should be oriented toward the long-term health of the economy. Creditors and investors who benefit from higher secondary debt prices should count themselves fortunate regarding this policy focus, but they should not mislead themselves that they are the intended beneficiaries of government policy.

## Pakistan

### Value Maximisation of Non-Performing Loans and Distressed Assets: Pakistan's Experience (October 1999 – October 2003)

by

*Salman Ali Shaikh<sup>1</sup>*

The composition and inherent characteristics of non-performing loans (NPLs) can vary significantly between and, indeed, within countries and cultures. These variations include: which economic segments and sub-segments are most affected (real estate, manufacturing, services), what are the key geographical concentrations, competitive characteristics, obsolescence issues, management quality, the regulatory environment, labour and employment sensitivities. Therefore, it is important to look at Pakistan's NPLs in terms of such characteristics and issues prior to making a determination/judgement as to whether the country's value maximisation efforts were successful or not. The traditional yardstick of measuring success (or failure) in terms of how many cents out of each dollar was recovered is much too narrow if the analyst's canvas is the whole country and its socio-economic framework. To adopt such an approach towards value maximisation entails posing, and being able to answer coherently, three very basic questions. They are as follows:

- a) Where are we?
- b) Where do we want to be?
- c) How do we get there?

In other words, the desired outcome(s) should determine the choice of tools and implements to be used. As Walter Gropius (Bauhaus School of Architecture) stated in the 1920's: "the function must determine the form." Therefore, while planners and regulators quite understandably agonise over "the NPL problem" and how to deal with it, they often fail to see that the NPL issue also has up-sides. The main "advantage" of high NPLs is that it can be creatively handled in a way that the post-NPL economy is much more efficient than the pre-NPL economy *i.e.*, by making a well-reasoned judgement on "sickness worthy of revival", the planner/regulator can change the shape of the future economy.

#### **1) *Where are we? Key features of Pakistan's NPLs***

At the time of independence in 1947, the country had virtually no industrial base: it was an agrarian economy with around three-fourths of the population living in rural areas. The population of Pakistan's economic capital, Karachi (now over 12 million) was less than half a million. Fairly rapid and sustained industrialisation started after the Korean War boom, which resulted in a major jump in commodity prices. The process of industrialisation itself can be broken down into three distinct phases. The import substitution phase - up to 1980 - was characterised by a major emphasis on building infrastructure and industries like fertilisers, chemicals, and engineering. This was followed by the export-oriented phase, 1980-1995, with exports led primarily by textiles like spinning and weaving, and its related downstream industries like knitwear, garments, bed sheets, and towels. The third phase - 1995 and onwards - is consumer-oriented industries with substantial growth in sectors like automobiles, cement, consumer durables, food processing, and telecommunications.

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<sup>1</sup> Turnaround Consulting, Recovery and Reconstructing, Pakistan.

The key characteristics of the country's NPLs are as follows:

- a) Concentrated in the large-scale manufacturing sector: With a few exceptions (e.g., trading and construction), the worst affected sector was the large-scale manufacturing sector with key concentrations in textiles, cement, sugar and public sector companies. Interestingly, the SME (small and medium-sized enterprise) sector was not seriously impacted. This was primarily because of high leverage/under-capitalisation in the former (i.e., large-scale manufacturing) and debt aversion/low leverage in the SME sector.
- b) Concentrated in the public sector banks and financial institutions: To a significant extent, Pakistan's NPLs were "man-made" and avoidable. The proof of this is that at their peak, nearly 90% of the country's NPLs were concentrated in banks and financial institutions in the public sector. The ratio of NPLs to total loans in the private sector and the foreign banks has rarely exceeded single digits. The reason for low NPLs to be the norm rather than the reverse is not difficult to understand. Except for the 1990's (the country's so-called lost decade), economic (and industrial) growth rates have been fairly robust. Additionally, large segments of industry, until recently, enjoyed protection from overseas competition through tariffs for the import-substitution industries and a mixture of below-market interest rates and direct subsidies for export-oriented industries.
- c) Culture of "zero equity" projects: In the 1980's and 1990's a lethal cocktail of liberal project finance (minimal/cosmetic due diligence by the banks), collusive lending, poor corporate governance and bureaucratic regulators led to what, understandably, became a major problem. In this period, hundreds of projects were set up where in many cases the "kick-back" received by the sponsors of the project from the overseas machinery supplier exceeded the paid-up capital of the company. With under-capitalisation and high gearing becoming the norm, many of these projects could not withstand even a minor business downturn.
- d) Dilettante entrepreneurs: While there are several well-established and well-managed business groups, around a third of the NPLs came from new entrants into industry with diverse backgrounds (e.g., agriculturists, bureaucrats, senior military officials, and judges). Vertical mobility may be a laudable characteristic in society. However, the passage of time has proved that the capacity of these dilettante entrepreneurs to run an efficient enterprise, along with their motives to set up a project, is questionable. Furthermore, these influential defaulters<sup>2</sup> often blocked efforts at enlightened NPL reform.
- e) Chronic over-capacity/lack of competitive advantage: These factors are responsible for a large portion of NPLs. Certain large industrial segments have significant over-capacity, which only a sustained period of high economic growth can cure e.g., the cement industry has been functioning at less than two-thirds capacity utilisation for over a decade. There are other industrial segments that suffer from an inherent lack of competitive advantage and should not have been set up in the first place e.g., sugar, where the average yield for most mills (expressed in terms of sugar extracted as a percentage of sugarcane crushed) is 7%, which is 30-40% below the yield in efficient producers like Cuba and the Philippines.
- f) Directed lending: The senior management of public sector banks and other public sector enterprises was traditionally selected by politicians and/or military officials for considerations other than professional competence. These individuals were often asked to repay political patronage by making loans that were designed not to be repaid i.e., NPLs at birth. Needless to say, bankers did what they were told and, in many cases, joined the bandwagon by being fairly generous to themselves in terms of using public money.

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<sup>2</sup> Sometimes nicknamed "the protected species".

2) ***Where do we want to be and how do we get there? Value maximisation: the basic imperatives***

Viewing this NPL map in the late 1990's, a value maximisation/NPL reduction strategy was required which should have contained the following key features:

- a) *Fast-track implementation is crucial:* With well over three-quarters of the NPLs concentrated in manufacturing, and with many of the distressed assets being relatively new or modern industrial plants, speed and the avoidance of closures were of the essence. Allowing manufacturing entities to close often results in degeneration (*i.e.*, pilferage and lack of maintenance of sensitive equipment), which in turn substantially increases the cost of rehabilitation. Even in the simple case of a change of management through court action, the value received from closed units is much lower than running plants. For example, perceptive banks were extracting settlements from NPLs/distressed borrowers at values as high as P (Principal) +50%, and managing to auction running companies at values ranging from P +40% to P +25%.
- b) *Avoidance of cosmetic tools:* Traditional methods of corporate re-structuring and debt re-scheduling involving small deferrals of debt instalments and balance sheet "patch-ups" by lengthening loan repayments had caused much harm by creating the fiction that all NPLs can eventually be recovered. Whereas, in reality, significant write-offs were required. This needed a new methodology to determine the level of sustainable debt, which can be defined as a level of term debt that can be paid from cash flows over the remaining useful life of the project *i.e.*, 10-12 years. Unfortunately, until recently, the regulatory environment continued to view write-offs as a criminal loss of public money. This issue got much worse after the military takeover, whereby under the National Accountability Bureau (NAB) Law, bankers could be "nabbed", *i.e.*, jailed and tried in an Accountability Court for causing write-offs.
- c) *Change of management as a value maximisation tool:* The treatment of distressed assets under existing insolvency systems, including the legal system – both the laws and the related procedures - and the regulatory environment has a built-in preference for retaining the existing management. Whereas, in reality, in many cases the management is the cause of the asset becoming distressed in the first place. In such cases, the removal of existing management and their subsequent replacement is the best way to cure the company's NPLs and to maximise value. To do this successfully, the asset management company (AMC) or the larger banks must have the capacity and skills to run the project/distressed asset until the new management can be found and inducted through an auction or a private sale.
- d) *Creating a national scale of priorities:* Just like a fire cannot be extinguished by throwing a little bit of water on the whole affected area, value maximisation is often best achieved by creating priorities across the whole spectrum of industrial default/NPLs. The 80:20 rule actually becomes the 67:33 rule, *i.e.*, if two-thirds of the most significant NPLs, in terms of the national economy, are resolved, and the related distressed companies are returned to health, the entire industrial economy will rebound several years earlier than the typical case-by-case approach. In Pakistan's context, we had the opportunity of defining priority segments, *e.g.*, textiles, the growth engine of the export base, and non-priority economic segments, *e.g.*, sugar, a perpetually sick industry. This is particularly important when the whole banking sector has low loan loss reserves and a feeble provisioning capacity, *e.g.*, where the bulk of the provisions in the public sector banks come from periodic re-capitalisation of their balance sheets. In such an environment, scarce resources need to flow to those economic segments that have the capacity to jumpstart the national economy quickly, provide maximum employment opportunities, and are economically viable in the

long-term. Conversely, the denial of these resources can contribute to the early demise of terminally ill segments, which are a long-term liability in socio-economic terms.

- e) *Clarity and consistency are required in regulator’s signals to the market:* Regulators have to drive the whole process, and both banks and borrowers watch their signals (words, deeds and nuances) carefully. In the context of fast track NPL reduction, these signals need to be very focused, consistent and unidirectional. In Pakistan, regulators opted to spend a lot of time seeking consensus-based solutions. This strategy (a *quid pro quo* for all players) in a zero-sum game has resulted in fuzzy signalling and significant value erosion of NPLs/distressed assets.
- f) *The need for capacity building:* The NPL crisis revealed that, just when they were needed, skills were either partially or wholly absent in several key areas of specialisation and expertise. The areas where there is an urgent need to build capacity and to create an institutional framework include professional receivers, auctioneers, administrators, forensic accountants (important in a culture where the majority of balance sheets are “cooked”), asset tracing specialists, and evaluators.

### 3) ***Value maximisation: challenge and response***

How well did the country and its regulatory systems cope with and respond to these challenges (growing NPLs, low economic growth rates and declines in fixed investment) during the past four years? The first legal enactment of the military government that seized power in a coup in October 1999 was the National Accountability Bureau (NAB) Ordinance. It was clearly drafted in a couple of weeks, and like all hasty legislation, was seriously flawed. A deadline was announced whereby all loan defaulters were asked to settle their outstanding loans or face the consequences. The underlying theoretical premise was that NPLs could be recovered in full, some of it from the project’s cash flow and the balance from the sponsors. The somewhat simplistic assumption was that if a company was making a loss, then an equivalent amount of cash had to be lying somewhere *e.g.*, in the sponsor’s house or under the mattress. In this line of thinking, a genuine business loss was fiction. The first batch of industrialists was arrested late at night in November 1999. This “Sheriff of Nottingham phase” of NPL reduction through the use of coercive techniques continued for a year or so. In spite of this, NPLs continued to grow, economic growth stagnated and investment slumped. Bankers stopped making decisions, particularly in the areas of debt restructuring and write-offs, as they were also potential NAB targets.

The negative consequences of these actions on the country’s NPL can be seen from the following chart:<sup>3</sup>

3.4 billion US dollars	(31 December 1998)
3.9 billion US dollars	(31 December 1999)
4.9 billion US dollars	(31 December 2000)
5.4 billion US dollars	(31 December 2001)
5.1 billion US dollars	(31 December 2002)
4.9 billion US dollars	(30 June 2003)

<sup>3</sup> Exchange rate is 1 US dollar = 57.4 Pakistani rupees.



To disguise the growth in the country's NPLs over the past 2-3 years, the regulators have started reporting "net NPLs" in most public documents. Net NPLs are defined as gross NPLs minus provisions held by the banking system (3.2 billion US dollars) minus NPLs transferred to the Corporate and Industrial and Restructuring Corporation (CIRC) (of 600 million US dollars). The CIRC is a public sector AMC. An additional problem in calculating correct NPL figures is the existence of two different regulators of the financial system. The banking system is regulated by the State Bank of Pakistan (SBP). The SBP publishes NPL figures regularly. However, Non-Bank Financial Institutions (NBFIs) are supervised and regulated by the Security and Exchange Commission (SECP). SECP does not publish NPL data for the NBFIs. The consequence of this dual regulator system is that the total NPLs for the financial system cannot be accurately measured. It is, however, estimated that the correct figure for the whole financial system could be 1 billion US dollars higher than the figure reported by SBP for the banking system.

CIRC was set up in 2000 and it was assumed that it would clean up a large portion of the stock of NPLs. However, it appears that the sheer volume of new NPL flows in 2000-2002 took regulators by surprise, *i.e.*, they had not planned for it. Consequently, by the autumn of 2002, the combined failure of NAB, CIRC and the informal loan workout process through a national committee for the rehabilitation of distressed assets, forced the regulators to re-vamp the whole strategy.

The SBP executed a sharp U-turn on the NPL reduction strategy. Through a directive issued to the banking system in October 2002, banks were mandated to effectively cut their losses. They were directed to make aggressive settlements with their defaulting borrowers at values well below the actual debt outstanding and/or the amount awarded through the court process, *i.e.* large haircuts/write-offs. This was radically different from the premise, only a couple of years earlier, that NPLs were recoverable in full and when write-offs were viewed with great suspicion. This directive looks at all NPLs in terms of liquidation/fire sale value (FSV) and not in terms sustainable debt or going concern valuation principles.

The directive contains detailed mechanics for repayment procedures and puts severe limitations on flexibility in terms of debtor-creditor negotiations of individual banks that may be able to strike a better deal for themselves. Borrowers are encouraged to make a 10% down payment of the FSV of the project, and pay the balance over a three-year period. The remaining amount would be written off *i.e.*, at the end of the third year. This sudden change of heart went far beyond the wildest dreams of most borrowers.

The major positive outcome of this forgiving approach is that it should make a major dent in the country's NPLs. Although the final figures will not be clear until next year, it is expected that NPLs amounting to over 1.5 billion US dollars may be settled. This, in itself, is a welcome change. Another positive outcome for the beneficiaries of this scheme is that within three years, the balance sheets of borrowers will look quite respectable when the write-off benefit is exercised. However, these positive outcomes carry some fairly heavy costs, some of which are as follows:

- a) *Heavy guzzler of provisions:* As mentioned earlier, prior to the 1999 military coup, some of the smarter banks were making aggressive one-shot settlements with borrowers at values ranging from P (Principal) +25% to P +50%. Whereas, now under the new directive, similar distressed assets are being settled at values as low as P -75% to P -25%. Consequently, the provisions used up by this scheme could exceed 1 billion US dollars. In fact, some of the weaker banks in the public sector may require yet another dose of re-capitalisation to beef up their provisions/reserves. This amount could have been substantially reduced had going concern/sustainable debt concepts been used and not FSV.

Furthermore, instead of maximising value from distressed assets, this methodology actually minimises value.

- b) *The mechanics of determining FSV:* We do have professional evaluators in the country and the SBP maintains an approved list. However, these firms have evolved over time without any licensing requirements. There is no professional body and, most important, there is no significant cost/penalty for being economical with the truth. This scheme has given these individuals/firms enormous power when determining the FSV of a company's distressed assets.
- c) *This scheme protects existing management:* As discussed earlier, the condition of a significant number of sick companies/distressed assets is due to the poor managerial capabilities of their sponsors. This scheme makes it practically impossible for creditors to evict inefficient sponsors and replace them with owners that are more professional. This feature of the scheme is very unfortunate as many of these companies will return to NPL status within five to six years. An opportunity to weed out inefficient sponsors has been lost.
- d) *Promotes a continuation of the default culture:* This debtor-friendly scheme is the second amnesty scheme announced by the central bank within a relatively short period of six years. The first scheme of this kind that allowed the old stock of NPLs to be settled on terms favourable to the borrower was announced and implemented in 1997. The moral hazard created by successive waves of amnesty and "incentive" schemes does more harm than good. This is because borrowers who have been adhering to agreed repayments terms in good times and in bad times feel cheated. More seriously, this feeling gives rise to an emulative instinct based on the belief that they should not miss the next round of amnesty or incentive schemes. This whole process results in retarding the development of good corporate governance, reduces the incentives to improve financial disclosure standards and generally promotes what has come to be known as the default culture.

#### **4) *The Corporate and Industrial Restructuring Corporation (CIRC)***

CIRC was launched in 2000 with very high expectations. It was expected to make a significant contribution in terms of eliminating a large part of the stock of NPLs in the public sector banks. It was also expected that since it operated under a strong enabling law, it would be able to extract better value from distressed assets than the banks operating under the auction process through the courts. Finally, it was expected to complete its mandated tasks with considerable speed. Hence, it has a sunset clause built into its enabling law whereby it is to be wound-up six years after commencing operations by September 2006.

It has, unfortunately, not lived up to expectations owing to a variety of factors including the poor quality of staff, lack of expertise, bureaucratic procedures and absence of procedures for corporate rehabilitation. With exactly half its mandated life left, the data on progress made so far does not inspire much confidence:

- 722 cases (of distressed assets/companies) were referred to CIRC by banks with NPLs of 2.1 billion US dollars.
- CIRC returned 387 cases back to the parent banks with NPLs of 1 billion US dollars. The main reason for returning a case is that the underlying asset/company is operational and can be revived by the banks themselves.

- Out of the balance of 1.1 billion US dollars, CIRC has actually acquired 191 cases with NPLs of 600 million US dollars at a purchase price of 89 million US dollars. The remaining 144 cases with NPLs of 500 million US dollars are still under discussion with the banks. Their acquisition status is still pending.
- Since inception, CIRC has sold 77 units (40% of the units acquired). These assets were sold for 46 million US dollars, and the underlying NPLs settled as a result of these sales was 200 million US dollars or around 4% of the country's NPLs. In terms of value maximisation, initial data suggests that the banks have been able to extract better values from distressed assets either through aggressive settlements with borrowers or through the auction process.

Last year, the World Bank conducted a detailed analysis on the workings of CIRC. This report was released in January 2003, and contained several key recommendations in terms of changes to its working procedures, valuation criteria with respect to asset acquisitions, and personnel issues including the need to up-grade skills. The best part of a year has passed without much evidence that these recommendations are being implemented. This could mean that the regulators have determined that there is very little merit in allocating more resources to an entity that is designed to fade away in a few years. In anticipation of this, the Banking Law Review Commission (BLRC) has incorporated enabling provisions for the creation and emergence of private sector AMCs/Corporate Restructuring Companies (CRC's) into the draft Corporate Rehabilitation Act.

#### **5) *The draft Corporate Rehabilitation Act***

The Corporate Rehabilitation Act (CRA) is clearly needed. It is designed to assist in improving the investment climate (fresh investment in industry is a major national problem) and promote risk-taking. The draft law has been ready for enactment for nearly a year. However, owing primarily to a hung parliament since October 2002 it has still not been presented to the legislature. The BLRC has used this time to make some significant changes and improvements in the draft law.

#### **6) *The beginning of the end or the end of the beginning?***

It has been over six years since the recognition that resolving the NPL crises is one of the key elements for the financial sector reform agenda. While the country has made significant improvements in several areas of financial sector reform, the handling of issues relating to the maximisation of value from NPLs remains seriously flawed.

Interestingly, the battle against increasing NPLs is being won with significant assistance from the War on Terror. Pakistan's external debts have been re-scheduled, the economic growth rate has improved, foreign exchanges reserves are at an all-time high due, in part, to overseas Pakistani's sending money home, and the stock and real estate markets are booming. The SBP's debtor-friendly scheme should be able to reduce NPLs by around 1.5 billion US dollars; however, it will do so at a fairly heavy cost.

The CRA, once implemented, should restore balance between the rights of debtors and creditors and enhance predictability in the legal process. However, if the law is enacted in a vacuum without addressing issues like judicial capacity building and creating a strong institutional infrastructure, then it will be unable to deliver its potential. To conclude, we are currently on at the end of the beginning in this long process of maximising value from distressed assets.



## Philippines

### Philippine Trends in Addressing Distressed Assets and Vehicles for Maximising Value

by

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The difficult financial situation of the Philippine government has prevented it from setting up a super fund to bailout the financial sectors from the ill effects of the Asian Financial Crisis, or a super agency that would handle the non-performing loan (NPL) problems of the financial sector. The Philippine approach has been to improve key legal structures to give the private sector the opportunity to sort its way out of the financial morass. The strategy promises to:

- upgrade the country's corporate rehabilitation and insolvency systems to world-class standards with the setting-up of special commercial courts to handle the various proceedings;
- improve the country's credit transaction infrastructure;
- pass the Special Purpose Vehicle (SPV) Act to provide tax and other incentives for the financial sector to sell and dispose of its non-performing assets to asset management companies; and
- pass a Securitisation Act and other component pieces of legislations.

#### *1) Upgrading the Philippine corporate insolvency regime*

With the onset of the Asian Financial Crisis, it became important for the country's political, financial and business leaders to provide both local and foreign creditors clear and transparent structures that ensure the collection or eventual realisation of their investments and credit extension into the country, preferably under a regime which conforms to world-class standards and overseen by tribunals who have the competence to decide on difficult issues covering corporate rehabilitation and dissolution.

Certified to the Philippine Congress as urgent legislation, is the Corporate Rehabilitation and Insolvency Act (CRIA), which is aimed at overhauling and consolidating the entire system governing corporate rehabilitation, dissolution and liquidation, and contains provisions on such important matters as cross-border insolvency. The bill is still with the technical committee of the House of Representatives, and has been pending for more than two years.

The bill seeks to provide speed and efficiency in the resolution of rehabilitation and insolvency cases, and at the same time achieve a balance between the rights of creditors and debtors, all in accordance with international standards.

Pending the passage of CRIA, the judiciary has taken up an interim modernisation of laws and practice pertaining to corporate rehabilitation and insolvency.

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The obscure Insolvency Act<sup>2</sup> was up-graded using the provisions of the charter of the Philippine Securities and Exchange Commission (SEC), under Presidential Decree No. 902-A, to usher in a system of corporate rehabilitation. By way of special provision in the Securities Regulation Code,<sup>3</sup> the exclusive jurisdiction to act on corporate rehabilitation proceedings was transferred and consolidated in the special commercial courts. Pursuant to its constitutional power to promulgate rules of procedure<sup>4</sup> the Supreme Court did not waste time nor the opportunity to assume a leading role in pushing forward the development on the whole body of corporate rehabilitation. Using the experience of the SEC as laid out in the SEC Rules on Corporate Recovery, the Supreme Court invoked its procedural law making power under the constitution, and promulgated the Interim Rules of Procedure on Corporate Recovery (Interim Rules) which not only contain rules and procedure, but key provisions that bordered on substantive laws, since such provisions created substantive rights which did not previously exist, or which have the effect of supplanting or adversely affecting existing property rights. It is argued that those areas in the Interim Rules go beyond mere rules of procedure and are an encroachment by the Supreme Court on legislative prerogatives.

