Annex III: FINANCE

ASIAN BANKERS' ASSOCIATION
POSITION PAPER ON CORPORATE DEBT RESTRUCTURING

1. One of the major consequences of the current financial crisis is the corporate debt problem being faced by several economies in the region. High levels of corporate debt prevent recovery in various ways. The rolling over of loans by banks to distressed debtors crowd out credit to other firms, especially small and medium enterprises. Increased costs of debt servicing threaten the solvency of corporations. High debt levels threaten to prolong the recession, with firms unable to de-leverage by way of retaining earnings and issuing equity. Faced with these problems, several economies have decided to undertake comprehensive corporate debt restructuring.

A SET OF PRINCIPLES FOR CORPORATE DEBT RESTRUCTURING

2. The Asian Bankers' Association (ABA) recognizes the importance of these efforts in the overall context of promoting economic recovery in the region. We also see the importance of these efforts in strengthening the region's capability to avoid and weather similar systemic banking crises in the future. To achieve success in pursuing these goals, it is important to apply the lessons from the various debt restructuring efforts undertaken in the past. Drawing from studies of these experiences