The Interim Rules themselves represent a great experiment on the part of the Supreme Court embodying cutting-edge judicial technology, in that the:

- a) proceedings under the Interim Rules are mandated to be *in rem*: through compliance with publication requirements, the results of the proceedings are binding on creditors and other affected persons even when they do not participate in the proceedings;
- b) proceedings are declared “summary”, “non-adversarial”, and “technology friendly,” such that pleadings are prohibited that unduly delay, causes of actions and oppositions are established based of sworn statements filed, attaching thereto the actionable documents when necessary, and that service of pleadings may be effected by fax or e-mail;
- c) proceedings are strictly time-bound; the whole process cannot exceed 18 months; and
- d) orders of the courts are immediately executable, even on appeal, unless enjoined by the Court of Appeals or the Supreme Court.

## 2) ***Special Purpose Vehicle Act of 2002***

The Special Purpose Vehicle (SPV) Act was enacted into law in January 2003, and became effective in April of the current year.

The SPV Act provides the legal framework for the establishment of SPVs that can acquire the non-performing assets (NPAs) of the covered financial sector, whereby the participants in the SPVs are able to avail of tax, value-added tax (VAT) and capital gains tax exemptions for transactions involving the transfer of NPAs from Financial Institutions (and specifically qualified individuals) to SPVs.

The SPVs can then rehabilitate the acquired assets and sell them off for a profit within five years, although the window to avail of the SPV is only two years.

If one looks into the essence of the SPV Act, it essentially constitutes a bailout for the financial sector of the Philippine economy. The financial sector is in need of restructuring because of the high

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<sup>2</sup> Act No.1956 was enacted in early 1909.

<sup>3</sup> R.A. 8799.

<sup>4</sup> Section 5(5), Article VIII of the 1987 Constitution.

level of NPAs. The SPV Law affords it a cushion and allows the maximisation of the realisation value.

The tax incentives and privileges under the SPV Act may be classified into three categories:

- a) all sales or transfers of NPAs from a bank to an SPV, or transfers by “dation in payment” or *dacion en pago* by the borrower or by a third party to the bank;
- b) transfers from an SPV to a third party of acquired NPAs; and
- c) transfers of individuals of a single-family residential unit constituting as an NPA of a bank.

The above-enumerated transfers shall be exempt from the following taxes:

- a) documentary stamp tax (DST);
- b) capital gains tax imposed on transfer of land and/or other assets treated as capital assets;
- c) creditable withholding income taxes imposed on the transfer of land and/or building treated as ordinary assets; and
- d) value-added tax (VAT) or gross receipts tax (GRT) whichever is applicable.

In addition, the covered transfers enumerated above shall be subject to only 50% of the applicable fees imposable.

Apart from the foregoing, the SPV shall, for a period of not more than five years from the date of acquisition of the NPLs by the SPV, be entitled to the following tax breaks and incentives:

- a) the SPV shall be exempt from income tax on net interest income, DST and mortgage registration fees on new loans in excess of existing loans extended to borrowers with NPLs which have been acquired by the SPV; and
- b) in case of a capital infusion by the SPV to the borrower with NPLs, the SPV shall also be exempt from the DST.

Any loss that is incurred by the financial institutions as a result of the transfer of NPAs shall be treated as an ordinary loss, subject to the following conditions:

- a) except for a loss incurred by the bank from the transfer of NPAs within two years from the effect of the Interim Rules, which may be carried over for five consecutive taxable years following the year of such loss, the accrued interest and penalties shall not be included as loss on said loss carryover from operations subject to the NIRC provisions on net operating loss carryover (NOLCO);
- b) for purposes of corporate gain or loss the carryover shall be subject to pertinent laws; and
- c) the tax savings derived by the bank from the NOLCO shall not be made available for dividend payments but shall be retained as a form of capital build up.

### 3) ***Preliminary assessment of the impact of the SPV Law***

Under the SPV Law, interested investors have until October 2004 to set up and register an SPV or asset management vehicle with the Philippine SEC, while the covered financial sector has until April 2005 to transfer idle assets to any such SPV in order to avail of the tax incentives under the law. In turn, duly established SPVs have until April 2010 to dispose of their NPAs in order to avail of the law's incentives.

More than ten months since the enactment of the SPV Law, no bank has availed of its provisions, and the anticipated influx of foreign funds to set up SPVs has not materialised. The lack of use of the SPV Law has been attributed to the large gap between the discount that local financial institutions are willing to accept and the discount that buyers demand (50% to 90% of face value). Philippine financial institutions generally cannot absorb such large discounts even when the Philippine Central Bank allows them to book the losses over a seven-year period. More importantly, the local sentiment is that similar schemes adopted in the ASEAN region had negative consequences for local companies and were a windfall for foreign investors.

With the government's deficit problem and the political and foreign exchange uncertainties prevailing in the country (especially with the May 2004 presidential, national and local elections), it is unlikely that the bid prices for Philippine NPAs will improve. The situation has been summed up rather well by a financial observer: "On the part of local banks, a discount of such magnitude would be untenable. Their capital bases cannot possibly absorb the potential hit and the banks either have to infuse more capital, search for strategic investors, merge with rivals or go bankrupt. Or they can ignore the SPV Law and go on with their lives as if the law's perks never came about. This is the likely course that will be taken by the banks. It would be as if the SPV Law never existed."<sup>5</sup>

There is no evidence yet that the provision of the SPV Law requiring banks to have to try to restructure the loan by negotiating with the borrower before they can transfer it to the SPV is proving to be a deterrent. To date, the biggest concern of the financial sector is the large losses to be sustained due to the large discounts to be realised in the sale of the NPAs to SPVs.

### 4) ***Proposed legislation***

#### *The Securitisation Act*

The current version of the Securitisation Act pending in the Philippine Congress seeks to:

- a) promote securitisation to support the development of the capital market by:
  - establishing the legal and regulatory framework for securitisation;
  - creating a favourable market environment for a wide range of asset-backed securities;
  - rationalising and streamlining the rules and taxes applicable to the securitisation process; and
- b) pursue development of the secondary mortgage market for asset-backed securities and other related financial instruments:
  - as essential to its goal of generating investment; and
  - accelerating the growth of the housing finance sector, especially for social and low-income housing.

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<sup>5</sup> Reyes, *Random Walker*, 12 November 2003 issue of Business World.



Unlike the SPV Law which constitutes a one-time remedial measure to tackle a particular problem (*i.e.*, NPAs of the financial sector of the Philippine economy), and limits its tax breaks and incentives to specific sectors of the market, the Securitisation Act aims to institutionalise Asset-Backed Securities (ABS) and Secondary Mortgage Institutions (SMI) in the Philippine economy in specific ways mandated under the Act, as the condition for granting tax breaks and incentives.

One of the issues being addressed in the current version of the Securitisation Bill is that, since ABS and SMI schemes are market-driven institutions, it may be unwise or even detrimental to the Philippine economy for the government to mandate the only schemes that may be accepted for tax breaks and incentives. Limitations on ABS and SMI schemes may undermine development and innovation, or otherwise make them more expensive or costly to implement according to the parameters mandated by the Securitisation Act.

The ABS and SMI systems are rather well developed in modern economic jurisdictions, fairly well understood in the Philippines, and applied whenever the circumstances are auspicious. It is not the lack of schemes or non-formal legislative acknowledgment that has impeded their growth in the Philippines but, rather, the heavy tax burden on the securities and transactions underlying such schemes.

The question may then be asked whether it is better to change the thrust of the Securitisation Act from an institution building exercise, to a simpler tax measure to reflect the government's endorsement of the ABS and SMI in the Philippines. To a great extent, ABS should be a market led development, rather than spearheaded by the government. Government efforts should be limited to providing the correct tax and fiscal incentives for such types of securities to evolve and providing for reasonable safeguards for the investing public.

Therefore, evaluation of the proposed Securitisation Act should be viewed with one eye firmly on the issue on whether what Congress should pass is a bill that properly evaluates the tax breaks or incentives that would cover the secondary market on ABS and other securities; essentially a tax measure, rather than an over-reaching law that would dictate the form of such transactions.

After all, there is already a general law that governs the issuance of all types of securities, including ABS the institutions that issues them, and provides for punishment of fraudulent transactions pertaining to such securities, *i.e.* the Securities Regulation Code.

#### *The overhaul of the Law on Documentary Stamp Taxes*

Recently, the Philippine Congress approved a bill removing the DST on secondary sale of stocks and debts. The bill (which is expected to be signed into law by the Philippine President who has previously certified it as an urgent legislation) is intended to revive the stock market by breaking investment barriers and removing distortions in the domestic capital market, particularly the cascading impact of the DST on financial transactions.

Flaws in the documentary stamp taxes regime have been perceived as impeding growth of the Philippine capital market. It has been observed that government securities have become the dominant financial instruments in the Philippine financial sector when compared to the miniscule share of private sector debt issues.

The bill has set a uniform rate of 0.5% on instruments such as time deposits, special savings account bonds, loan agreements, and government securities. A range of lower tax rates has been set for other instrument such as insurance and pre-need plans, mortgages, deeds of trust, lease agreements,

and acceptance of bills of exchange. The bill also removes the DST on transfer of land to a merged corporation.

*Effective removal of redemption rights for foreclosure of mortgages of corporate mortgagor*

On a related front, the General Banking Law (GBL) of 2000 has not only strengthened the supervision and control of the Philippine Central Bank over the banking industry and provided for better corporate governance, but also introduced measures to assure realisation by banks of their loan exposures.

Prior to the GBL, the foreclosure of banks on real estate mortgages, whether effected judicially or extra-judicially, always accorded to the mortgagee a one-year redemption period. Under Section 47 of the GBL, when the mortgagee is a legal entity and the mortgage is foreclosed extra-judicially (the preferred approach of banks), although there is a reduced redemption period of three months for the mortgagor within which to redeem, registration of the certificate of sale with the Registry of Deeds extinguishes any right of redemption. In practical terms, since banks usually register with dispatch the certificate of sale, this mode of extra-judicial foreclosure has afforded the banking institutions a cheap and quick mode of realising defaulted loans.

**5) *Conclusions***

The Philippine approach towards addressing the NPAs of its financial sectors may be considered below average. Rather than having a definitive national approach, the remedies resorted by the Executive Department have at times been rather improvised and patchy, in particular, in the light of the slowness of the Legislative Department in enacting the legislation certified for urgent passage. The Philippine Supreme Court, in exercising its power under the Philippine Constitution to promulgate rules of procedure, seems to provide a bridge for what is lacking in substantive law. Political will and national discipline seem to be the necessary ingredients to get the Philippine economic engine going full throttle.

## Thailand

### **Informal Workouts and Insolvency Reform Initiatives to Address Non-Performing Loan Problems in Thailand**

*by*

*Tumnong Dasri<sup>1</sup>*

To address Thailand's non-performing loan (NPL) problem, informal workout processes have been created and the formal rehabilitation process in the court has been amended. To support the informal workout process, Thailand has instituted central bank guidelines and initiatives for debt restructuring, the Bangkok Framework, the Inter-Creditor Agreement, the Debtor-Creditor Agreement, the Court Mediation Center guidelines and other incentives. In addition, the government also amended the Bankruptcy Law to allow qualified debtors to restructure their bad debts through the court process. Since the implementation of these measures, Thailand has witnessed a steady decline in the level of NPLs.

#### ***1) The new definition of non-performing loans***

In the second half of 2002, the Bank of Thailand's definition of non-performing loans was revised to reflect international standards, which disallow the practice of write-off from the non-performing loan figures of the portion of an uncollateralised loan for which full provisioning has been made. Thus, the current definition includes the entire amount of loans that are classified as substandard, doubtful, doubtful of loss, and loss. The criteria for classification are based on both aging and quality considerations as specified in the Bank of Thailand's (BOT) Notification Regarding Worthless or Irrecoverable Assets and Doubtful Assets That May be Worthless or Irrecoverable, dated 18 February 2002.<sup>2</sup> The substandard loans are based on loans which are overdue for over three months from the contractual period or where other evidence indicates that there are difficulties in the recovery of assets or claims, or where the assets or claims do not generate a normal return, as ordered by the BOT.

The result of this more stringent definition was the apparent "increase" in non-performing loan levels from prior levels under the old definition. However, steady progress is being made in the reduction of NPLs under the new definition.

#### ***2) Institutions and policies for insolvency workouts***

A number of informal workout initiatives have been established to tackle the distressed asset problem after the severe economic crisis in 1997. They include the Central Bankruptcy Court, the Financial Sector Restructuring Authority (FSRA), Asset Management Corporations (AMCs), State-Owned Asset Management Companies, privately-owned Asset Management Companies, the Thailand Asset Management Corporation (TAMC), the Corporate Debt Restructuring Advisory Committee

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<sup>2</sup> Please see the Bank of Thailand's Notification Regarding Worthless or Irrecoverable Assets and Doubtful Assets That May be Worthless or Irrecoverable, dated 18 February 2002 at: [http://www.bot.or.th/bothomepage/notification/fsupv/eNotification\\_Index.asp?instType=BF](http://www.bot.or.th/bothomepage/notification/fsupv/eNotification_Index.asp?instType=BF).

(CDRAC), the Provincial Sub-Committee for Debt Restructuring, the Court Mediation Center for Small and Medium-sized Enterprises, and the Personal Financial Advisory Center (SFAC).

The tools used for expediting the informal workouts include the Bank of Thailand's Notification on Debt Restructuring (or BOT Guidelines), the Framework for Corporate Debt Restructuring in Thailand (Bangkok Framework), the Inter-Creditor Agreement on Restructuring Plan Votes and Executive Decision Panel (ICA), the Debtor-Creditor Agreement on the Debt Restructuring Process (DCA), the Simplified Debtor-Creditor Agreement (Simplified Agreement or SA), and the BOT Initiatives for Debt Restructuring for cases in the Court Process and Legal Execution Process.

### **3) *Bank of Thailand Guidelines for Debt Restructuring (1998)***

To facilitate informal workouts, on 2 June 1998, the Bank of Thailand issued a notification to serve as a general guideline for financial institutions in order to assist in the restructuring of the large number of distressed assets in the financial system. The guidelines were later amended on 1 June 1999 to reflect practical concerns. If the debt restructuring of any cases followed these guidelines, the cases would qualify for pre-arranged tax benefits, stamp duty exemptions and a reduction of land transfer fees to 0.01%.

As the BOT Guidelines are only general approaches for regulatory purposes, each individual financial institution must develop its own specific procedures for restructuring its NPLs. The individual guidelines must not only be in line with the BOT Guidelines, but should also be compatible with the institution's structure. The institution must seek approval from the Bank of Thailand of its guidelines.

### **4) *Bangkok Framework (1998)***

In order to generate a more co-ordinated informal workout approach, the Board of Trade of Thailand, the Federation of Thai Industries, the Thai Bankers' Association, the Association of Finance Companies and the Foreign Banks' Association jointly prepared the Framework for Corporate Debt Restructuring in Thailand in early 1998 (the Bangkok Framework). The framework is non-binding and non-statutory. It is a statement of the approach that is expected to be adopted in corporate workouts involving multiple creditors. The framework is based on general market practices and may be altered or amended to serve the needs of the business and financial communities. It is designed to promote a spirit of timely co-operation amongst concerned stakeholders for their mutual benefits.

### **5) *CDRAC's debt restructuring process***

The Joint Public-Private Consultative Committee (JPPCC) Resolution dated 22 June 1998, established the Corporate Debt Restructuring Advisory Committee (CDRAC) to encourage and accelerate informal workouts. CDRAC's key role is to act as a facilitator or an independent intermediary in the restructuring process in order to expedite the negotiation among all parties concerned.

CDRAC's restructuring process is based on the Inter-Creditor Agreement on Restructuring Plan Votes and Executive Decision Panel Procedures (ICA), and the Debtor-Creditor Agreement on Debt Restructuring Process (DCA) that are used for large and multi-creditor debtors, and the Simplified Agreement (SA) that is used for small and medium-sized debtors. These agreements were modified from the Bangkok Framework, approved by CDRAC and signed by financial institutions in Thailand

in March 1999 as part of the operation of the structured informal workout process through the CDRAC.<sup>3</sup>

In contrast to the Bangkok Framework, the CDRAC process is enforceable to a certain extent. All stakeholders commit to a definitive timetable for restructuring, forcing decisions to be made and actions to be taken, and the process includes guidelines for all parties to follow, making the restructuring clear and concise. The structured informal process has been significantly assisted by the ICA and DCA through efficiency improvements and the reduction of unnecessary delays in the process. These agreements also provide for mechanisms to deal with any breaches of the agreements. For example, a non-complying creditor may be given a warning letter and a fine imposed by the Bank of Thailand.

#### **6) Court mediation processes (2001)**

Mediation permits the resolution of disputes in the interest of the disputing parties and also of the court proceedings by expediting the trial of the case in an economical way, and settling the dispute to the satisfaction of the parties. Mediation has proven to be an essential alternative available for the courts of justice in the settlement of disputes. To promote the use of proper, efficient methods of mediation, there need to be standard rules and procedures. These rules are called the Guidelines of the Court of Justice Administrative Committee Concerning Dispute Mediation (Mediation Guidelines)<sup>4</sup> and were laid down by virtue of the Justice Administration Act.<sup>5</sup>

The judges in quorum shall be empowered to mediate under the provisions of the Civil Procedure Code. These rules will not affect the power of the judges in quorum to mediate in the cases that they are in charge. After a case has entered into the court process, the judge in quorum, or a designated official, may appoint one or more judges, court officials or third persons (to the satisfaction of all parties involved) to help the court mediate the case. The appointees are not entitled to fees or expenses. All mediators shall disclose to all involved, any personal interests/conflicts or relationship with any party involved. The court may order the removal of the mediator if the mediator fails to conduct his work for the benefit of all parties involved.

After the court has ordered the appointment of the mediator(s), the sending and obtaining of documents, case-files or any communications between the court and the mediators shall be in the manner prescribed by that court. If the parties are individuals, they should attend the mediatory meeting(s) themselves. They may also appoint a representative for that purpose. If the parties are legal entities, they may appoint any representative(s) empowered (in writing) to attend and make decisions at the meetings.

Before the mediation takes place, the mediator will have the parties agree in writing to mediate and be bound by the Mediation Guidelines. The mediator may discuss the mediation procedures and guidelines with the involved parties and agree on them before the mediation takes place. In the interest of the mediation, the mediator may ask the parties to furnish the mediator with facts or preliminary information about the dispute, including a proposal for dispute resolution, or may suggest the exchange of such information between the parties.

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<sup>3</sup> Only those who sign the agreements are bound by the CDRAC debt restructuring process. Initially, they were signed by commercial banks, finance companies, EXIM Bank, and the Industrial Finance Corporation of Thailand. In 2001 and 2002, asset management companies also signed them.

<sup>4</sup> B.E. 2544 (2001)

<sup>5</sup> B.E. 2543 (2000)

The mediator is responsible for determining the manner in which the mediation takes place, including its date, time and place. The mediator is also responsible for notifying all concerned parties, including absent parties, of mediation activity carried out in their absence. The mediator may permit the parties to be present at the mediation meeting.

The mediator may have a draft compromise prepared for the parties, if appropriate. The parties involved will need to consent to the draft in the event that there are any costs involved. The mediator will carry out the mediation activity within the limits prescribed by the court. An extension may be granted if the mediator requests it, and the parties in dispute are close to resolving the conflict. However, if the mediator observes that any party carries on the mediation in a way that delays the trial of the case, then the mediator shall report this fact to the court without delay.

After the mediation process comes to an end, the mediator reports the results of the mediation to the court for further action. If the parties have agreed to settle the dispute in part, or admit to certain facts and have agreed that such agreement be used in court proceedings, the mediator shall make proper note of the agreement and notify the court.

#### **7) *The Bank of Thailand's new initiative for debt restructuring (BOT Initiative) (2003)***

In an historic meeting between the Governor of the Bank of Thailand and all the presidents of Thai commercial banks at the end of 2002, a comprehensive timeframe and methodology to further speed up the resolution of NPLs was developed. To speed up resolutions, all agencies involved segmented debtors into four groups and committed to the following timeframes:

##### *a) Debtors that have successfully restructured their debt and that are in the process of repayment*

For debtors that have already signed the debt restructuring agreement or are in the process of signing the agreement, successful repayments for three months must be made before the debtor's loans can be re-classified as performing loans. During that period, financial institutions are committed to:

- a) expedite the signing of the debt restructuring agreement (if not already done) and monitor debt repayments until the debt is qualified to be reclassified within four months; and
- b) report on the progress made to the Bank of Thailand's Corporate Debt Restructuring Group on a monthly basis.

##### *b) Debtors in the process of restructuring*

For debtors undergoing restructuring, financial institutions are committed to:

- a) expedite the debt restructuring process to be completed within one year; and
- b) report results of successfully restructured cases that have signed the debt restructuring agreement to the Bank of Thailand's Corporate Debt Restructuring Group.

##### *c) Debtors in the court process*

For debtors in the court process and debtors that have received a notice from creditors, financial institutions may submit the list of cases for which they would like the Bank of Thailand's Corporate Debt Restructuring Group to serve as mediator/facilitator in order to expedite the debt restructuring process outside of court. Target debtors for this process include debtors of financial institutions

(commercial banks, finance companies, asset management companies, the Industrial Finance Corporation of Thailand and the Export-Import Bank of Thailand) that are currently in the legal process or have received repayment notices from creditors as well as debtors of the Thai Asset Management Corporation.

As with other debt restructuring programmes, participation in the new programme is voluntary for both debtors and creditors. As a requirement, persons with decision-making authority from both the debtor and creditor's sides are to participate in every meeting. The following procedures for negotiations are to be completed in no more than three meetings and within two months:

*Step 1: Preparing to negotiate*

The Corporate Debt Restructuring Group (CDG) of the Bank of Thailand shall co-ordinate with financial institutions in order to select target debtors. Financial institutions finalise the list of target debtors and provide the contact address for the CDG and the BOT's regional offices to inquire about the debtors' willingness to participate in the programme. Creditors shall continue legal action against debtors who are unwilling to join the programme. Debtors that voluntarily participate in the programme and their creditors will be expected to provide information and documents as instructed by the CDG. Furthermore, each party shall send representatives with decision-making authority to the negotiation meetings, which will be organised by the CDG.

*Step 2: First meeting*

The timeframe for the entire debt-restructuring negotiation process is defined. The debtor will use the developments made in the first meeting to construct a debt repayment proposal that is to be submitted to the debtor in 21 days. Upon receipt of the debt-restructuring plan, creditors have 14 days to consider the proposal and decide whether to accept or reject it.

*Step 3: Second meeting (the creditor announces results)*

In the second meeting, the creditor announces whether the debt-restructuring plan as submitted by the debtor is accepted or rejected. In the event that the plan is accepted, both parties are to draft and sign a Debt Restructuring Agreement for presentation to the court as soon as possible. In the event that the creditor rejects the plan, the creditor must provide their reasons for rejecting the plan along with their requirements for an acceptable debt-restructuring plan. Debtors will have 14 days to amend their plan for re-submission to creditors. Creditors will then have 14 days to consider the revised plan.

*Step 4: Third meeting (if necessary)*

In the third meeting, the creditor announces whether the revised debt-restructuring plan as submitted by the debtor is accepted or rejected. In the event that the plan is accepted, both parties are to draft and sign a Debt Restructuring Agreement for presentation to the court as soon as possible. In the event that the revised plan is rejected, creditors shall continue to take legal action. In the event that either party fails to meet a deadline, the negotiation process is considered a failure and in-court legal action is to be resumed.

*d) Debtors in the legal execution process*

The Bank of Thailand's Corporate Debt Restructuring Group also aims to expedite the resolution of cases in the legal execution process by serving as an out-of-court mediator/facilitator in order to expedite the debt restructuring process outside of court. Debtors for this initiative include debtors of

commercial banks, finance companies, asset management companies, the Industrial Finance Corporation of Thailand and the Export-Import Bank of Thailand that are currently in the legal execution process, including cases where the court has pronounced judgement. As with the facilitation of cases in the legal process, entry of cases in the legal execution process is voluntary for both debtors and creditors.

Participation in this initiative requires the representation of both the debtor and creditor in every meeting. For cases in the legal execution process, a resolution is to be reached through the following procedures in no more than two meetings and within 45 days:

*Step 1: Preparations*

The Corporate Debt Restructuring Group (CDG) of the Bank of Thailand shall co-ordinate with creditors and debtors in the legal execution process who are willing to join in the BOT initiatives. Voluntary debtors and creditors provide information and documents as instructed by the CDG. Each party shall send representatives with decision-making authority to every meeting. Each party shall prepare preliminary debt restructuring alternatives to resolve the debt.

*Step 2: Convening the first meeting*

The timeframe for the entire debt-restructuring negotiation process is established. In the event that the creditor and debtor are able to reach an agreement, the creditor shall request the Legal Execution Officer to stay or cease the legal execution proceedings. In the event that the creditor requires the debtor to revise the debt-restructuring proposal, the debtor will have 15 days to revise the plan for the second meeting. In the event that the creditor and debtor are unable to reach an agreement, the legal execution proceedings shall continue.

*Step 3: Convening the second meeting (if necessary)*

In the event that the creditor and debtor are able to reach an agreement, the creditor shall request the Legal Execution Officer to stay or cease the legal execution proceedings. In the event that the creditor and debtor are unable to reach an agreement or the time limit has been violated, the legal execution proceedings shall continue.

**8) *Recent developments in CDRAC's effort in the resolution of non-performing loans***

In the year 2003, CDRAC started the NPL resolution procedure on Debtors in the Legal Process by employing the BOT Initiative framework. From April 2003 to the end of September 2003, CDRAC targeted 971 cases with outstanding credits of 8176 million baht. Of these, 461 cases with outstanding credits of 2143 million baht were resolved, comprising 334 debtors with outstanding credits of 1584 million baht that were successfully restructured, representing 80% of resolved debtors. A summary of developments of cases in the legal process follows:

*a) 2003 target debtors*

*71% of debtors in the legal process have been successfully restructured:* As of the end of September 2003, creditors have submitted the names of 2220 debtors in the legal execution process with credits outstanding of 18507 million baht, which they would like to re-negotiate. After three months, 461 debtors with credits outstanding of 5871 million baht indicated their willingness to renegotiate and are currently doing so under the CDRAC process. Of these, 156 debtors with outstanding credits of 967 million baht have been restructured, representing 71% of resolved debtors.



*85% of debtors in the legal execution process are successfully restructured:* As of the end of September 2003, creditors submitted the names of 939 debtors in the legal execution process with outstanding credits of 4938 million baht, which they would like to re-negotiate. After three months, 77 debtors with outstanding credits of 299 million baht indicated their willingness to renegotiate and are currently doing so under the CDRAC process. Moreover, the Bank of Thailand's regional offices have received walk-in requests to participate in the re-negotiation process from 113 debtors with outstanding credits of 399 million baht. It is noteworthy that 85% of debtors that reached a resolution during the re-negotiation process have been successfully restructured.

*92% of walk-in debtors have been resolved:* In addition to the debtors proposed by financial institutions, there have been 433 debtors with credits outstanding of 2,006 million baht that have indicated their intention to enter into the process directly. As at the end of September 2003, a total of 192 debtors with outstanding credits of 644 million baht have been resolved. Of these, 176 debtors with credits outstanding of 604 million baht, or 92% if resolved debtors, have been successfully resolved.

*b) 1998 – 2002, 85% of the target debtors are successfully restructured*

Since 1998 to date, CDRAC approved a total 15,386 target cases with outstanding credits of 2,841,749 million baht. Currently, only 157 debtors with credits outstanding of 73,102 million baht remain in the negotiation process. The remaining 15,229 debtors with outstanding credits of 2,768,647 million were resolved.

A total of 10,346 cases with outstanding credits of 1,398,328 million baht have been successfully restructured, representing 85% of the resolved debtors. Most of these debtors are in the commerce sector, followed by the retail sector and industrial sectors.

*c) Debtors of the financial institution system in September 2003*

From 1998 to September 2003, financial institutions successfully restructured 2,961,244 million baht of outstanding credits. Non-performing loans with outstanding credits of 29,593 million baht were left in the restructuring process.

**Progress of Debt Restructuring of the Financial Institution System \*31 December 1998 - 30 September 2003**

Item	1998	1999	2000	2001	2002
<b>Completed Cases</b>	<b>156 865</b>	<b>1 072 095</b>	<b>1 953 520</b>	<b>2 429 093</b>	<b>2 725 923</b>
<b>In Process of Restructuring</b>	<b>690 480</b>	<b>1 120 513</b>	<b>386 854</b>	<b>141 847</b>	<b>122 839</b>
<b>Total</b>	<b>847 345</b>	<b>2 192 608</b>	<b>2 340 374</b>	<b>2 570 940</b>	<b>2 848 762</b>

Item	2003		
	Q1	Q2	Q3
<b>Completed Cases</b>	<b>2 793 857</b>	<b>2 881 820</b>	<b>2 961 244</b>
<b>In Process of Restructuring</b>	<b>115 134</b>	<b>111 493</b>	<b>29 593</b>
<b>Total</b>	<b>2 908 991</b>	<b>2 993 313</b>	<b>2 990 837</b>

\* Thai Commercial Banks, Foreign Banks & New IBFs, Finance Companies and Credit Fonciers

Unit : Million Baht

Of the above-mentioned figures, private Thai commercial banks were able to restructure the most debt (1 974 billion baht) followed by state-owned banks (712 billion baht).

#### NPL of Financial Institutions as of September 2003

Unit: Million baht

Details	Completed Cases and in the Payment Process	Restructuring	In the Legal Process	Total	NPL/Total Loans
<b>Creditors</b>					
Private Banks	25 185	229 324	326 319	580 828	20.2
State-owned Banks	2 845	61 005	49 812	113 662	8.02
Thai Commercial Banks	28 030	290 329	376 131	694 490	16.18
Foreign Banks	6 450	19 635	6 324	32 409	7.02
Finance Companies	1 322	5 086	17 034	23 442	11.43
<b>Total</b>	<b>35 802</b>	<b>315 050</b>	<b>399 489</b>	<b>750 341</b>	<b>15.13</b>

The majority of restructured debtors are represented by the manufacturing sector followed by wholesale and retail trade sectors and the construction and real estate business sectors. Most debtors successfully restructured are based in Bangkok and the Central Region.

#### Completed Debt Restructuring of the Financial Institution System: Classified by types of businesses

Unit : Million Baht

Business Sector	1998	1999	2000	2001	2002	2003		
						Q1	Q2	Q3
1. Agriculture and forestry	2 573	23 841	50 573	63 198	73 157	76 001	77 861	80 350
2. Mining and Quarrying	1 911	6 309	10 820	14 262	16 815	17 455	17 721	18 298
3. Manufacturing	51 088	318 422	579 394	748 024	819 894	851 751	881 928	900 429
4. Trade & Commerce	29 446	211 044	400 039	479 449	547 536	567 553	582 023	600 106
5. Banking & Financial Businesses	2 710	57 183	80 151	92 621	102 364	104 043	107 222	109 627
6. Construction & Real Estate	36 602	199 622	348 819	449 342	500 870	512 111	519 019	534 477
7. Public Utilities	4 728	40 430	74 347	83 589	96 859	99 310	100 004	102 824
8. Services	20 086	131 796	259 505	310 752	350 866	358 518	365 218	376 253
9. Personal consumption	7 699	82 718	148 611	185 696	215 222	222 923	228 444	236 500
10. Leasing	22	730	1 261	2 160	2 341	2 380	2 380	2 380
<b>Total</b>	<b>156 865</b>	<b>1 072 095</b>	<b>1 953 520</b>	<b>2 429 093</b>	<b>2 725 923</b>	<b>2 812 045</b>	<b>2 881 820</b>	<b>2 961 244</b>

The quality of debt restructuring in Thailand is satisfactory, judging from the relatively low rate of non-performing loan re-entry. As of December 2003, there were only four cases of re-entries out of the top 25 debtors in the CDRAC's restructuring process as all debtors eligible for the process must pass business viability criteria.

## 9) *Recent measures for debt restructuring*

In addition to the government's extension of debt-restructuring benefits, the Bank of Thailand has also made some of the following regulatory modifications since 2002.

The Revenue Department has extended the exemption period for income tax, value-added tax, specific business tax and stamp duties, and the Land Department has also extended the reduction of the registration fee of real estate and buildings to 0.01% for cases that have been restructured in compliance with the BOT guidelines until the end of 2003.

The BOT has modified its guidelines that concern debt restructuring and supervision of financial institutions in order to create a more uniform debt restructuring effort throughout the financial system. For example, commercial banks are now allowed to hold more than 10% of the shares of a debtor's company until 31 December 2003. Commercial banks are allowed to sell real estate that was transferred into their possession between 1 January 1997 and 31 December 2003 that was in their possession for less than five years, or was in their possession for five years but can be sold for more than the minimum requirement. Commercial banks are also allowed to conduct rent and leasing activities involved in debt restructuring up until 31 December 2003.

Authorities and the private sector will continue to work together to resolve the remaining NPLs in the financial sector. The Bank of Thailand is working on the Financial Sector Master Plan to create a blueprint for a competitive financial system. Companies are regaining health through concrete and steady reforms. Meanwhile, sound monetary and fiscal policies, and a positive economic outlook, sustain the continued corporate and financial sector reforms.

## 10) *Legal reforms*<sup>6</sup>

### *Bankruptcy laws*

The Thai Government made major amendments to the country's bankruptcy law, including those that would allow for the rehabilitation of struggling businesses. The appropriate legal framework for the new Thai bankruptcy law was designed to be in line with international best practices. Bankruptcy policies from other countries were studied, including the UK Insolvency Act of 1986, the Singapore Organisation Law and the renowned Chapter 11 of the United States Bankruptcy Code. The amendments to the Thai Bankruptcy Act would prove to be practicable in the Thai business context.

Thailand's House of Representatives and Senate approved and adopted the long-awaited amendment to Thailand's 1940 Bankruptcy Act on 4 March 1998. The amendment became effective on 10 April 1998 in the form of the Bankruptcy Act Amendment No. 4.

### *The 1998 Bankruptcy Act Amendment (Amendment No. 4)*

The 1998 Amendment adds a new chapter to the old act. Chapter 3/1, introduces alternative avenues for creditors to seek satisfaction of amounts owed to them. Of particular significance, the amendment is designed to rehabilitate a debtor's business and to render viable a distressed company while protecting the interests of the creditors. Under Section 94(2) of the old law, a party extending new loans to insolvent companies did so at its own risk during the known insolvency of the receiving

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<sup>6</sup> Adapted from *The Reform of Thai Bankruptcy Law in the Wake of the Asian Financial Crisis* by Karen Wong, Chiridacha Phunsunthorn, and Tiziana Sucharitkul.

company. This naturally was an impediment to the restructuring of viable businesses as it prevented institutions from lending funds to entities in need.

The amendment allows new creditors, such as those putting fresh funds into a cash-strapped company, to seek the right of repayment under the reorganisation plan by sending a letter to the planner or, by a repayment request with the receiver. This allows parties to inject new capital into ailing businesses without the fear that they will be denied the opportunity to recoup their investment.

*The 1999 Bankruptcy Act Amendment (Amendment No. 5)*

To further refine and strengthen the 1998 amendment, the Parliament passed the Bankruptcy Act Amendment No. 5, in March 1999. This amendment also addressed the issue of the exemption of guarantors of debts from bankruptcy suits. In Thailand, individuals often give personal guarantees to lenders as a security. Such guarantees act as a check against poor corporate management, lack of accounting standards, and the improper channelling of funds by insiders. The immunity from bankruptcy of personal guarantors conflicted with international business standards and was successfully removed in the 1999 amendment.

Another issue of contention under the 1940 Act concerned the time period after which the obligations of a bankrupt person would be discharged. Originally, under the old law, the period was ten years. A compromise was reached and is currently reflected in Section 35 of the 1999 Bankruptcy Act Amendment, which shortens the time period from ten to three years on the condition that the bankrupt person is not guilty of any misconduct or fraud contributing to his insolvency.

The 1999 amendment also introduced a mechanism for the classification of creditors. Classes of creditors are set up according to the percentage of debt owed. Each class has equal rights, as the plan must be approved by a special resolution (being at least 75% in value and 50% in number) passed by one or more groups of creditors holding at least 50% of the debts in value of creditors voting on the resolution.

There are three types of creditors who are automatically deemed to accept the plan and who are therefore excluded from the classification. They are 1) creditors who are to be repaid within 15 days of the plan, 2) creditors who receive payments under existing contracts, and 3) subordinated creditors.

Furthermore, the 1999 amendment increased the amount of debt required before a bankruptcy proceeding could be initiated against a debtor. The 1998 amendment had raised the amount to 50 000 baht for a natural person and to 500 000 baht for a legal entity. Section 9 of Amendment No. 5, however, further increased the amount to 1 000 000 baht for an individual and 2 000 000 baht for a legal entity.

The 1999 amendment also extends the definition of acts that the court can set aside as acts committed which represent undue preferences. Acts, such as debtors' transfers of assets made within three months before or after a filing of a petition for adjudication of bankruptcy, are deemed to be undue preferences; a one-year rule is implemented for "insiders of the debtors". Thus, if the transferee of a debtor's assets is an "advantaged creditor" (an advantaged creditor includes directors, managers, partners, and shareholders owning more than 5% of the shares, and their spouses and minor children, and juristic persons holding more than 30% of the equity), the court can cancel a transfer done one year before the application for bankruptcy. Section 115 reads in part "[I]f any advantageous creditor is an insider of the debtor, the court is empowered to order the cancellation of the transfer or any act done under paragraph one which had been committed between the period of one year before the

application for adjudication of bankruptcy and thereafter.” Section 114 also allows transfers at below market value to be set aside.

Furthermore, fraudulent transactions may also be set aside pursuant to Section 237 of the Thai Civil and Commercial Code which reads, in part, that a “...creditor is entitled to claim cancellation by the Court of any juristic act done by the debtor with knowledge that it would prejudice his creditor; but this does not apply if the person enriched by such act did not know, at the time of the act, of the facts which would make it prejudicial to the creditor, provided, however, that in case of a gratuitous act the knowledge on the part of the debtor alone is sufficient.”

#### *Establishment of the Bankruptcy Court*

The reorganisation of a debtor company is a court-supervised matter whereby the court oversees the entire restructuring of the business of the distressed entity. From the beginning of the procedure until the very end, the court makes inquiries and issues orders. In light of the lack of case law in this field, Thailand established a court specifically to hear bankruptcy cases.

The Act Establishing the Bankruptcy Court and Bankruptcy Case Procedure was passed on 18 June 1999. The act creates a Central Bankruptcy Court for the Bangkok metropolitan area as well as Area Bankruptcy Courts. It also sets out the procedures to be followed in the handling of such cases, mandates the appointment of judges, allows the Central Bankruptcy Court limited authority to develop some of its procedures, and provides for provisions to deal with existing cases that arose prior to the establishment of the court. As bankruptcy cases differ in essence from general civil cases, and as such cases affect the economy as a whole, the creation of a forum in which cases are heard by judges with special knowledge of business and financial matters was welcomed. In addition to offering judges with specialised experience and training in the areas of law concerned, specialists may also be called upon to comment on matters of the case.

Another advantage presented by the Act Establishing the Bankruptcy Court and Bankruptcy Case Procedure is that hearings of bankruptcy cases are now expedited. Previously, only one trial date was set for each case per month. This resulted in cases being prolonged for months or years, generating excessive costs for creditors and encouraging debtors to avoid paying off their debts as they realised that the time frame worked to their advantage. Currently, cases concerning the reorganisation of businesses are required to be heard continuously on a daily basis until completion, and the court avoids postponing hearings. This has resulted in cases being completed within one month of the date of filing. Cases have also been expedited because writs or notice of summons may now be served by mail and no longer have to be physically presented to defendants.

#### *Foreclosure laws*

In line with the amendment to the Bankruptcy Act and the establishment of the Bankruptcy Court, new foreclosure laws have also been passed. The new laws will allow most foreclosure cases to be completed within a 12 to 18 month period. Apart from giving the courts discretionary power to deny appeals based on delaying tactics, the laws also direct that “non-complicated cases” be heard continuously every day until judgment is rendered. This is in contrast to the old law under which cases could be extended for months. Moreover, the execution process, which follows the foreclosure adjudication, has also been shortened due to the fact that there can only be one objection to a bid price at an auction and that, if the price at the second auction is close to the one offered at the first auction, the property must be sold. Previously, the process could be prolonged, as anyone was allowed to object to a bid price at the auction. In addition to such new elements of the law, the expansion of the Courts of Appeal will also allow for faster processing if foreclosure cases are taken to the appeal stage.

## ***11) Conclusions***

The debt restructuring efforts of financial institutions together with the insolvency process and legal reforms in Thailand have all contributed to a lowering of the NPL levels over the past several years. It is further expected that the level of NPLs that have been restructured and are in the process of repayment and non-performing loans in the Court Process and the Legal Execution Process will further be reduced. With the continued legal reforms and the joint effort of all the parties involved, it is expected that NPLs will continually decline, reaching a level of 10% of total credits in the system by the end of 2004. In addition, it is further expected that the steady growth of the economy, supportive measures (for instance, the amendment of the law to allow Asset Management Corporations to buy non-performing assets from financial institutions, the amendment of the Civil and Bankruptcy laws to support debt restructuring), as well as continued restructuring efforts will lead the ratio of non-performing loans relative to total credits to a more normal single-digit level by the end of 2005.

Italy

**Italian Banks' Workout Activity: Costs, Timing and Recovery Rates**

*by*

*Pierpaolo Grippa, S. Iannotti and Fabrizio Leandri<sup>1</sup>*

***Abstract***

The results of a survey on loan recovery activity of Italian banks that are presented in this paper provide insight into recovery rates, timing and costs of workout procedures. Evidence is found that banks respond to lengthy court procedures by increasing the use of private agreements with debtors before engaging in legal actions. The average duration of the recovery process remains, nevertheless, long enough to cause a substantial impact on the amount recovered net of recovery costs. Some other factors, such as collateral or personal guarantees, have a significant impact on recovery rates whose high dispersion is likely to depend more on hard-to-identify idiosyncratic factors.

***1) Introduction and synthesis of main results<sup>2</sup>***

The loan recovery process is a significant step in credit activity. Recovery rates together with the costs of managing non-performing loans have a significant impact on banks' economic outputs.

The estimated loss rate in case of debtor's insolvency is a key element for the assessment of the expected loss in a bank's loan portfolio, and also allows banks to calculate capital requirements for credit risk by using internal estimates of the default rate and of the amount recovered in case of default.

To this end, a profound knowledge is required both of data on the duration and outputs of the recovery activity, and of the organisational procedures used for credit recovery and management.

Following these considerations, a survey was carried out among banks aimed at collecting information on both qualitative and quantitative aspects, the first relevant to the management of non performing loans,<sup>3</sup> the latter relevant to costs, timing and percentages of credit recovery<sup>4</sup>.

The main findings are as follows:

- As far as recovery channels are concerned, there is a predominance of private agreements (41% of non-performing loans closed in 1999), followed by bankruptcy procedures and foreclosure (10%);

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<sup>1</sup> Bank of Italy, Financial and Credit Supervision Area. The authors' opinions cannot be attributed to the Bank of Italy.

<sup>2</sup> Some of the preliminary results have been reported in the Supervision Bulletin of December 2001, which can be found on the Bank of Italy's website : [www.bancaditalia.it](http://www.bancaditalia.it).

<sup>3</sup> The positions considered are so-called "sofferenze". In this sense, the definition of default is narrower than the one proposed by the Basle Committee on Banking Supervision for capital requirements on credit risk under the New Capital Accord; specifically, (90 day or 180 day) past-due and "incagli" are not considered.

<sup>4</sup> The quantitative estimate referred to credit positions towards resident customers which were non-performing as by 31 December 1998, and which were entirely cancelled by 1999.

- Recovery length varies according to the type of procedure and the geographical area: ranging from six to seven years for bankruptcy procedures and legal compositions to around two years for private agreements. Foreclosures are lengthier than recoveries based on pledged securities. Both are lengthier in the centre and south of Italy than in the north;
- The cost of personnel engaged in recovery activities adds up to 1% of overall operational costs, while the costs of external professional services are 1.3% in terms of nominal value of non-performing loans; the average annual cost of recovery activity has been estimated to be 1.2% of the nominal value of non-performing loans.
- For all the defaulted positions settled by 1999, the average recovery was 37%; there was considerable dispersion of recovery rates among banks;
- An inverse relationship between timing and recovered amount was observed; in particular shorter procedures such as private agreements entail higher recovery rates;
- Recovery rates are usually lower for loans to enterprises than for loans to consumer families whose mean recovery rate is in line with the overall average, while higher rates were recorded in the case of producer families.

This paper is organised according to the following sections: After a short summary of the main empirical evidence at an international level; the characteristics of the sample used for estimation; and finally the methodology followed in the work.

In the last two chapters of this paper, the costs faced by banks and the outputs of recovery procedures are examined.

## 2) *Literature*

With the exception of early surveys on commercial and industrial credit (Eales and Bosworth, 1998 and Citibank, 1998), empirical studies on recovery rates have been mainly concerned with syndicated loans and bonds issued by large corporations and placed either in private or public form. Most of the studies on rated bonds were carried out by US ratings agencies and referred to large mainly US corporations. In 1994, the Bank of Italy carried out an analysis of loan recovery among Italian banks<sup>5</sup>.

For recovery rate definition, three methodologies have been generally followed: the first one considers the price of bonds after default as a proxy for the amount recovered. For most of the investors, this price coincides with the percentage recovered, as they generally do not wish to hold bonds that do not produce interest for the whole restructuring procedure. Moreover, the bid price of each defaulted bond can provide a quicker recovery estimate (roughly 15 to 60 days after default in the US market) as compared to the lengthiness of restructuring /liquidation procedures of usually 1.75 years. (See Table 1).

The second methodology refers to cash flows obtained by investors within the recovery procedure. The procedure may be aimed at reorganising and restructuring debt. In this case, other bonds are offered to investors. Even in this case, the definition of recovery is linked with a market price - the one of new bonds offered to investors during the restructuring process.<sup>6</sup>

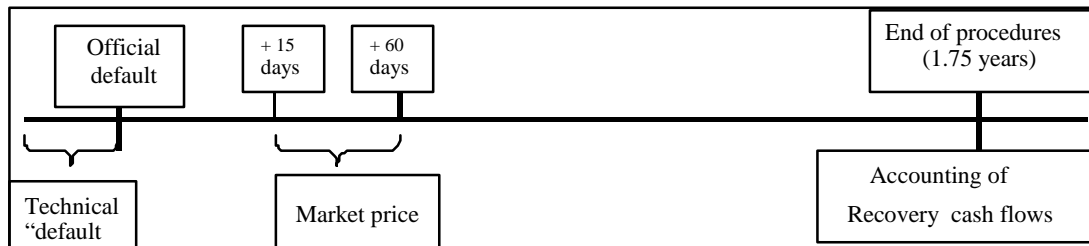
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<sup>5</sup> The results of the analysis can be found in A. Generale and G. Gobbi (1996)

<sup>6</sup> In such cases, there are investors (vulture investors) that purchase default bonds with the aim of obtaining them at a lower price than the cash value they expect from liquidation.



**Table 1: Timing and definition of recovery (typical for US firms' bonds and loans)**



Alternatively, the default can be settled by liquidating the firm's assets and by distributing the amounts recovered to creditors. In this case, the recovery corresponds to the cash flows deriving from the different forms of credit. This third methodology, which refers to effective recovery obtained between the default time and the position closing, fits better the calculation of recovery rates for small credits that have no market quotation, since they are not placed either in private or public form.

The recovery rates examined in the different US surveys vary according to the reference period, the asset typology, the definition of default, the definition of recovery and the kind of procedure used in case of failure. Generally, we can see that the recovery rate is higher for loans than for bonds and increases with the bond's absolute seniority. Another important factor is relative seniority *i.e.*, the bond position within the firm's liabilities. The presence of loans that are junior with respect to defaulted bonds (debt cushion) causes higher recoveries and lower dispersion linked with recovery. As a matter of fact, apart from the subordinate activity, all recovery rates show a very high dispersion, with peaks on highest or lowest values. Besides, the recovery rate varies according to the presence of guarantees and to the kind of collateralisation; recovery increases and dispersion at the mean rate value decreases as the liquidity of collaterals increases.

Several studies point out that for recovery rates to be explained, one should consider the idiosyncratic aspects of each industry in default and the individual experience of recovery. In fact, the analysis of the aggregated recovery rate (Merrill Lynch, 2000) revealed that, apart from an effect linked with the trend of the basic economic cycle with the lowest rates recorded just before downturns, there are no elements that can explain all the variations observed, either individually or generally.

One of the most important factors underlined by the latest surveys (Altman and others, 2001) is the availability of defaulted bonds or the relative composition of defaulted bonds over a given year according to degree of seniority. In fact, these surveys generally use market price to define the recovery rate; a determinant factor is the quantity of defaulted bonds offered with respect to the demand coming from specialised investors. As a consequence, a link has been observed between recovery and default rates, since the number of insolvent companies determines the number of defaulted bonds available in the market.

As far as recovery rate estimates are concerned, Moody's ratings service has developed a new model. The model is called Loss Calc and uses information on the instrument, the industry's capital framework, the sector it belongs to and the economic cycle. The econometric model and its coefficients are not disclosed. However, among the different factors analysed, the main contribution to recovery rate forecasting is associated, according to the authors, with the kind of debt and the degree of seniority of the instrument.

### 3) *The sample characteristics and the methodological aspects*

The number of banks participating in the survey on recovery rates is high, both in terms of quantity and representation of the Italian whole banking system: 253 banks, representing 90% of total domestic loans by the end of 1999.

The questionnaire was composed of three sections: the first was concerned with organisational aspects, the second with credit recovery procedures (recovery channels); the third asked for analytical data on individual positions.

Particular attention was focused on the financial aspect, *i.e.* the capitalisation of intermediate cash flows between the default and the definite closure of the position. This is particularly important, considering the lengthiness of recovery procedures.

#### *Channels for credit recovery*

The second section of the survey questionnaire was aimed at measuring average recovery rates and the length of procedures according to the channel chosen for credit recovery.

#### *Frequency of procedures*

Data relevant to procedures employed, ordered by total amounts of closed positions, show the predominance of private agreements (41% of closed defaulted positions) followed by bankruptcy procedures (21%) and foreclosure (10%); among other procedures there are legal compositions, credit transfers and securitisations.

#### *Average use of recovery channels*

When differentiating between procedures according to the mean value of positions, one can observe higher values for legal compositions, (mean value: 221 000 euros) and for bankruptcy procedures and securitisations (both summing to around 200 000 euros); foreclosure is used for lower amounts (74 000 euros) just like private agreements (50 000 euros) and procedures based on pledged securities (21 000 euros) (See Table 2).

**Table 2: Use of recovery channels and mean value of positions**

<b>Recovery Channel</b>	<b>% use of the procedure</b>	<b>Mean value of position (000's Euros)</b>
Based on pledged securities	3	21
Foreclosure	10	74
Legal compositions	5	221
Bankruptcy procedures	21	203
Private agreements	41	50
Credit transfer	5	17
Credit Stock transfer	2	150
Securitisation	5	204
Other	8	37

#### 4) *Procedure length and recovery duration*

The questionnaire required two kinds of information on recovery length:

- average duration, in months, of the different procedures, from beginning to conclusion, according to the debtor's geographical area;
- duration of positions, from the passage to non-performing status up to their conclusion.

As a consequence, two different durations could be applied to the same position, where the first one (duration of the single procedure employed, or of the predominant one) could not be higher than the second one (time from default to closure).

##### a) *Procedure length*

There are different recovery lengths, according to the kind of procedure and the geographical area. They range from 6 to 7 years for bankruptcy procedures and legal compositions to about two years for private agreements. Foreclosure is lengthier than procedures based on pledged securities; both are longer in the middle and south of the country than in the north (ranging from 7 years in the south to 5.3 years in the north for foreclosure; from 3 years in the south and 2.3 years in the north-east for recoveries based on pledged securities) (See Table 3).

**Table 3: Time of recovery procedures (in years)**

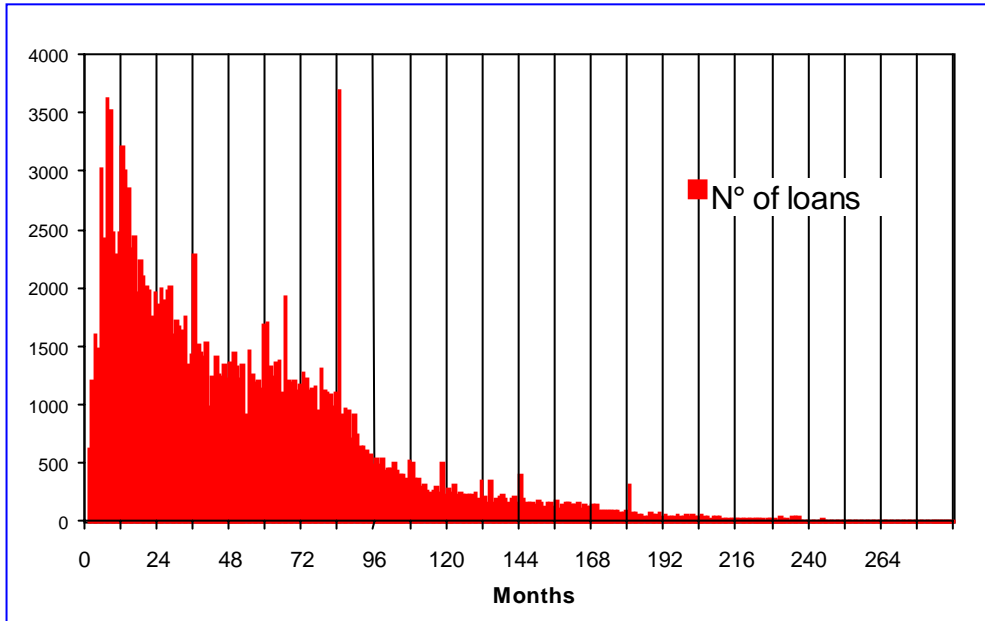
	Northwest	Northeast	Central Italy	South-Islands	Italy
Based on pledged securities	2.8	2.3	2.6	3.1	2.8
Foreclosure	5.8	5.3	6.6	7.1	6.3
Legal Compositions	7.4	6.0	6.2	5.4	6.2
Bankruptcy procedures	6.4	6.0	7.3	7.3	6.8
Private agreements	2.3	2.0	2.4	2.3	2.1

##### b) *Duration of positions*

For each position, a duration has been calculated, in months, representing time between default and closure. Consistent with the evidence on procedure length, there is a long-lasting durability of defaulted positions in banks' portfolio before their definite closing.

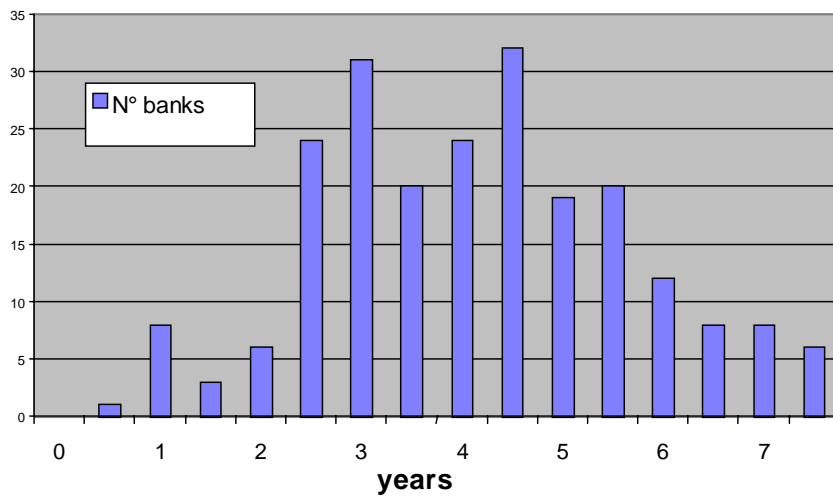
However, though closing time is often quite long (4.5 years on average), half of the positions are closed in a shorter period (3.5 years is the median value) (See Illustration 1).

**Illustration 1: Duration of positions**



The average duration of positions shows a considerable dispersion among banks.

**Illustration 2: Distribution of positions' average duration per bank**

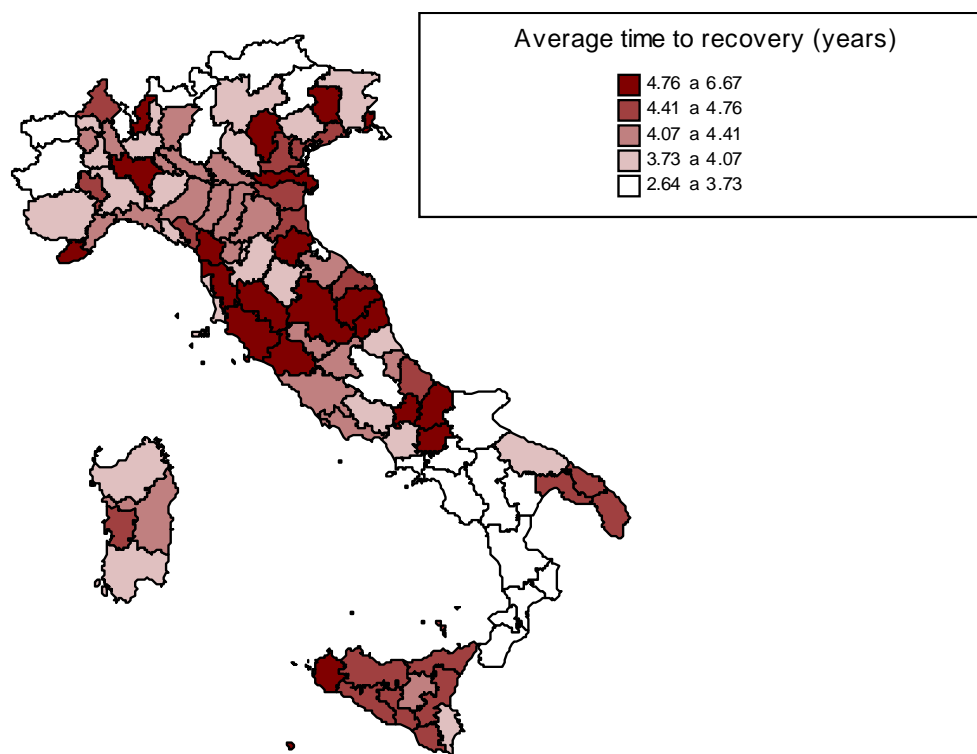


For around a fifth of banks, the average duration of positions is lower than 2.5 years, while for another 15% it is higher than 5.2 years.

The recovery duration also shows a considerable geographic dispersion, with generally lower time of recovery in the south. (See Illustration 3). This evidence, in contrast with the one on procedure length for geographical area, can be explained by a “composition” effect, *i.e.*, a more frequent use of private agreements (more rapid than legal procedures) with southern counterparts.

The dispersion observed among the different provinces within their specific areas could also reflect specific factors inherent in the local area, such as the efficiency of individual courts.

**Illustration 3: Average duration of positions per province (in years)**



### 5) *Costs of workout activity*

Loan recovery activity is a crucial moment in the whole credit management process, due primarily to the costs involved. Information investments, organisational solutions (in particular the choice of outsourcing) and the technologies used, affect effectiveness and efficiency in terms of timeliness and recovery rates.

The survey analysed both the costs of the personnel involved in recovery activities and the costs of external professional services.

After excluding from the database those banks that, due to few managed positions and/or resources employed, are not fully representative of the population under study, it appears that the expenses for personnel engaged in credit recovery affect operational costs by 1%, whereas the costs of external professional services by 1.3%, for a total of about 2.3%.

Dispersion among banks is considerable, as shown by the data per size category and geographical area of banks. In particular, recovery costs are higher, on average, for small banks and southern banks. (See Tables 4-5).

**Table 4: How recovery activity costs affect total operational costs: (%) by bank geographical area**

<b>Northwest</b>	1.78
<b>Northeast</b>	1.80
<b>Centre</b>	2.69
<b>South</b>	5.34
<b>Islands</b>	3.14
<b>ITALY</b>	2.25

**Table 5: How recovery activity costs affect total operational costs: (%) by bank size**

<b>Major banks</b>	1.84
<b>Large banks</b>	2.38
<b>Medium banks</b>	2.36
<b>Small banks</b>	2.29
<b>Minor banks</b>	3.42
<b>ITALY</b>	2.25

In terms of value of defaulted loans, the recovery activity causes an annual average cost of around 1.2 euros per 100 of nominal value.

The evidence that small banks generally have higher expenses for credit recovery suggests the existence of a functional link between average costs, quantity and amount of positions.

As a consequence, based on available data, a function has been estimated where the costs (both external and internal) of the recovery activity carried out by each bank during 1999 depend on the number and amount of total defaulted loans (1999 average totals) in a Cobb-Douglas type of relationship.

$$CR = \alpha \cdot SOFF^{\beta} \cdot N^{\gamma}$$

The regression was done on the logarithms of the variables:

$$\ln CR = \ln(\alpha) + \beta \cdot \ln(SOFF) + \gamma \cdot \ln(N) + \varepsilon$$

The regression, carried out on 207 observations, generated significant results both in terms of goodness of fit (corrected  $R^2 = 88\%$ ; F-statistic = 759.66) and of sign, statistical significance and economic relevance of coefficients:

**Table 6: Outcome of the regression**

	<b>Coefficients</b>	<b>T</b>
<b>Ln (<math>\hat{\alpha}</math>)</b>	4.83	9.10
$\beta$	0.31	6.83
$\gamma$	0.53	1.70

Results point out that unit costs are:

- increasing, with decreasing rates, with respect to the mean value of positions.
- decreasing, with decreasing rates, when the number of positions increases.

Finally, once verified that the sum of the elements of the two explanatory variables is considerably lower than 1, it can be argued that some scale economies are present in the credit recovery activity. An equal percentage increase in the number of defaults and in their total amount (such as to keep the mean value of positions constant) causes a less than proportional increase in the unit cost of recovery.

#### **6) Recovery rates**

In the survey, banks were asked to provide analytical data on individual loans settled during 1999, based on some classification variables (sector of economic activity, geographical area, collateral, etc.).

For all the defaulted loans, the average recovery percentage was 37%<sup>7</sup>. However, the dispersion of recovery rates among banks and within individual banks remains considerable, with particular emphasis on the effect of recovery duration, size of loans, collateralisation degree and the kind of procedure employed.

As far as recovered positions are concerned, one can observe that recovery rates are decreasing with respect to the loan amount from an average of 39% for exposures lower than 75 000 euros up to 23% for defaults higher than 500 000 euros.

Evidence on the link between recovery rates and collateral can be found only for those banks providing data on the quota of positions backed by qualified collateral.

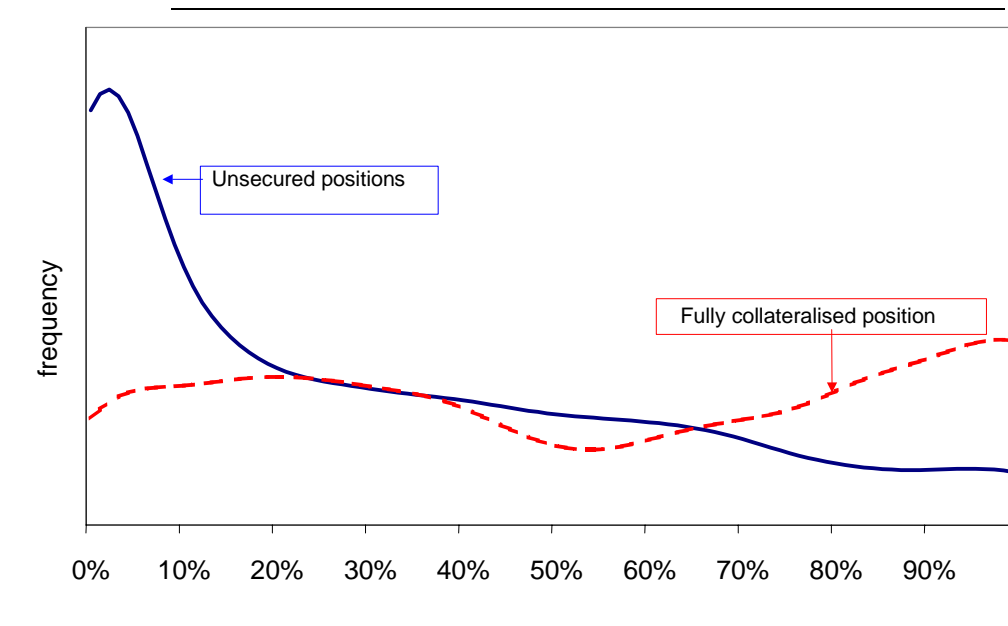
Fully collateralised positions make it possible to reach an average recovery rate of 70%. For non-collateralised positions, the average financial recovery rate is 32%. Moreover, dispersion around these values is quite high.

For a clearer understanding of the characteristics of both collateralised and non-collateralised recovery rates, the frequency distributions of recovery rates in both cases were reproduced through a non-parametric technique (Kernel estimates) (See Illustration 4). The graphic representations confirm the high dispersion of distributions, especially in the case of full collateralisation which is bimodal (with a local peak of 20% and a global peak of near 100%), but not so different from a uniform distribution.

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<sup>7</sup> The low figure for recovery rates is also a consequence of the narrow definition employed (that of “sofferenze,” *i.e.* non-performing loans). The survey did not concern “incagli” and 90-day or 180-day past-dues that, especially in the case of the latter, represent a “softer” version of default (*i.e.* with much lower expected loss rates).

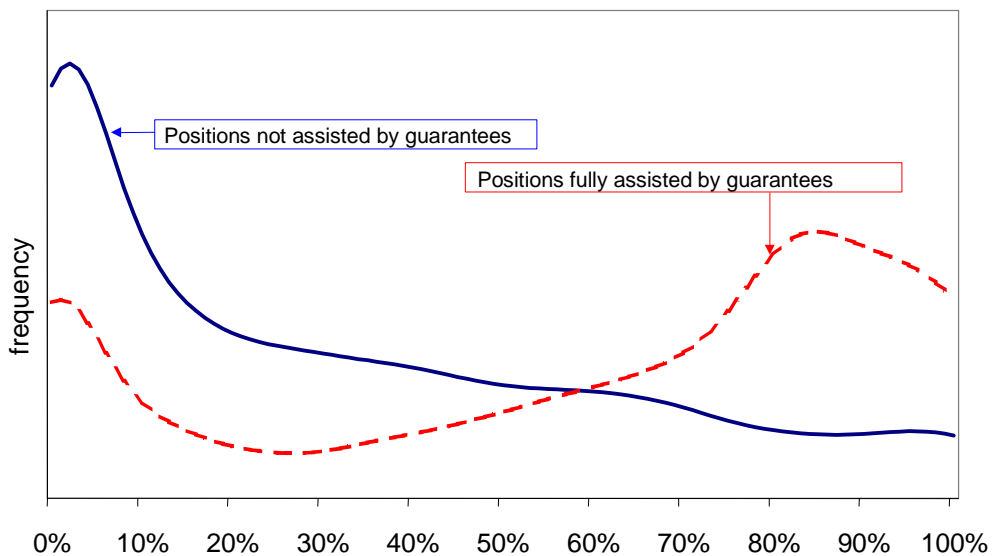
**Illustration 4: Frequency distribution of recovery rates according to the presence/absence of collateral**



In the absence of collateral, the distribution of recovery rates has a more regular shape with a peak next to zero and a (monotonous) decreasing trend.

Similar conclusions can be drawn from the analysis of the frequency distributions of recovery rates both for non-guaranteed positions and for fully-guaranteed ones. (See Illustration 5). Non-guaranteed positions are characterised by a one-way distribution concentrated on low recovery rates, whereas fully-guaranteed ones show a peak near 0% and a second peak near 90%.

**Illustration 5: Frequency distribution of recovery rates according to the presence/absence of guarantees**





### *Recovery rates and channels employed*

The analysis carried out based on the channel employed shows an inverse relation between time and recovery rates. In particular, shorter procedures, such as private agreements, entail higher recovery rates. (See Table 7).

**Table 7: Recovery rates per channel employed**

<b>Recovery Channel</b>	<b>Duration (Years)</b>	<b>Average Recovery Rate</b>
<b>Based on pledged securities</b>	2.8	44%
<b>Foreclosure</b>	6.3	57%
<b>Legal compositions</b>	6.2	36%
<b>Bankruptcy procedures</b>	6.8	27%
<b>Private agreements</b>	2.1	68%

Recovery rates on bankruptcy procedures and legal compositions are the highest (27% and 36% respectively).

In the case of sale of defaulted loans, (transfer and/or securitisations) recovery rates are usually lower. Particularly, in the case of credit transfer, recovery percentages are lower than 30%. This instrument is employed mainly for smaller positions, for which “saving” is crucial, especially in terms of a bank’s ability to reduce its running costs, often by transferring a high number of non-collateralised positions.

For higher amounts, credit stock transfers and securitisations seem to be more common. Particularly for securitisations, the recovery rate (calculated as the price of transfer as of the date of default and as a proportion of the original nominal value of the position) is slightly over 30%. (See Table 8).

**Table 8: Recovery rates and mean value of positions for credit transfer and securitisations**

<b>Recovery Channel</b>	<b>Recovery Rate</b>	<b>Mean Value of Positions (000s Euros)</b>
<b>Credit transfer</b>	29	17
<b>Credit stock transfer</b>	27	150
<b>Securitisation</b>	32	204

### *Recovery rates and debtor’s characteristics*

Recovery rates are usually lower for industries (33%) than for consumer families, that show percentages in line with the mean data (36%). Higher rates can be recorded for producer families, where the percentage is over 40%.

However, such a result varies according to the geographical area. In particular, in the south and centre of the country, the industry recovery rate is higher than the one relevant to consumer families. On the other hand, in the north of Italy, one can observe higher rates for consumer families than for industries and producer families (See Table 9).

**Table 9: Recovery quotas per sector and geographical area**

Area	Firms	Producing families	Consumer families
Northwest	28.81%	31.77%	35.44%
Northeast	31.61%	34.68%	38.96%
Centre	32.81%	27.60%	29.42%
South	45.38%	44.63%	34.73%
Islands	38.32%	31.19%	24.65%

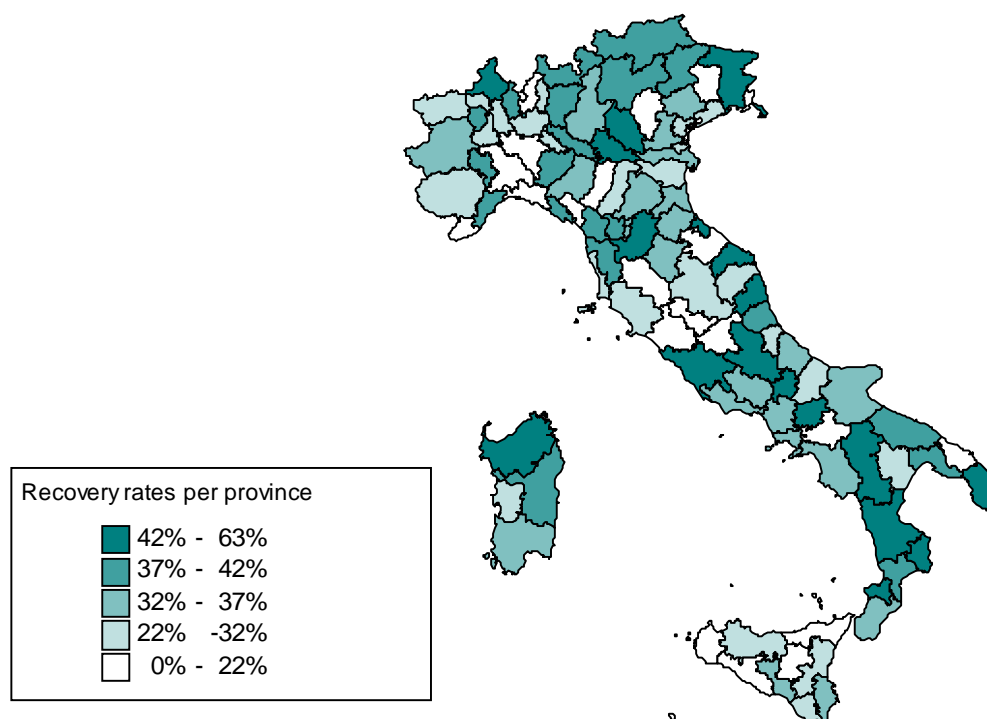
The best overall result in the south is linked with shorter recovery duration, smaller size of positions and higher collateralisation.

As far as the first aspect is concerned, shorter recovery duration in the south derives from a more frequent use of private agreements which, as explained before, have a shorter duration if compared to legal procedures.

As far as position size is concerned, it is observed that there is a higher concentration of small positions in the south and in the islands, which, as shown, entail higher recovery rates.

Finally, as far as collateral is concerned, within the sample analysed, collateralisation seems to be higher for loans to southern counterparts (21% compared to 14.6% at a national level). The need for higher collateralisation reflects the potential higher riskiness of southern customers. It should be noticed that, within the geographical areas considered, there is a certain dispersion of recovery rates, with significant differences among provinces.

**Table 10: Recovery rates per province**



## 7) Multivariate analysis

In order to estimate the combined effect of the different factors on recovery rates, a regression analysis on the sub-sample of banks, providing the complete range of information required, has been carried out, focusing particularly on qualified collateralisation. Though it cannot be considered fully representative of the whole dataset, the sub-sample is composed of more than 22 000 positions reported by 50 banks.

In the econometric estimate, the recovery rate was linked with the following variables:

- existence of collateral or guarantees;
- size of loans;
- geographical dummies;
- sector dummies (institutional sector and economic area of the counterpart)
- individual (*i.e.* bank-specific) variables and dummies (defaulted loans as a percentage of total loans, quota of external costs on the total costs of the recovery activity, use of private agreements, number of defaults per employee, short/long-term bank dummy, dummy for participation in a banking group).

After discarding insignificant variables, the estimate is as follows:

**Table 11: Regression outcome (dependent variable: recovery rate)**

	<b>Coefficients</b>	<b>T</b>
<b>Constant term</b>	44.16%	35.934
<b>Percent Collateralised</b>	22.40%	25.792
<b>Percent Guaranteed</b>	12.31%	8.446
<b>Log (original amount) (#)</b>	-4.26%	-26.092
<b>Industrial dummy</b>	-8.35%	-15.988
<b>Agricultural dummy</b>	14.87%	9.857
<b>North-Western dummy</b>	4.13%	8.166
<b>Southern dummy</b>	17.915	16.645
<b>Percent external costs on recovery total costs</b>	-10.40%	-5.918
<b>Percent use of private agreements</b>	34.88%	22.147

Note: when collaterals/guarantees are larger than the loan, the secured/guaranteed percentage is conventionally set at 100%. – (#), the logarithm of the loan amount at the moment of default, capitalised up to closure of the position. – (\$), short-term collection (0) or long/medium-term banks (1).

The econometric estimate leads to the following observations:

- the presence of collateral/guarantees has a strong positive effect on the recovery capacity, which is stronger in the case of collateral;
- there is still an inverse relation between the position size and the recovery intensity;
- defaults towards firms determine lower rates, *coeteris paribus*;
- on the basis of geographical location, higher recoveries can be obtained in the north east and, above all, in the southern regions;
- resorting to external counterparts in the recovery activity is not so profitable. The survey shows an inverse relation between recovery rates and the quota of external costs on the total costs of the recovery activity;
- the banks, which generally prefer private agreements, obtain better results as which can be expected.

The regression is significant overall, but has low explanatory power (corrected  $R^2 = 23.32\%$ ), which is typical of surveys on recovery rates. High variability of recovery rates seems to be linked mainly with idiosyncratic factors. In fact, the level of detail of the surveys is still insufficient to satisfactorily explain the observed dispersion.

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## Japan

### Inauguration and First Stage of the Industrial Revitalisation Corporation of Japan

by

*Professor Dr. Shinjiro Takagi<sup>1</sup>*

The Japanese economy has been in a slump for 13 years. To spur its economic recovery, Japan has enacted a series of legislation meant to rehabilitate struggling companies, such as the Financial Revitalisation Law, the Industrial Revitalisation Law, the Civil Rehabilitation Law, the Corporate Reorganisation Reform Law, the Special Law for Reorganisation of Financial Institutions and laws for the Recognition and Assistance of Foreign Insolvency Proceedings. In addition, the Guidelines for Multi-Creditors Out of Court Workout were established, referring to the International Federation of Insolvency Professionals' (INSOL) eight Principles. Now Japan boasts one of the most extensive legal systems for corporate rehabilitation in the world. Nevertheless, the country is still in a long and intractable recession. Under these circumstances, the Industrial Revitalisation Corporation of Japan (IRCJ) was established in May 2003 as one of the last resorts to recover Japanese economic prosperity.

#### **1) Outline of the IRCJ as defined in the Basic Policy**

The Comprehensive Measures to Accelerate Reforms proposed that the IRCJ be established as a key part of a plan to aggressively rehabilitate companies and industries, and accelerate non-performing loan (NPL) disposal with the aim of cutting NPLs by half within two years. The Basic Policy (BP) was adopted on this basis, and defines the IRCJ and its operational policies as follows:

- a) The IRCJ will act as a neutral intermediary in helping companies with excessive debt reorganise themselves when the company is viable but conflicts of interests prevent the company and creditors from agreeing on a rehabilitation plan.
- b) The IRCJ will intercede in matters that should be resolved by private entities. Therefore, the IRCJ should utilise private initiative as much as possible, promote the development and expansion of loan credit markets and securitisation, and foster a market for corporate recovery funds.
- c) The IRCJ shall not attempt to prolong a hopeless company's life. It will help regroup industries with overcapacity in co-operation with governing ministries and agencies and by using the amended Industrial Revitalisation Law if necessary.
- d) The IRCJ will be financed by government-guaranteed loans. It will be incorporated as a joint-stock company, allowing the government's involvement in setting criteria for financial support and choosing executive directors.
- e) The IRCJ will give support to companies classified as "borrowers requiring attention" (including "special attention" and "doubtful" debtors considered capable of rehabilitation). The IRCJ will purchase the loan obligations from the debtor's non-main banks and draw up a reorganisation plan in co-operation with the main bank and the debtor company if the IRCJ

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<sup>1</sup> This report was written before the author's appointment as a chair of the IRC Commission in early May 2003. It reflects his personal views only, and is in no way intended as the official view of the IRCJ.

determines that more loans can be collected by reorganising the company than by liquidating it and the reorganisation plan agreed on by the main bank and the debtor company is considered feasible.

- f) In preparing a reorganisation plan, the IRCJ will ask for assistance from private sector experts in corporate restructuring. It will also use statutory procedures for corporate rehabilitation such as the Civil Rehabilitation Law and Corporate Reorganisation Law.
- g) Debt-to-equity swaps and DIP financing by government-affiliated financial institutions will be used. The IRCJ will be able to give additional loans, inject capital, form trusts and give guarantees to reorganising and reorganised corporations.
- h) The IRCJ will concentrate its purchase of NPLs in the first two years and sell the purchased NPLs and equities acquired via debt-to-equity swap within its five-year life span. In doing so, the IRCJ will strive to minimise the secondary losses taxpayers will ultimately bear.
- i) The IRCJ will set fair and transparent standards for the NPLs it purchases. NPLs will be purchased at a market value deemed fair, paying due consideration to the reorganisation plan. No NPLs should be purchased or sold without approval of the IRC Commission.
- j) A reorganisation plan must be completed within three years and include measures to improve the balance sheet and profitability of a debtor company so that the debtor company will be able to be re-financed by itself and the IRCJ will be able to sell the loans it purchased. In principle, a plan must set targets that meet the standards stipulated in the Industrial Revitalisation Law—standards of productivity enhancement and balance sheet restoration that are described below—for the debtor company to be approved for rehabilitation under the IRCJ scheme. The Industrial Revitalisation Law is to be amended concurrently with the adoption of the IRCJ Law. The IRCJ will apply criteria that are flexible, and be ready to make exceptions if the Commission believes there is good reason to do so.
- k) A reorganisation plan must include measures that enable a debtor company to achieve at least one of the following goals related to productivity improvement at the end of the planned three-year period or less:
  - 1. An increase in return on equity (ROE) of more than 2% (if a corporate recovery fund or other company buys the debtor company for the purpose of reorganising it, cash flow—adjusted return on assets (ROA)—must increase by more than 2%.)
  - 2. An increase in turnover ratio of tangible assets exceeding 5%.
  - 3. An increase in added value per employee exceeding 6%.
- l) Similarly, a reorganisation plan must include measures aimed at achieving all of the following targets of financial health by the end of the three-year period or less:
  - 1. Interest-bearing debt ten times less than the annual cash flow.
  - 2. Ordinary income that exceeds ordinary expenses.



## 2) *The IRCJ Law and the operations overview*

The IRCJ Law provides insight into the workings of the IRCJ. The main points can be summarised as follows:

- a) The IRCJ helps individual businesses with viable resources but excessive debt to reorganise by purchasing this debt from financial institutions, thereby ensuring that a healthy financial system is maintained through industrial revitalisation and bad-loan disposal.
- b) The IRCJ is a business corporation (K.K.) established by approval from the authorising ministers, which in this case are the prime minister, finance minister, and ministers of economy, trade and industry. These ministers must approve the IRCJ's executive appointments, budget plans, and financing (guaranteed by the government). They may use their supervisory positions to issue administrative orders requesting reports and inspections of the IRCJ's operations.
- c) The Industrial Revitalisation Commission (with a membership not to exceed seven and including three or more directors, two of whom must be a representative director and external director) determines whether to extend revitalisation support and makes decisions regarding the purchase and disposal of loans. Once a decision has been reached, the commission consults with the authorising ministers whereupon the ministers administering the relevant industries might make recommendations in light of the extent of the industry's overcapacity and relevant matters. The decision to extend support and purchase loans must meet the publicly disclosed criteria for support.
- d) Companies will apply for reorganisation support by submitting a business reorganisation plan to the IRCJ with their financial institutions (in general, the main bank or banks). Based on the Commission's conclusion, the IRCJ will move quickly to decide whether to support those plans deemed to have a high chance of success. Non-main banks and other financial institutions should decide whether to sell loan claims to the IRCJ (including loan trusts) or accede to the business reorganisation plan within the designated period of up to three months, and the IRCJ will generally request that these banks temporarily stay on debt collection during this period.
- e) The IRCJ will purchase the loans when these financial institutions request the purchase, or when the total sum of loans held by the financial institutions agreeing to the reorganisation plan meets the sum necessary for revitalisation (in the event that most financial institutions agreed to the purchase or agreed to the reorganisation plan). The purchase price will be the appropriate market value decided by the IRC Commission paying due consideration to the feasibility of the reorganisation plan. The decision to provide support will be retracted if revitalisation is not feasible due to the exclusion of financial institutions that do not apply for debt purchase or of financial institutions that hold large amounts of debt but do not agree to the reorganisation plan, thus preventing the plan from reaching the necessary debt sum.
- f) If financial institutions provide financing to the targeted company from the time the IRCJ decides to provide support to the time it decides to purchase debt, the super-priority claim of the DIP lender is noted in the reorganisation plan, and the financial institution can request that the IRCJ acknowledge the necessity and super-priority claim of this DIP financing. The company may start proceedings for civil rehabilitation or corporate reorganisation at a later point (before the IRCJ disposes of the purchased debt). Any unpaid DIP loans should be given priority in the reorganisation plans, which would be approved in the subsequent

rehabilitation or reorganisation proceeding. The courts may determine whether the authorisation would go against the equitable treatment of creditors, but the courts must keep in mind that: 1) the IRCJ has given their approval to the claim; and 2) financial institutions forgave loans according to the terms of the reorganisation plan formed in former IRCJ proceeding, so the super-priority claims of DIP lenders will not hurt other creditors. (This has set a precedent for the preferential treatment given to the claims of DIP lenders established before the debt transfer in subsequent statutory reorganisation procedures.)

- g) The IRCJ can support the revitalisation of a company whose debt it has purchased by providing financing, guarantees and capital. It can also review and adjust company operations, provide advice and conduct any other necessary task.
- h) The last date for debt purchase is 31 March 2005, and the IRCJ must attempt to transfer or dispose of all purchased debt and/or converted stocks within three years of the purchase decision date. The IRCJ can raise funds by borrowing through government guarantees, and the government will compensate for losses to be incurred by IRCJ's negative net worth at its liquidation.

### 3) *Practice of the IRCJ*

The sections of the IRCJ law pertaining to the IRCJ's administrative responsibilities could have been drafted in reference to part of the Guidelines for Multi-Creditors Out of Court Workout. Referring to these guidelines, the IRCJ's actual responsibilities can be summarised as follows:

- a) Companies that are struggling due to excessive debt can draft a reorganisation plan with their main bank(s). The company and bank staff will develop this plan with help or backing from certified public accountants and restructuring advisers. The reorganisation plan will encompass both financial and business reorganisation, the first achieved by using debt forgiveness and debt-equity swaps to cut interest-bearing debt and increase/decrease capital, and the latter by closing and cutting unprofitable businesses in peripheral divisions, strengthening profitable core divisions, and even splitting up the company, using mergers and affiliations and business transfers. Preparing the draft plan takes from two to three months, and more than 20 staff—including bank and company staff and external specialists—work on the plan. Financial advisers provide help, and the staff looks for candidates for sponsors and corporate recovery funds.
- b) The main bank and the company hold preliminary discussions with the IRCJ's professional office. The office uses external sources such as restructuring advisers, and follows the advice of members in the IRC Commission as necessary, in reviewing the accuracy of the financial data and the draft's validity, feasibility and economic rationale. Revisions are made as necessary, and the office calls on the advice of certified public accountants, tax accountants, and lawyers as necessary. The office also performs a due diligence process to set the appropriate market value for the debt purchase price. This process requires about 20 staff and a two-month period.
- c) Once a reorganisation plan with high feasibility is completed, the company and its main bank(s) officially apply to the IRCJ for aid. After consulting with the relevant ministers, the IRC Commission makes a decision without delay on whether to offer revitalisation support. Based on this decision, the IRCJ makes its own decision on support, and distributes the plan to the non-main banks, requesting a temporary stay on collections. The IRCJ also asks that the banks decide within a maximum of three months between two choices: whether to apply for debt purchase or to agree to the reorganisation plan. The detailed reports prepared by the

restructuring advisers and specialists will be used by the relevant ministers in their consultation, and by the commission in making their decision, regarding the prospects for the company's successful revitalisation. In other words, a great deal of preparatory work is done out of sight during the period from the prior consultations mentioned to the application for revitalisation support. Most plans that do not seem likely to be successful, despite revisions made at the review stage, probably never make it to the official application stage. The IRCJ does not publicly release information on plans that make it to the application stage and are not accepted.

- d) With the exception of a few creditors that can be excluded without impeding revitalisation, the IRCJ purchases the debt when the non-main banks apply for debt purchase or agree to the reorganisation plan. The IRCJ withdraws from the decision process if it does not gain the cooperation of the necessary financial institutions, and in this case, the companies are likely to go through statutory reorganisation procedures. The IRCJ sells the purchased debt within three years of purchase, and during this time, it monitors the progress of the plan with the main bank. Any breakdown in the revitalisation process will likely result in transfer to statutory reorganisation procedures.

#### **4) *Impact of the IRCJ on revitalising businesses***

The IRCJ's objective is to help reorganise individual companies—a role normally left to the private sector to conduct on its own initiative. However, practical experience in establishing and administering the Guidelines for Multi-Creditors Out of Court Workout has shown the necessity of the semi-private, semi-governmental IRCJ's involvement in reducing the interest-bearing debt of companies with excessive debt and restoring these companies to health quickly, for private-sector efforts are often insufficient for full-fledged revitalisation.

In October 2001, the government's economic council issued its Programme to Accelerate Reform, which aims, among other things, to establish many corporate recovery funds and make DIP financings more popular in Japan at the initiative of the Development Bank of Japan (DBJ), after which the DBJ received an additional 100 billion yen in the fiscal year 2001 supplementary budget. In 2002, many corporate recovery funds were set up with or without involvement of the DBJ and DIP financing saw increasing use. This is similar to the IRCJ's scheme in that the public sector provides support for corporate and industrial reorganisation efforts. Reports state that IRCJ policy does not exclude small and medium-sized enterprises (SMEs) from this programme. The IRCJ was given the immense sum of 10 trillion yen to efficiently rehabilitate enterprises that cannot be left to the private sector, on the premise that the IRCJ was created to complement the Resolution & Collection Corporation (RCC).

The revisions in 2001 to the Financial Revitalisation Law enabled the RCC to help companies reorganise by buying up their loans, but this alone has not been sufficient, which explains the need for the IRCJ. The IRCJ and RCC should work together to clean up debt-ridden companies and efficiently rehabilitate as many companies as possible. Of course, it will take effective economic policy, and not just the revitalisation of individual companies, to resurrect the overall Japanese economy.

- a) Limits to relying on private-sector initiative for revitalisation

As stated in the Basic Policy, ideally the private sector should be able to revitalise corporations through its own efforts, but factors such as the difficulty involved in balancing the interests of creditors require the presence of an institution that can consolidate debts and serve as a neutral

mediator to accelerate the revitalisation of companies with potential but which cannot be left to the private sector.

In 1999 and 2002, a number of major companies received large amounts of financial aid. Given the worsening asset deflation, and the banks' own compliance problems and restrictions posed by taxation, it was probably inevitable, but financial weakness prevented the main banks from extending sufficient support to these companies, as many analysts noted. This indicates the limits of the private sector's ability to rehabilitate companies.

According to the IRCJ Law, the IRCJ can provide aid to companies that are deemed likely to recover by following a reorganisation plan. Since a great deal of the taxpayer's money will be poured into these companies, the final decision on whether to proffer aid must rest on thorough asset evaluation founded on conservative estimates and a reliable business plan based on realistic projections—it is not enough to simply determine that the company would not necessarily collapse. If the financial profile and revenues improve more than the conservative assessments initially suggested, the IRCJ could realise gains on a rise in the price of stock obtained through a debt-equity swap.

Although many companies have gone through the statutory reorganisation procedures and continue to do so, these procedures inevitably lead to deterioration in corporate value. As such, ailing companies tend not to file for court protection until it is too late for them to be revitalised.

#### b) Difficulties with main banks in out of court workout procedures

The Guidelines for Multi-Creditors Out of Court Workout were established in September 2001 as a tool to facilitate the private sector's own efforts to revitalise corporations, but it was only used 12 times through the end of July of 2003.

The reorganisation plans made in out of court workout proceedings under the guidelines provided that companies limit their requests for loan forgiveness to their main and secondary main banks, and ask their tertiary banks only to maintain their credit balance. This was motivated by the fear that the tertiary banks would not agree to requests that losses be spread evenly among the creditor banks and that any attempt at out of court workout would be over before it had started.

In an equitable division, the main banks typically take on an amount equivalent to that forgiven by the tertiary banks. Next, the company would request aid from its secondary main banks, such as debt forgiveness equivalent to the amount of aid needed from all its creditor banks (including tertiary banks), but this would most likely result in a situation in which the main banks have to take on a larger share of the burden in order to decrease the secondary main banks' burden enough so that the debt forgiveness scheme is agreed on by all parties. For main banks, this disproportionate burden compared to other banks limits the merits of out of court workout resolution. The December 2002 reorganisation plan for Nippon Yakin Kogyo faced so many difficulties that some suspected it would be the last out of court workout case under the guidelines requiring support from secondary main banks.

Less than ten banks are involved in out of court workout cases under the Guidelines at the position of main banks. Although it is merely speculation, reasons why other banks did not use the workout proceeding under the Guidelines might be that there is no room to ask secondary and tertiary banks for their co-operation in the loss sharing because banks other than main banks withdrew their loans, or because the main banks were determined to maintain their policy of helping their group companies under their umbrella even in adversity.

Whatever the reason, main banks were required to shoulder almost the entire burden from October 2002, making it extremely difficult to work out reorganisation plans under the Guidelines. The only way to rehabilitate companies so that they regain profitability and a healthy financial profile—which is certainly beyond the ability of most banks to accomplish alone—is for the IRCJ to buy up debt from the secondary and tertiary banks and hold three-way discussions with the main bank and the company to establish a sound reorganisation plan.

At this point, it was essential for the IRCJ to be set up as soon as possible. Reorganisation plans for Seibu Department Store and Hazama Gumi launched in January 2003 have been worked out under the Guidelines. According to Hazama Gumi's plan, its tertiary banks will be asked for help with half of the financial losses allocated on a pro-rata basis. After the first reorganisation plan requiring secondary and tertiary banks to share losses had been worked out, the RCC bought up the non-performing loan assets from those banks as requested.

c) Incentives encouraging applications for loan purchases

In addition to 100 billion yen in capital, 10 trillion yen of funds will be available for the IRCJ for use in revitalising companies. This will enable the IRCJ to rehabilitate many major corporations, but this certainty is marred by fears that non-main banks might not respond to the IRCJ's call for offers to purchase debt. However, even in this case the goal will have been achieved if these non-main banks consent to the reorganisation plan and provide financial support in the form of debt forgiveness and debt-equity swaps.

The price for the loans will be set at a level commensurate with the business recovery plan, but there is some doubt as to what this will actually mean. Although market value is the usual alternative to book value, it will not be used in this case since the debt will not be traded in the market. The net book value prior to the reorganisation plan worked out in agreement with creditors is equivalent to the value of the loan less reserves, but the net book value employed when a reorganisation plan is worked out would be equivalent to the loan value less the amount of debt forgiven and the value of stocks gained in a debt-equity swap.

Neither of these methods will be used here. Rigid standards would not be appropriate even if referring to the market's valuation methods. The value used will likely be a sum discounted from the face amount depending on the reorganisation plan's feasibility, given the amount likely to be recovered in estimated future cash flow. However, the IRCJ will provide aid when it determines that a recovery plan has a high chance of saving the company, so setting a price for the loan purchase that sharply undercuts the loan's face value could shed doubt on the validity of its valuation of the company. Buying up loans at a high price increases the risk of secondary losses, but setting a low price could limit the number of buyers.

This is certainly a point of difficulty. Even if they are uncomfortable with the price, non-main banks can agree to reorganisation plans for companies they deem capable of recovery, and offer support through debt forgiveness and debt-equity swaps. This kind of participation is enough to efficiently resurrect struggling companies without the IRCJ having to use public money to buy up loans.

d) Possibility of increase in pre-packaged statutory reorganisations

Pre-packaged statutory reorganisation procedures involve the preparation of a reorganisation plan that is negotiated and consented to by interested parties including creditors before the company actually files for bankruptcy with the court that has jurisdiction over the case. Pre-packaged

procedures have certain advantages such as the availability of DIP financing, the approval of the rehabilitation plan by creditors' majority vote, avoiding power to cancel preferences and fraudulent transfers, and rejection of executory contracts.

Convincing creditors other than the company's main bank(s) to forgive debts, allocating losses to the secondary main banks as well as convincing tertiary banks to maintain a credit line for the reorganising company is an extremely difficult undertaking. Although the main bank and creditor companies may plead with the non-main banks for their co-operation, it takes about a year to gain the agreement necessary for reorganisation (a year-and-a-half if preparation time is included), and it is not unusual for the banks to force the reorganising company to increase the deposits serving as collateral as a condition for their consent. The procedures laid out in the Guidelines for Multi-Creditors Out of Court Workout shorten the period—including preparation—to six months (within two or three months of the notice of stand still), but it has not been unusual for some banks to resist co-operation to the last, requiring tremendous efforts to persuade them.

The involvement of the semi-governmental IRCJ will make financial reorganisation much easier compared to out of court workout, but even in this case it will be no simple matter to gain co-operation from the creditors accounting for the necessary portion of debt. When the total debt held by the banks agreeing to the plan is less than the total necessary debt, the company will have to give up on the IRCJ's scheme and instead follow procedures for civil rehabilitation or corporate reorganisation.

Previous cases have shown that out of court workout under the Guidelines involving only financial creditors result in much less damage to corporate value than is typically incurred in the statutory reorganisation procedures. This is likely because the news that only financial institution debt will be affected, relieves trade partners enough for them to continue transactions. The temporary suspension or standstill request made simultaneously with the IRCJ's decision to provide aid will also affect only financial institutions.

When there are worries that the necessary number of financial institutions will not agree, the necessary steps regarding trade receivables will be taken during the review period, making it possible to avoid involving general creditors in reorganisation plans. Once statutory reorganisation procedures start, the general creditors will be protected, as their receivables will be dealt with as minor debt. These measures also minimise the extent of the damage to corporate value, even if the company is forced to undergo statutory reorganisation procedures. In this procedure, the reorganisation process begins unless it is clear that the reorganisation plan will not be drafted, adopted, or approved, and definite decisions are not made regarding the feasibility of reorganisation in the early stages.

However, the IRCJ has a team of experts, including external restructuring advisers, who conduct an intensive review over a two to three month-period, whereupon the IRC Commission decides to help the debtor corporation only if the Commission is satisfied that the proposed reorganisation plan is highly feasible. This means that the civil rehabilitation and corporate reorganisation procedures, which accede to the IRCJ's decision, have a higher chance of success than other cases. Awareness of this further restricts the damage to the company's credit in the eyes of its trade partners, which could ensure that the civil rehabilitation and corporate reorganisation procedures run faster and more smoothly.

This suggests that conversion to statutory reorganisation procedures should not necessarily be avoided. Such a conversion may be made when some banks insist not to agree to the proposed plan, but a good track record of successful reorganisation under converted statutory procedures could make it easier to gain banks' co-operation in future IRCJ cases.

Flexible management by the courts has made it easier to use the civil rehabilitation procedures. In December 2002 the Corporate Reorganisation Reform Law was enacted, and became effective after April 2003. The extensive revisions include a partial DIP mechanism allowing the current executive officers to be appointed as trustees, more flexible majority criteria for accepting reorganisation plans, and the use of fair value in asset assessment and evaluation of collateral, all of which facilitate the application for corporate reorganisation procedures (similar to civil rehabilitation). Japan's bankruptcy laws are now among the most user-friendly in the world. The launch of the IRCJ will help to transform Japan's statutory reorganisation procedures into tools similar to Chapter 11 bankruptcy procedures in the US.

#### 5) *The first stage of the IRCJ*

The Industrial Revitalisation Corporation of Japan (IRCJ) was established on 16 April 2003 and started its business operation on May 8 of the same year. After intensive due diligence of the debtors' assets and investigation of the feasibility of the draft reorganisation plans made by the professional staff of the IRCJ, the Industrial Revitalisation Commission (IRC Commission) decided to assist the reorganisation of four debtor corporations on August 28 and September 1.

They are Kyushu Industrial Transportation Corporation (Kyushu Sanko), DIA Construction, Usui Department Store and Mitsui Mine. Kyushu Sanko (KS) and its subsidiaries operate passenger and cargo transportation and other businesses including travel agencies and hotel operations. KS is an unlisted company with approximately 4 000 employees. Should KS go bankrupt, the adverse impact to the regional industrial society would be severe. DIA is a condominium developer doing business throughout Japan and is listed on the Tokyo Stock Market. Usui Department is a local department store in Koriyama, Fukushima whose closing would cause a serious decline in the shopping arcade in Koriyama-City, which is the biggest city in Fukushima Prefecture. Mitsui Mine (MM) started its coal mining business in 1911 and was the biggest coal mining company in Japan until terminating its coal mining business several years ago. MM and its subsidiaries engage in many kinds of business, including trading of coal, production of coke, manufacturing machinery, cement plants, cargo transportation and land development. MM is a listed company with more than 3 000 employees.

Journalists have criticised that the targeted debtor corporations are smaller than expected in size and wondered if the IRCJ could carry out its task to recover Japan's economical prosperity through reorganising many influential distressed corporations with excessive debts. Professional staff members of the IRCJ are working hard, often through the night, on weekends and holidays to investigate the financial status, evaluate assets, draft restructuring plans and other related matters of many candidate debtor corporations. Regrettably, most of these candidate debtor corporations are small to medium-sized companies.

It cannot be denied that to-date banks are hesitant to bring cases to the IRCJ. Minister Takenaka of the Financial Service Agency sent letters to banks encouraging more use of the IRCJ as advised by Minister Taniguchi who is in charge of the IRCJ. Nevertheless, it is not easy to change the banks' cautious attitude toward the IRCJ. The IRCJ is able to deal with cases only when banks bring cases to it. Without the positive support of banks, the IRCJ cannot play its role. Why do banks not bring a sufficient number of substantial cases to the IRCJ?

In order to explain the reasons, one must mention the "main bank" system, which is unique in Japanese business society. A main bank used to maintain a special close relationship with a particular business corporation and supply funds to the corporation, which may be needed for business operations and additional investments. In addition to the funds, main banks often send managers to the borrower corporations to assist in the debtors' operation. Although the main bank system was

pervasive for a long time in Japan, the financial environment is changing now. Corporations with a good financial reputation are able to raise funds in the capital markets and are not relying on main banks. Corporations, who cannot raise money by themselves from the market, have continued to rely upon the main banks. Banks other than main banks, fearing additional non- or poorly-performing loans, tend to refuse to consent to rolling over loans which become due so main banks have to fill the gap continuously. Japanese mega banks, losing their power during the prolonged economic recession, have little room to help corporations with huge debts. However, mega banks, that may have indirectly controlled the debtor corporations for years, find it difficult to persuade other banks to share losses on a pro rata basis in an out of court workout process.

In order to accelerate the wiping out of NPLs and encouraging business revitalisation at the same time, the IRCJ was established. The IRCJ will purchase loans from non-main banks at the request of debtor corporations with excessive debts and their main banks, when the IRC Commission is satisfied that their reorganisation plans are feasible and equitable. Experienced and talented professional staff of the IRCJ, evaluate assets including the goodwill of debtor corporations on a discounted cash flow basis using the purchase method, and may request that debtor corporations and their main banks amend the draft reorganisation plans to increase the amount of debts forgiveness to avoid a possible second failure. This is done before the IRC Commission examination regarding the feasibility of the plans.

Mega banks, who are concerned about losing control of the valuation process, are reluctant to bring large influential cases to the IRCJ. Mizuho Holdings, UFJ Holdings, Sumitomo Mitsui Banking Corporations and Bank of Tokyo-Mitsubishi have now established subsidiaries or divisions specialised to assist borrower corporations' efforts to rehabilitate. Many regional banks have created similar specialised divisions. Inauguration of the IRCJ played a significant role in stimulating these actions by the banks. A concern, however, is that these measures may, in some cases, hinder the recognition of appropriate losses in wiping out NPLs and delay Japan's economic recovery. It is important that the banks not take half measures to reduce their NPLs.

The Japanese government infused 2 trillion yen into Resona Bank in July 2003 and Resona is eager to reduce its NPLs by recognising their actual value. This may be a good example. IRCJ is ready and hopes to use 10 trillion Japanese yen to purchase NPLs, if the banks bring cases to it before the end of March 2005, which is the designated deadline for buying loans. As of the end of September 2003, six companies have done so.



# Trade Credit in Japan: Its Relationship with Bank Loans

by

*Ichiro Uesugi*<sup>1</sup>

## 1) Introduction

How do firms procure funds when they face an adverse shock such as tight monetary policy? Numerous papers have examined this issue, many of which have focused on bank loans. However, the flow of funds is not only through bank loans, but also through other financial instruments such as commercial paper, corporate bonds and funding from non-bank institutions. In addition, many small and medium-sized businesses rely on trade credit. In daily commercial transactions, many firms often prefer to pay later. In this case, accounts payable or notes payable show up on the liability side of the purchasing firm's balance sheet, and accounts receivable or notes receivable on the asset side of the supplier. Trade credit is particularly important for small and medium-sized firm financing since these firms often do not have sufficient access to direct financing, and are often refused additional loans by banks. In this article, we discuss the issue of trade credit, and specifically its relationship with bank loans.

A definitive conclusion on the substitutability between trade credit and bank loans has yet to be offered by economists. In one of the earliest looks at this, Meltzer (1960), found that during periods of tight money in the U.S., firms with relatively large cash balances tended to extend trade credit, thus, favouring firms against whom credit rationing was said to be applied. His conclusion is supportive of the view that trade credit and bank loans are substitutes. In contrast, Oliner and Rudebusch (1996) find little evidence that a monetary policy shock changes the ratio of bank loans to total short-term debt.<sup>2</sup> Their view is consistent with the hypothesis of no substitutability between trade credit and bank loans. While many other articles have provided empirical evidence on both sides of this issue, definitions of substitutability, specifications of shocks and degrees of data aggregation differ across all these studies and make comparison almost impossible. The purpose of this paper is not to settle the entire debate over substitutability, but to instead provide a useful perspective by investigating actual procurement behaviour. Although based on the previous studies, the contributions of this paper are as follows:

We employ a panel data set, collected by the research division of the Small and Medium Enterprises Agency of Japan, with two periods, multiplied by approximately 4 000 observations. Using the data, we are able to analyse the effects of idiosyncratic shocks to firms, not the effects of aggregate shocks such as contractionary monetary policy. In addition, the panel nature of the data allows us to eliminate firm-specific factors.

The panel contains not only balance sheet data, but also non-balance sheet data such as the highest short-term interest rate in the current fiscal year, provision of collateral and changes in the length of payment terms.

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<sup>1</sup> Ichiro Uesugi, Research Institute of Economy, Trade and Industry. Thanks are extended to Takahito Tachibana for his instructions on the Survey of Financial Environment implemented by the Small and Medium Enterprises Agency of Japan. Gratitude is also expressed for comments by Takehiko Yasuda, Kazunari Kaino, Seiichiro Inoue, Tomoaki Tagami, Toru Shimizu, Yusuke Adachi, Arito Ono and Daisuke Tsuruta.

<sup>2</sup> Trade credit is included in the measure of short-term debt.

There are two main uses for trade credit: one is daily commercial transactions among non-financial firms, and the other is the need for short-term finance. We emphasise the importance of the distinction between them to discuss substitutability.

As a result, we show with changes in firms' credit risk and their growth prospects, the trade credit-total asset ratio and the loans-total asset ratio move quite differently with one another. However, once we adjust for the transactional motivation of trade credit, we find that these two ratios move in similar directions.

The paper is organised as follows. It summarises the theoretical explanations for the use of trade credit in Section 2. In Section 3, it documents the previous empirical studies on the relationship between trade credit and bank loans. It discusses the data source, Survey of the Financial Environment by Small and Medium Enterprises Agency of Japan, in Section 4. Section 5 summarises empirical findings. Section 6 concludes.

## 2) *Why do firms use trade credit?*

Trade credit is regarded as a short-term loan provided by a supplier to a purchaser upon transaction of goods and services. When the firms agree to make payments at a later date, the supplier side has accounts receivable or notes receivable on the asset side of its balance sheet, while the purchaser has accounts payable or notes payable on the liability side of its balance sheet. Almost all of these items are classified, on the balance sheet, as short-term assets/liabilities. In Japan, there is a large amount of outstanding trade credit. 13.7% and 16.6% of total corporate assets are trades payable (accounts payable + notes payable) and trades receivable, respectively. The share of trade credit as a part of total assets is comparable to other major sources of firm financing, such as loans (37.1% of total assets) and short-term loans (15.2%).

However, we still must understand why non-financial businesses supply funds to purchasers, without the borrowing firm's balance sheet information. Following Petersen and Rajan (1997), Ono (2001) and Schwartz (1974) we classify motivations for trade credit into demand side and supply side factors.

### a) *Incentives to supply trade credit*

Those who supply goods and services have an advantage over financial institutions when they issue trade credit. The reasons include reducing credit costs and increasing the demand for their goods and services.

*Retrieving updated information on a purchaser's credit risk:* a supplier of goods and services can retrieve information about the purchaser's daily management through its day-to-day transactions. Even though the supplier lacks the purchaser's balance sheet data, information which financial institutions have, its day-to-day information is sometimes more useful in detecting fatal incidents of a company, *e.g.* bankruptcies.

*Properly handling purchaser's inventories:* the supplier has more detailed information on the purchaser's inventories through its daily business, and evaluates them more properly than financial institutions can. Provided that the supplier holds inventories, it will find appropriate markets to dispose of inventories upon a purchaser's bankruptcy.

*Applying pressure to assure payment:* the supplier can use its goods and services that are indispensable to the purchaser as a means to assure payment. The purchaser will pay regularly if it needs the supplier to sell its necessities on schedule.

*Increasing demand from high-risk firms:* firms with higher credit risk tend to be credit rationed, and, as a result, its demand elasticity is thought to be high in both the short and the long term. By extending trade credit, a supplier can expect higher sales to these credit rationed firms.

b) *Incentives to demand trade credit*

On the other hand, the demanders of trade credit benefit from the reduction in transaction and opportunity costs.

- *Reducing transaction costs:* with cash flow uncertainties, a purchaser needs to hold a certain amount of cash, which may generate sizable opportunity costs. The use of trade payables significantly reduces the cost since the purchaser can determine when to pay by cash.
- *Benefit from paying late:* in the case of the amount of payment being invariant,<sup>3</sup> paying later is always preferred to paying now. This is especially true with a fixed payment scheme, as in Japan.<sup>4</sup>

c) *Use of trade credit in Japan*

In table 2-1, we see the use of trade credit by firm size using the Financial Statements Statistics collected by Japan's Ministry of Finance. Since our concern is on the substitutability of trade credit for loans, we focus on trade payables, which is on the liability side of a balance sheet. The share of trade payables to total assets is above 10% on average, which is comparable with other financial instruments. Among small and medium enterprises (SMEs) whose employment size is below 300, relatively large companies with 101 to 300 employees rely more on trade payables. In contrast, once firms become larger, they depend less on trade payables. These are consistent with the observation that some SMEs are too small to be creditworthy for trade payables, especially accounts payable and that large-scale enterprises have an easy access to other financial instruments including commercial papers, corporate bonds and equities.

Trade credit use differs significantly across industries. For example, wholesale businesses depend on trade payables since they do not have enough fixed assets for collateral. In contrast, retail stores with consumers usually making cash payments rely less on trade credit. Real estate and construction firms owe long-term trade payables to suppliers because of their long-term contracts such as construction of buildings and purchases of real estate. Table 2-2 summarises the trade payables to asset ratio by industry and by firm size. The figure is based on the Survey of the Financial Environment by the SME agency of Japan. We observe that larger construction businesses rely more on trade credit while larger wholesale and retail firms depend less on trade payables. The difference between these industries may be consistent with the difference in their payment terms length and in the

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<sup>3</sup> Sometimes the cash payment amount is less than the trade payable amount. Petersen and Rajan (1997) assumed that purchasers are always willing to pay later and that suppliers determine the ratio of credit on accounts.

<sup>4</sup> In the U.S., in addition to trade payables, whose payment is invariant until due, there is a kind of accounts payable that gives discounts for early payment. For example, 2/10 net 30 means that a firm gets a 2% discount if it pays by the tenth day. If not, the firm has to pay the full amount by the thirtieth day. For further information on the practices specific to each industry see Ng, Smith and Smith (1999).

creditworthiness required to obtain trade payables. Larger construction firms are possibly preferred for their creditworthiness to obtain long-term credit.

### 3) *Previous studies on the relationship between trade credit and bank loans*

There has been a substantial amount of literature on the relationship between trade credit and bank loans. Using data aggregated by firm size, Meltzer (1960), in one of the pioneering works in the field, posited that during the tight monetary policy of the mid-fifties in the US, firms with relatively abundant cash balances extended trade credit, possibly alleviating the discrimination against credit rationed firms. Subsequent work supported the findings of Meltzer and presented further evidence of substitutability between trade credit and bank loans. For example, Herbst (1974) used data aggregated by industry and found evidence of a co-movement between the amount of loans near due, and trade credit, implying substitutability between the two methods of financing. Among the recent literature, Nilsen (2002) examined substitutability from a credit channel perspective. He specifically focused on trade credit as a possible alternative to bank loans to support the substitution hypothesis.

On the opposite end of the spectrum, many papers have also found evidence against any kind of substitutability between bank lending and trade credit. Based on US manufacturing data, Nadiri (1969) observed that trade credit dropped in the tight money periods. Oliner and Rudebusch (1996) and Gertler and Gilchrist (1993) both insisted that differences in the effect of tight monetary policy are propagated more by firm size than by differences between bank loans and non-bank loans. This implies no sizable substitution between bank loans and trade credit, one of the main components of non-bank loans.

Most of the articles in the literature simply used data aggregated by firm size or by industry. Economists have not really used firm-level micro data until quite recently. Nilsen (2002) used balance sheet data of large US firms to claim that big companies, without bond ratings, used trade credit more intensively than those with ratings during periods of tight money. Blaiso (2003) employed panel data of Italian firms for 18 years to estimate his inventory investment function. During the tight money period, he found that net trade credit, not liquid assets such as cash, constrained inventory investment. Based on this finding, he insisted on the substitutability between trade credit and bank loans.

Smaller firms with limited access to direct finance are thought to rely more heavily on trade credit than larger firms. Petersen and Rajan (1997) implemented a cross-sectional analysis using a firm-level micro data set, the National Survey of Small Business Finances (NSSBF), jointly collected by the US Small Business Administration and the Board of Governors of the Federal Reserve. Using this data, Petersen and Rajan asserted that those firms with lower credit limits tended to have more accounts payable.

In Japan, there have been several intriguing articles about the relationship between these two procurement measures. Using aggregated data, Ono (2001) showed that the ratio of trade payables to trade receivables increases as banks become looser in lending, providing evidence for the complementarity of trade credit and bank loans. Takehisa and Ohkusa (1995) arrived at a similar empirical conclusion by using panel data of larger firms who file their balance sheets annually with the Ministry of Finance. Tsuruta (2003) compiled his panel data set of as many as 80 000 firms for five years based on the information assembled by the government-backed credit guarantee corporation. He regressed differences in trade payables on differences in the interest rate and obtained a positive coefficient, implying substitutability between trade credit and bank loans.

The problem with the existing literature is that a direct comparison of articles is quite difficult as the papers differ quite a bit in terms of their methodology (under which environment do we see

substitutability?), data sets (large firm vs. small firm, firm-level data vs. aggregate data) and in their definition of substitutability (examining the relationship between the amount of outstanding trade credit and bank loans, using qualitative data such as the lending attitude of banks, etc.). In this paper, our approach is to employ firm-level, panel data containing not only balance sheet information but also non-balance sheet information. Our focus will be on liabilities, analysing the relationship between trade payable and bank loans.

#### 4) *Data*

The Research Division of the Small and Medium Enterprises Agency of Japan collected Surveys of the Financial Environment (SFE) for the years 2001 and 2002. 15 000 sample firms, non-financial and non-agricultural, were extracted from the database collected by the Tokyo Shoko Research, Ltd. (hereafter TSR) and stratified by industry. The division sent questionnaires under the name of the director general of the agency and received 7565 (2001) and 8446 (2002) replies. Among them, 4 065 observations, comprising our sample, are common across the years. This data set is accompanied by balance sheet data collected independently by TSR. Among the respondents, 85.1% are categorised as small and medium-sized enterprises,<sup>5</sup> which is smaller than the figure of more than 99% for all of Japan. The original survey sample of 15000 contains about 1500 large firms. In addition, some sample firms may be too small to answer detailed questions about their financing. Thus, the share of small businesses amongst respondents is less than 90%. Statistics show that means and medians of employee numbers are about 90 and 40, respectively, which implies many in the sample are relatively large SMEs.

It should be noted that SFE contain numerous items about the financial environment faced by each firm. This data is normally impossible to obtain from a balance sheet. These variables include changes in terms of payment over the past year, the number of banks by type per firm, the type of main bank, if the firm was unable to obtain loans, if the firm was requested to accept an increase in the interest rate, the highest short-term rate paid over the past year, the supply of collateral, personal guarantees and government backed guarantees. These non-balance sheet variables are combined with the balance sheet data for analysis.

A predecessor to the Japanese survey of small and medium enterprises is the US Survey of Small Business Finances (SSBF). The Federal Reserve Board and the US Small Business Administration jointly began the survey in 1987 and have done three surveys up to the present. From 3400 to 5300 samples with less than 500 employees responded to quite detailed questions about their financial environment. The sample firms are first sent questionnaires, which are followed by calls from trained interviewers.<sup>6</sup> These processes are designed to increase the precision of the survey. However, each SSBF is used for independent cross-sectional analysis, and samples in one survey year are unlikely to appear again in the next survey since there are about 7.5 million small businesses in the US. In addition, an interval of five years between surveys makes it difficult to analyse the immediate effects of shocks to firms, which are expected to appear in a year or two. In contrast, since Japan's SFE has been implemented for the past two years consecutively (the division in charge plans to implement the

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<sup>5</sup> Under the law concerning small businesses in Japan, the term small and medium enterprises refers in general to those with capital stocks not in excess of 300 million yen or having 300 or fewer regular employees, and sole proprietorships with 300 or fewer employees. The wholesale, retail and the service industry apply smaller threshold values.

<sup>6</sup> There seems to be a trade-off between the level of detail of the questions and the response rate. The 1998 SSBF survey had more than 200 pages, but only a response rate of 33%, which was much lower than past response rates.

survey again for the year 2003), one is able to construct a panel dataset to understand each individual firm's effect on the estimation.

### 5) *Effect of idiosyncratic shocks on the relationship between trade credit and bank loans*

Based on the SFE for the years 2001 and 2002, one can summarise the effect of changes in credit risk and sales growth on trade payables and bank loans. The focus is not only on the quantitative data on the balance sheet but also on non-balance sheet items such as changes in the terms of payment, the highest short-term rate paid over the past year and if the firm was requested to accept an increase in the interest rate. The assumption is that these items respond to idiosyncratic shocks.

#### a) *Effects of corporate ratings change*

As a proxy for the credit risk of a firm, a corporate rating by TSR is employed to analyse the effect of a rating change. TSR is a major private credit research company<sup>7</sup> that makes inquiries about a firm's management and business prospects upon requests by customers. TSR classifies many of the business characteristics of a firm into four major categories: management skills, growth prospects, stability and disclosure and a third party opinion. Based on the classifications, researchers collect both quantitative and qualitative data such as a CEO's management style, business records, prospects for sales growth, owned capital and reserved collateral. TSR then quantifies the data to score corporate ratings from 0 to 100, and provide the ratings to customers.<sup>8</sup>

These corporate ratings are widely utilised by both financial and non-financial enterprises when starting business relationships with another firm.<sup>9</sup> At the same time, these credit research companies interview those who have business relationships with the firms under examination. Therefore, the corporate ratings are endogenous in that they affect the behaviour of financial and non-financial institutions at the same time as being influenced by the actions of these institutions. This endogeneity deters us from determining causality between corporate ratings and financing actions of a firm. Nevertheless, it is still very useful to quantify the relationship among corporate ratings, trade credit, bank loans and other financial variables.

#### i) *Relationship between corporate ratings and the liabilities of a firm*

Figures 2 and 3 show the distribution of the level of corporate ratings and the difference in corporate ratings. Based on a change in ratings, Tables 2-1 and 2-2 display a firm's total assets, total liabilities, trade payables, loans, the trade payables-total asset ratio, the loans-total asset ratio and their changes respectively. We divide the samples into four groups according to the size of the ratings change. These sub-samples are not equal in size since the changes are discrete, and for many firms are zero.

The first thing to notice is that total assets and liabilities dropped across almost every category from 2001 to 2002, reflecting the recent behaviour of Japanese firms to remove dormant assets and unnecessary liabilities from their balance sheets in an attempt to improve their capital ratio. The larger the corporate ratings drop, the larger the trade payables decrease. In contrast, even with the drop in corporate ratings, we do not observe a larger decline in loans. Rather, in the first quartile, the group with the largest fall in ratings, we observe a smaller decline in loans and an increase in short-term

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<sup>7</sup> In Japan, Tokyo Shoko Research and Teikoku Data Bank are the two major credit research companies with databases that contain more than 1 million firms, respectively.

<sup>8</sup> Customers include financial institutions and business enterprises.

<sup>9</sup> Some city banks have a rule to not discount notes receivable by a company with below average ratings.

loans. Secondly, trade payables-total asset and loans-total asset ratios clearly behave quite differently. The fall in trade payables is larger than the decline in total assets, and this difference becomes more conspicuous as ratings drop further. Hence, the drop in the trade payable-asset ratio becomes larger with a larger ratings drop. On the other hand, the increase in loans as well as the short and long-term loans-total asset ratio becomes larger with a larger ratings drop. We can thus reject the null hypothesis that the ratios in the first quartile are the same as those in the fourth quartile.

Table 2-3 summarises other non-balance sheet items relating to the procurement environment of a firm. Our main concern is with accounting for consistent changes in both the balance sheet and non-balance sheet items. For trade payables, changes in the length of payment terms are obtained from the data. Many of the samples reported no change, while some extend payment terms when facing large ratings drops, which possibly alleviates their financial difficulties.

When we look at loans, there are many useful non-balance sheet items available for analysis. Even when banks extend loans to firms with deteriorating ratings, it may be justified if they are compensated with higher interest rates, or if firms provide more collateral. The first thing to notice is that the number of regional and second regional banks per firm increases as ratings drop, which implies firms with adverse shocks have difficulties in obtaining financing and tend to procure from relatively smaller-sized banks than larger city banks. Secondly, as ratings become lower, pressures increase from banks to impose more severe loan conditions, part of which is a short-term interest rate increase. Table 2-3 shows that the ratio of firms being asked to accept an interest rate hike is significantly higher in the first quartile than in the third and fourth quartiles. In addition, the actual interest rate hike in the first and second quartile is positive while in the fourth quartile the interest rate drops.<sup>10</sup> Finally, other than an increase in the interest rate, no significantly tighter procurement conditions are observed. For example, the ratio of firms newly providing collateral, personal guarantees and government backed guarantees are not significantly different across quartiles.

ii) Types of main bank, collaterals, and level of corporate ratings: do they matter?

To investigate the relationship between ratings and corporate procurement in more detail, we further divide the sub-samples by (1) a firm's main bank type, (2) loans with or without collateral, personal guarantees and government backed guarantees and (3) the level of corporate ratings. For the types of main banks,<sup>11</sup> smaller financial institutions may face tougher market conditions partly because of their higher cost structure. Separating by (1) allows us to see if the response of smaller main banks differs significantly from larger main banks. If they suffer from a lack of profit opportunities, these banks may risk their assets by lending to riskier firms. Regarding (2), trade credit is usually not backed by collateral,<sup>12</sup> while many of the bank loans are with collateral, personal guarantees or government backed guarantees, in which case it is a matter of course for banks to maintain loan contracts longer than suppliers retain trade credit. Therefore, we want to see if different responses of trade credit and loans are observed even if we adjust for the difference in guarantees. Dividing our

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<sup>10</sup> The interest rate, calculated by dividing paid interest by loans outstanding, moves irregularly across quartiles. A consistent explanation incorporating a change in ratings is difficult to obtain. The ratings change is thought to influence the current interest rate, in which case it is appropriate to use the interest rate in the past year rather than the rate based on the outstanding amount. Furthermore, trade credit is a form of short-term financing and so, the short-term interest rate is the appropriate one for comparison.

<sup>11</sup> In terms of asset size, the following inequalities: city bank > trust bank > regional bank > second regional bank > Shinkin bank > credit union roughly hold.

<sup>12</sup> Upon bankruptcy of a purchaser, suppliers can retrieve their goods from its stockyard. However, it is impossible to do so when the goods are already dispersed or suppliers are late detecting signs of bankruptcy. Once legal process starts for bankrupt firms, trade receivables are usually inferior to other collateral backed claims and its payoff is smaller than others.

sub-samples by the corporate rating (3), is an attempt to see if not only the changes, but also the level of ratings matter. Recently, it has been said that Japanese financial institutions have introduced a credit scoring lending scheme with which they determine the loan conditions according to the level of their own credit ratings. Even though the ratings by TSR are not identical to the ratings used by individual banks, TSR ratings are a good proxy. We present the results for each of these samples in Tables 2-4, 2-5 and 2-6, respectively.

In Table 5-4, the comparison is made between the samples with shinkin banks or credit unions as main banks and those with regional or second regional banks as main banks.<sup>13</sup> The former have larger increases in the loan-asset ratios not only in the first quartile but also across the entire sample. In contrast, we do not observe much difference in the change of the trade payables-asset ratio. Table 5-5 presents two samples: one with a government-backed guarantee for loans<sup>14</sup> and the other without any type of collateral, personal guarantees or government backed guarantees. Overall, changes in the trade payable-asset ratio do not depend much on the existence of guarantees. In addition, even in the samples with no collateral or guarantees, a change in the loan-asset ratio is much different from a change in the trade payable-asset ratio. Finally, Table 5-6 summarises the results for samples with the lowest ratings level category and those with the highest ratings level category. No significant correlation between ratings level and changes in the trade payable-asset ratio is observed, while a low ratings level is accompanied by an acute rise in the loans-asset ratio, in particular when a rating moves downward. In addition, there seems to be a correlation between the ratings level and the non-balance sheet variables, such as the ratio of firms declined for loans, the ratio of firms requested to accept the rate increase and the highest short-term interest rate paid over the past year.

b) *Effects of sales growth change*

In the previous subsection, we covered the relationship between corporate ratings and the procurement behaviour of firms. However, as we discussed in Section 5)a) above, corporate ratings are endogenous in that they not only affect trade credit provided by suppliers and loans made by banks, but they are also directly influenced by the comments of those suppliers and banks. Here in this section, we focus on the sales growth rate, and report the impact of sales growth on trade credit and bank loans. There are three major reasons to employ sales growth for analysis. First, sales growth plays an important role in generating corporate ratings by credit research companies since it represents future growth prospects. Secondly, sales are instantly influenced by the outside business environment and are therefore believed to be more exogenous than corporate ratings.<sup>15</sup> At the very least, sales of a firm are not directly affected even when suppliers and banks talk about the firm to research company officials, while corporate ratings are definitely affected. The third and most important point is that sales growth moves closely with the growth in trade payables due to transaction demand. This makes trade credit quite different from bank loans. Bank loans are not necessarily responsive to sales or purchase. Upon sales of products, trade credit appears while a loan contract and a purchase contract with suppliers are two distinct processes. In addition, actual correlation between purchase growth and loan growth is not significant. Hence, using the growth rate of sales, we dissect the change in trades

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<sup>13</sup> The judgment of TSR, not by the firm, was followed as to which is the main bank. There is said to be a bias for a firm to report a larger bank as its main bank since transactions with a larger and more reliable bank are thought to add credibility to the firm.

<sup>14</sup> When banks make loans to small and medium companies, credit-guarantee corporations, funded by local governments and financial institutions, guarantee the loans. Once the loans become irrecoverable, the guarantee corporation pays off the outstanding amount to banks. A part of this is recovered by the government-affiliated organisation, Japan Small and Medium Corporation.

<sup>15</sup> Some of the previous studies do not discuss the endogeneity problem but use sales growth rates as an explanatory variable for the trade payable amount. See Petersen and Rajan (1997, p. 683-684).



payable into two parts: the portion of the change driven by transaction demand and the portion affected by other factors.

We start by dividing the samples by the sales growth rate, just as we did earlier with the ratings change in subsection 5)a) in order to observe discrepancies in financial conditions across the samples. We then calculate the growth rate of purchases using sales growth. Using this purchase growth rate, we extract the trade payable growth without the transaction demand and compare it with the growth rate in loans. Declines in trade payables are regarded as negative for financing, but once we eliminate the automatic part of the decrease in trade payables, it will be possible to compare the attitudes between suppliers and banks in financing firms during adverse business conditions. This possibly provides a new perspective on the substitutability between trade credit and bank loans.

i) Relationship between sales growth and liabilities of a firm

After dividing samples into four groups according to growth rate of sales, we present descriptive statistics in Tables 2-7 and 2-8. Responses of the trade payables-asset ratio and the loans-asset ratio are similar as to those observed in Table 2-2. When we observe a drop in sales, the trade payables ratio drops and the loans ratio increases. In contrast, when sales are surging, the trade payables ratio rises, while the loans ratio drops both for the short and long-term. In Table 5-8, which covers non-balance sheet items, we observe that as sales decrease there are more loan rejections and increased requests to accept an interest rate rise. However, items such as the actual interest rate transacted in the past year and the number of banks per firm do not differ across quartiles.

ii) Trade credit adjusted for transaction demand

Now the trade payables are calculated excluding the portion attributable to transaction demand and compared to adjusted value with loans. Before beginning, it is necessary to clarify the relationship between flow and stock variables, which include sales, purchases and trade payables. In response to sales, firms have to purchase goods and services, and a certain portion of the purchase is paid with credit rather than paying completely with cash. This credit on account shows up on the liability side of the balance sheet as trade payables until the transaction is settled. Therefore, the stock value of trade payables is a function of purchase volume, the credit on account-purchase ratio and the length of payment terms. In addition, sales growth accounts for a significant portion of the purchase volume growth through sales and administrative costs.<sup>16</sup>

Provided that the credit on account ratio and the length of payment terms are stable, the purchase volume growth and the trade payables growth should be equal. The purchase growth is taken to represent the transaction demand of a firm, and the deviation of the trade payable from the purchase represents the non-transactional factors of trade credit.

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<sup>16</sup> It should be noted that by size or by industry, correlation between purchases and trade payables differs significantly. Wholesale and restaurant businesses, where the payment term is often short, have no choice but to use trades payable for financing. By contrast, real estate and construction industries, with their longer payment terms, regard trade payables as only one of their many financing options. Correlation between sales growth and trade payables growth in the wholesale industry is 0.44, while the correlation in real estate is only 0.03.

In addition, there is an asymmetry in correlation between increasing and decreasing sales. Trade payables drop automatically when a long-term supply contract is terminated, while there are many other options to procure funds when supply contracts are initiated.

Based on this conjecture, the growth in purchases is summarised<sup>17</sup> as growth in trade payables and the growth in loans to calculate the trade payables growth rate adjusted for transaction demand. These results are presented in Table 2-9. In the table, the purchase growth and the trade payables growth differ significantly in that the trade payables growth rate becomes larger, while the loan growth becomes smaller as sales growth increases. However, once the trade payables growth is adjusted for the transaction demand factor, it behaves similarly to loan growth in that both of them move upward as the sales growth increases. Hence, after adjusting for transaction demand, we find evidence for the substitutability between trade payables and loans.

## 6) *Conclusion*

This article focused on trade credit, a corporate financing measure of significant importance. Following the previous literature, it was attempted to add a new perspective using Japanese panel data collected by the Small and Medium Enterprises Agency. This use of panel data (primarily composed of small and medium businesses with non-balance sheet information) is unique to the literature. Furthermore, considering the fact that trade credit co-moves with purchases or the amount of sales, this portion was subtracted to adjust the growth in trade credit for transaction demand.

Changes in corporate ratings and sales amount are specified as idiosyncratic shocks to individual firms. The different responses of loans and trade credit were observed: the trade payables ratio declines and the loan ratio surges as corporate ratings or sales drop. In other words, suppliers are quick to distance themselves from bad businesses, while financial institutions respond slowly to changes in business environment. However, the behaviour of trade payables growth adjusted for the purchase growth is quite different from the behaviour of the original trade payables growth. This adjusted growth rate moves similarly to the loan growth in that a tougher financial environment comes with a smaller decrease in credit and a better environment coexists with a larger credit decrease. This is in accordance with the fact that suppliers tend to give longer terms of payment for trade payables during difficult financial times. At the same time, it is possible that they allow more purchases to be credited on accounts.

The impact of these shocks on non balance sheet items were also summarised. The results indicate mounting pressure from financial institutions on worse-off firms. However, the pressure takes the form of increases in interest rates and not necessarily more stringent loan contracts. Thus, while the short-term interest rate is sometimes higher, no significant difference is observed in collateral provision or other conditions.

The above results alone are useful to think about the transmission mechanism of a monetary policy with a proper econometric approach used to quantify the effect of idiosyncratic shocks. They can also be a starting point for further analysis. The above results have many possible implications for the recent criticism of banks' unwillingness to make loans and their withdrawal of loans. It should be possible to determine if banks really are unwilling to lend or if bank actions can be justified in terms of job creation and destruction.

It is also useful to analyse the sample by size or industry. It was stated in the introduction that small businesses are more prone to depend on trade credit than larger firms. Our sample is thought to

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<sup>17</sup> Ono (2001) calculated the amount of purchase as (change in inventories) + (cost of sales) + (selling, general and administrative expenses) - (personnel expenses) - (depreciation). We do not have the inventory outstanding at the end of fiscal year 2000 or personnel expenses. However, since we have the number of employees, we multiply this by about 5.9 million yen per employee to approximate personnel expenses for each firm.

represent small enterprises; nevertheless, it may be important to repeat the analysis by firm size. In trade payables there are two forms, accounts payable usually in the form of an invoice, and notes payable that explicitly specify due dates and other conditions. Very small firms are sometimes not allowed to use accounts payable since they are thought to be too risky without any written contract. If these are the prevalent practices across the board, size matters in terms of the choice between accounts and notes payable. In addition, as stated in Section 5)b)ii), there are large discrepancies in the trade credit practices across industries. For example, retail industries do not assume a sizable amount of trades receivable since they expect to receive cash from customers. Wholesale businesses differ greatly in that they use both trades receivable and payables heavily. Therefore, more detailed inquiry by size and industry will add further meaningful implications to the literature.

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**Table 1: Descriptive Statistics for Each Survey Year**

	Mean		Median		Standard Deviation	
	2001	2002	2001	2002	2001	2002
<b>Sales</b>	4 014	3 894	1 529	1 484	7 814.9	7 601.7
<b>Current Profit</b>	116	93	25	19	394.4	355.7
<b>Total Asset</b>	3 983	3 886	1 296	1 251	8 347.7	8 109.3
<b>Trade Receivable</b>	961	895	251	232	2 773.5	2 629.8
<b>Total Liabilities</b>	2 897	2 779	884	844	6 692.2	6 420.9
<b>Trade Payable</b>	707	648	195	175	1 873.7	1 727.3
<b>Loans</b>	1 580	1 547	359	350	4 793.5	4 638.1
<b># of Employees</b>	90.0	88.0	40	39	167.1	164.5

Note: Sample size for each year is 4 065 firms. Balance sheet items are in million yen.

**Table 2-1: Relationship between Corporate Ratings and Balance Sheet Items Level**

	<b>First Quartile</b>	<b>Second Quartile</b>	<b>Third Quartile</b>	<b>Fourth Quartile</b>	<b>Average</b>
<b>Change In Ratings</b>	<b>Less than 2</b>	<b>Less than 0</b>	<b>Less than +1</b>	<b>Larger than or equal to +1</b>	
<b>Number Of Samples</b>	853	818	1 218	760	3 649
<b>Total Assets</b>	4 392	4 229	4 213	3 418	4 092
<b>D (Total Assets)</b>	-200	-123	-110	+15	-108
<b>Total Liabilities</b>	3 196	3 021	2 931	2 500	2 924
<b>D (Total Liabilities)</b>	-165	-145	-136	-68	-131
<b>Trade Payable</b>	701	701	685	663	688
<b>D (Trade Payables)</b>	-96	-75	-62	-27	-65
<b>Loans</b>	1 871	1 679	1 558	1 368	1 619
<b>D (Loans)</b>	-9	-58	-35	-44	-36
<b>Short-Term Loans</b>	973	858	804	660	826
<b>D (Short-Term Loans)</b>	+25	-16	+2	-17	-1
<b>Long-Term Loans</b>	897	822	754	707	793
<b>D (Long-Term Loans)</b>	-34	-43	-38	-27	-36

Note: Unit is in million yen.

**Table 2-2: Relationship between Corporate Ratings and Balance Sheet Items Ratio to Assets**

	First Quartile	Second Quartile	Third Quartile	Fourth Quartile	Average
<b>D (Trade Payable/Total Asset)</b>	-2.04	-1.34	-1.07	-0.70	-1.28
<b>D (Loans/Total Asset)</b>	+2.57	+0.98	+0.37	-1.55	+0.62
<b>D (Short-Term Loans/Total Asset)</b>	+1.02	+1.05	+0.76	-0.74	+0.57
<b>D (Long-Term Loans/Total Asset)</b>	+1.55	-0.07	-0.39	-0.81	+0.05

Note: Unit is in % points.

**Table 2-3: Relationship Between Corporate Ratings and Non-Balance Sheet Items**

	First Quartile	Second Quartile	Third Quartile	Fourth Quartile	Average
<b>Number of City Banks</b>	2.236	2.182	2.336	2.193	2.283
<b>---- (Second) Regional Banks</b>	2.452	2.452	2.186	2.050	2.286
<b>---- Shinkin Banks and Credit Unions</b>	1.790	1.442	1.588	1.557	1.598
<b>Ratio of Firms Newly Providing Collateral</b>	0.048	0.055	0.044	0.052	0.049
<b>---- Personal Guarantee</b>	0.142	0.126	0.125	0.127	0.130
<b>---- Government Backed Guarantee</b>	0.058	0.079	0.066	0.066	0.067
<b>Highest Short-Term Interest Rate</b>	2.079	2.155	1.981	2.038	2.056
<b>D (Highest Short-Term Interest Rate)</b>	+0.091	+0.165	+0.037	-0.014	+0.068
<b>D (Interest Rate for Outstanding Loan)</b>	-0.225	-0.280	-0.453	+1.818	+0.113
<b>Ratio of Firms Without Request for More Stringent Conditions</b>	0.529	0.571	0.558	0.553	0.553
<b>Ratio of Firms With Request for Higher Interest Rate</b>	0.229	0.181	0.171	0.194	0.194
<b>Change In Length of Payment Terms</b>	1.969	1.980	1.956	1.940	1.961

Notes: Unit of interest rates is %. Change in length of payment terms is the average of 1 (=shorter than previous year), 2 (=unchanged), and 3 (=longer).

**Table 2-4: Relationship Between Corporate Ratings and Balance Sheet Items Ratio (By Main Bank Type)**

Shinkin Bank or Credit Union is the Main Bank in 2001

	<b>First Quartile</b>	<b>Second Quartile</b>	<b>Third Quartile</b>	<b>Fourth Quartile</b>	<b>Average</b>
<b>Number Of Samples</b>	96	91	141	99	427
<b>D (Trade Payable/Total Asset)</b>	-2.44	-0.65	-1.72	-0.19	-1.30
<b>D (Loans/Total Asset)</b>	+4.22	+0.23	+2.55	-2.60	1.23
<b>D (Short-Term Loans/Total Asset)</b>	+2.19	+0.52	+2.23	-2.13	0.85
<b>D (Long-Term Loans/Total Asset)</b>	+2.03	-0.29	+0.32	-0.47	0.39

Regional or Second Regional Bank is the Main Bank in 2001

	<b>First Quartile</b>	<b>Second Quartile</b>	<b>Third Quartile</b>	<b>Fourth Quartile</b>	<b>Average</b>
<b>Number Of Samples</b>	496	449	605	390	1 940
<b>D (Trade Payable/Total Asset)</b>	-1.96	-1.12	-1.26	-0.55	-1.27
<b>D (Loans/Total Asset)</b>	+2.23	+0.64	+0.48	-1.40	+0.59
<b>D (Short-Term Loans/Total Asset)</b>	+0.89	+0.96	+1.10	-0.44	+0.71
<b>D (Long-Term Loans/Total Asset)</b>	+1.34	-0.32	-0.62	-0.96	-0.12



**Table 2-5: Relationship between Corporate Ratings and Balance Sheet Items Ratio (By Collateral, Personal or Government Guarantee)**

- With Government Guarantee

	First Quartile	Second Quartile	Third Quartile	Fourth Quartile	Average
<b>Number Of Samples</b>	378	365	486	339	1 568
<b>D (Trade Payable/Total Asset)</b>	-2.50	-1.25	-1.17	-0.54	-1.37
<b>D (Loans/Total Asset)</b>	+4.07	+1.08	+0.27	-0.95	+1.11
<b>D (Short-Term Loans/Total Asset)</b>	+1.88	+1.28	+0.47	-0.80	+0.72
<b>D (Long-Term Loans/Total Asset)</b>	+2.19	-0.20	-0.19	-0.16	+0.39

- Without Collateral, Personal Guarantee, or Government Guarantee

	First Quartile	Second Quartile	Third Quartile	Fourth Quartile	Average
<b>Number Of Samples</b>	91	81	150	77	399
<b>D (Trade Payable/Total Asset)</b>	-1.72	-2.18	-0.97	-1.36	-1.46
<b>D (Loans/Total Asset)</b>	+1.32	-0.24	-0.39	-2.93	-0.46
<b>D (Short-Term Loans/Total Asset)</b>	+0.12	-0.49	-0.53	-0.76	-0.42
<b>D (Long-Term Loans/Total Asset)</b>	+1.20	+0.26	+0.14	-2.17	-0.04

**Table 2-6: Relationship Between Corporate Ratings and Balance Sheet Items Ratio (by Level of Corporate Ratings)**

- Group With Lowest Ratings in 2001 (Ratings lower than or equal to 54)

	<b>First Quartile</b>	<b>Second Quartile</b>	<b>Third Quartile</b>	<b>Fourth Quartile</b>	<b>Average</b>
<b>Number Of Samples</b>	163	221	345	335	1064
<b>D (Trade Payable/Total Asset)</b>	-1.21	-1.43	-1.41	-0.88	-1.22
<b>D (Loans/Total Asset)</b>	5.37	3.00	2.70	-1.16	1.96
<b>D (Short-Term Loans/Total Asset)</b>	2.09	2.17	2.34	-0.88	1.25
<b>D (Long-Term Loans/Total Asset)</b>	3.29	0.83	0.35	-0.28	0.70
<b>Highest Short-Term Interest Rate</b>	2.731	2.748	2.607	2.463	2.611
<b>D (Highest Short-Term Interest Rate)</b>	0.085	0.254	0.108	0.005	0.104
<b>Ratio Of Firms Without Request For More Stringent Conditions</b>	0.374	0.430	0.432	0.457	0.430
<b>Ratio Of Firms With Request For Higher Interest Rate</b>	0.405	0.348	0.325	0.260	0.321

- Group With Highest Ratings in 2001 (Ratings Higher Than 65)

	First Quartile	Second Quartile	Third Quartile	Fourth Quartile	Average
Number Of Samples	205	155	214	82	656
D (Trade Payable/Total Asset)	-2.28	-1.89	-0.99	-1.20	-1.63
D (Loans/Total Asset)	1.67	0.01	-0.32	-2.09	0.16
D (Short-Term Loans/Total Asset)	0.44	-0.40	0.05	-0.54	-0.01
D (Long-Term Loans/Total Asset)	1.22	0.41	-0.37	-1.55	0.17
Highest Short-Term Interest Rate	1.497	1.438	1.398	1.392	1.438
D(Highest Short-Term Interest Rate)	-0.010	-0.075	-0.009	-0.060	-0.032
Ratio Of Firms Without Request For More Stringent Conditions	0.614	0.665	0.636	0.743	0.649
Ratio Of Firms With Request For Higher Interest Rate	0.088	0.032	0.047	0.037	0.055

Table 2-7: Relationship between Sales Growth and Balance Sheet Items Ratio to Assets

	First Quartile	Second Quartile	Third Quartile	Fourth Quartile	Average
Sales Growth	<-13.1%	<-3.4%	<+4.3%	>=+4.3%	
Number Of Samples	913	911	913	912	3649
D (Trade Payable/Total Asset)	-3.61	-1.63	-0.53	+0.65	-1.28
D (Loans/Total Asset)	+3.77	+0.79	-0.70	-1.37	+0.62
D (Short-Term Loans/Total Asset)	+2.35	+0.51	-0.24	-0.33	+0.57
D (Long-Term Loans/Total Asset)	+1.42	+0.28	-0.46	-1.04	+0.05

\*Unit is in % point.

**Table 2-8: Relationship Between Sales Growth and Non-Balance Sheet Items**

	First Quartile	Second Quartile	Third Quartile	Fourth Quartile	Average
<b>Sales Growth</b>	<-13.1%	<-3.4%	<+4.3%	>=+4.3%	
<b>Number Of City Banks</b>	2.180	2.357	2.303	2.274	2.283
<b>---- (Second) Regional Banks</b>	2.278	2.201	2.170	2.506	2.286
<b>---- Shinkin Banks and Credit Unions</b>	1.549	1.474	1.744	1.626	1.598
<b>Ratio Of Firms Newly Providing Collateral</b>	0.033	0.044	0.058	0.061	0.049
<b>---- Personal Guarantee</b>	0.146	0.125	0.125	0.123	0.130
<b>---- Government Backed Guarantee</b>	0.078	0.063	0.063	0.064	0.067
<b>Highest Short-Term Interest Rate</b>	2.140	2.061	1.922	2.103	2.056
<b>D (Highest Short-Term Interest Rate)</b>	+0.078	+0.102	+0.034	+0.058	+0.068
<b>D (Interest Rate for Outstanding Loan)</b>	-0.446	-0.094	+1.088	-0.130	+0.113
<b>Ratio of Firms Without Request For More Stringent Conditions</b>	0.509	0.532	0.610	0.560	0.553
<b>Ratio of Firms With Request For Higher Interest Rate</b>	0.222	0.227	0.156	0.171	0.194
<b>Change In Length of Payment Terms</b>	1.964	1.965	1.934	1.981	1.961

Notes: Unit of interest rates is %. Change in length of payment terms is the average of 1 (=shorter than previous year), 2 (=unchanged), and 3 (=longer).

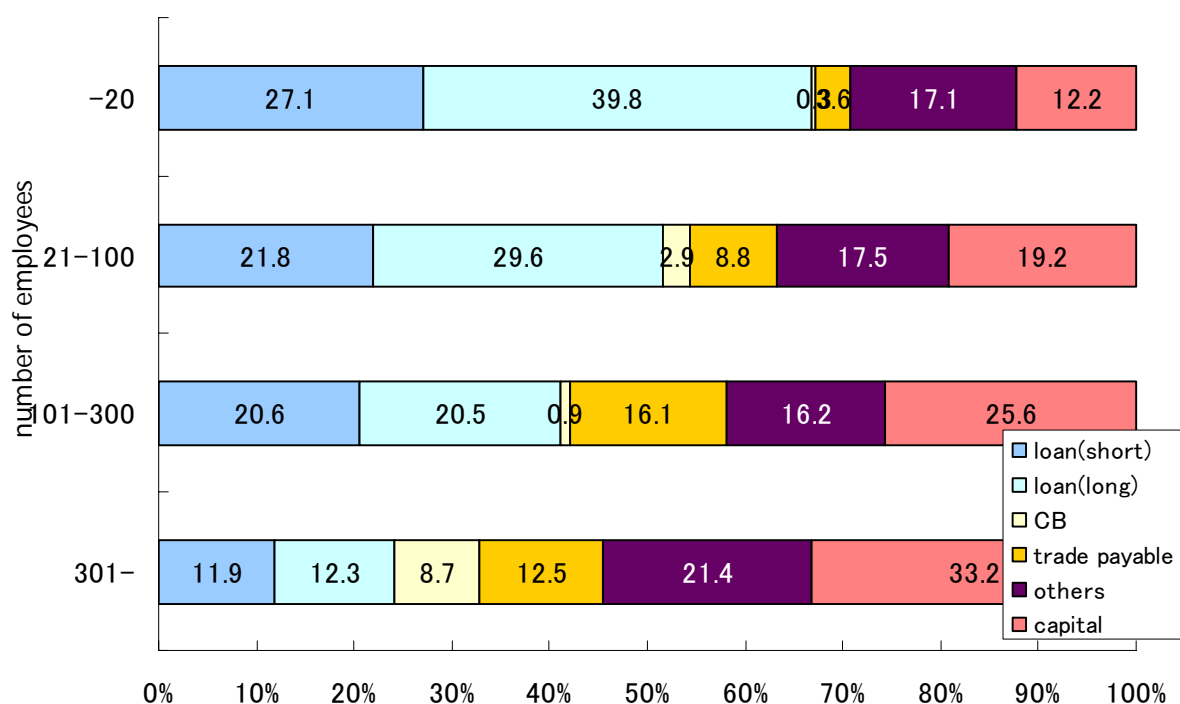
**Table 2-9: Growth Rate of Loans, Trade Payable, and Trade Payable Adjusted for Purchase Amount**

	First Quartile	Second Quartile	Third Quartile	Fourth Quartile	Average
<b>Trade Payable (Including Transaction Demand)</b>	-31.69%	-12.84%	-5.05%	+4.62%	-11.32%
<b>Amount of Purchase 2</b>	-33.09%	-8.58%	+1.74%	+18.64%	-5.33%
<b>Trade Payable 1 (Excluding Transaction Demand)*</b>	-4.65%	-5.64%	-5.53%	-13.75%	-7.46%
<b>Trade Payable 2 (Excluding Transaction Demand)*</b>	+1.40%	-4.26%	-6.80%	-14.02%	-5.99%
<b>Loans</b>	-3.25%	-6.34%	-4.86%	-6.69%	-5.83%
<b>Change In Length of Payment Terms**</b>	1.9635	1.9654	1.9344	1.9810	1.9611

\*Trade payable 1 does not deduct personnel expenses from the purchase amount, while trade payable 2 does.

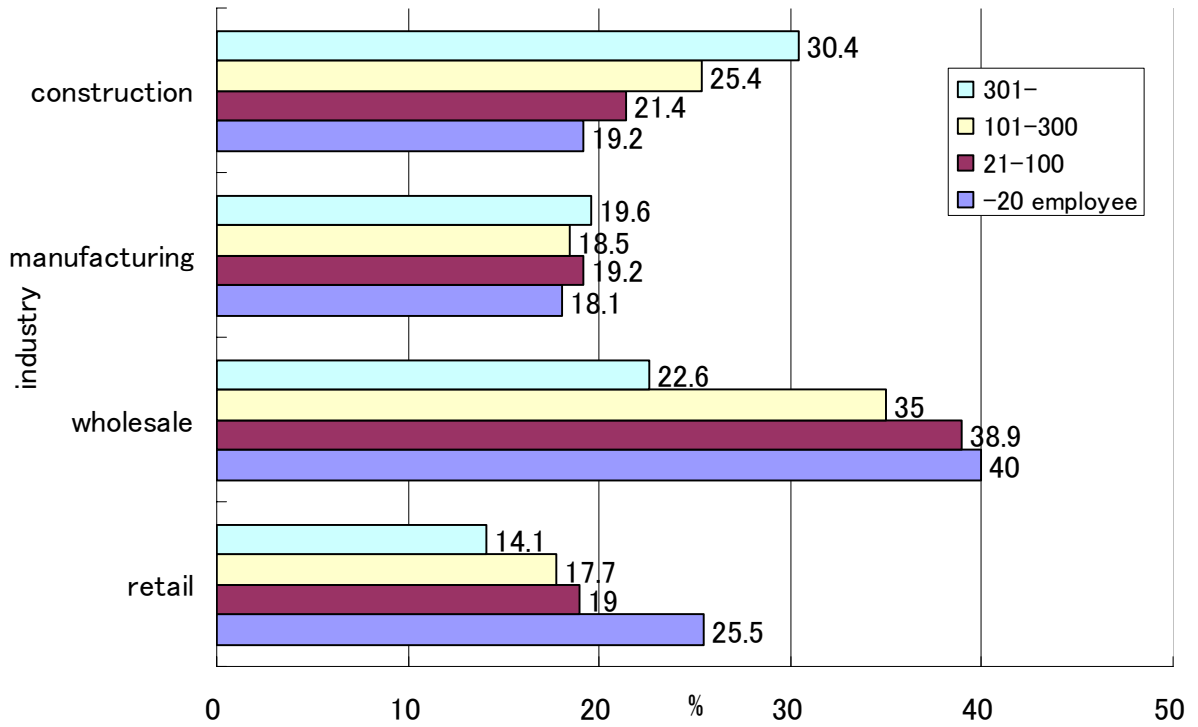
\*\*Change in length of payment terms is the average of 1(=shorter than previous year), 2(=unchanged), and 3(=longer).

**Figure 1. Liabilities to Asset Ratio by Number of Employees**



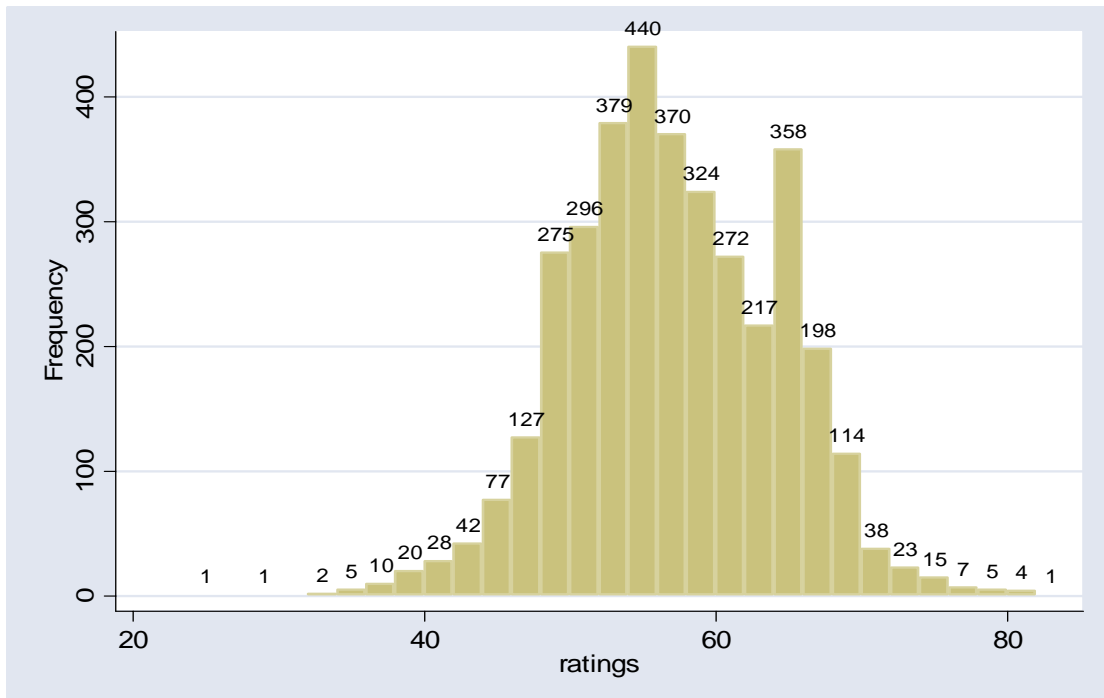
Source: Financial Statement Statistics of Corporations (Ministry of Finance of Japan)

**Figure 2. Trade Payable to Asset Ratio by Industry and Employee Number**



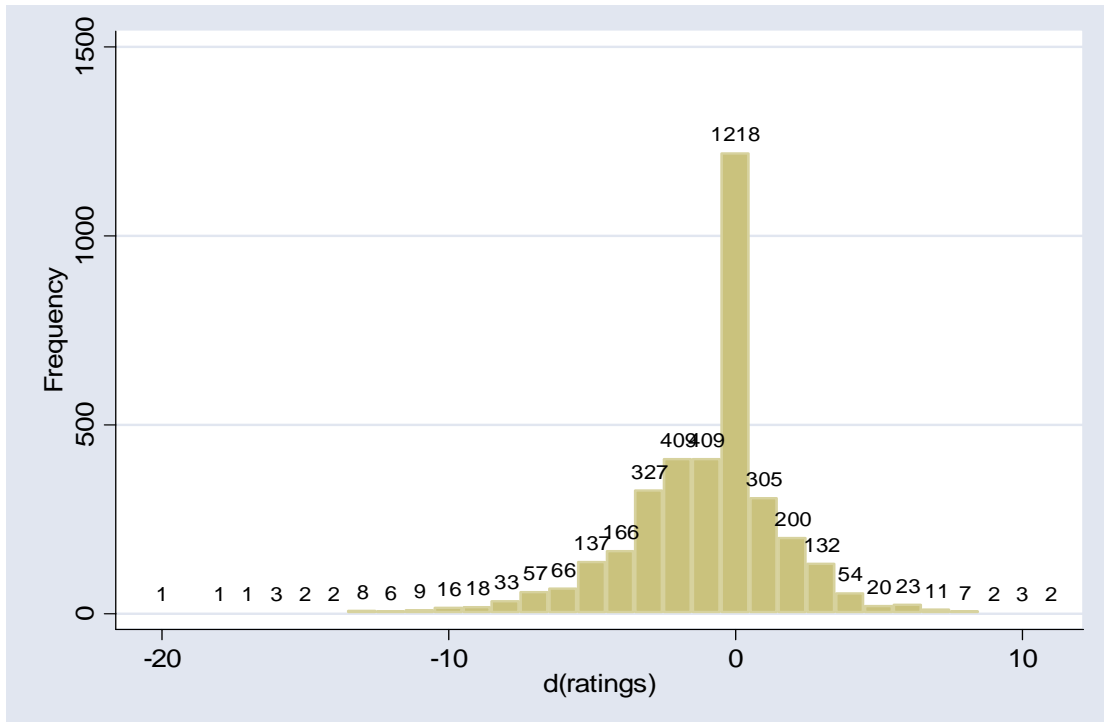
Source: Survey of Financial Environment (SME Agency of Japan)

**Figure 3: Distribution of Corporate Ratings (2002)**



Source: Survey of Financial Environment (SME Agency of Japan)

**Figure 4: Distribution of Changes of Ratings (From 2001 to 2002)**



Source: Survey of Financial Environment (SME Agency of Japan)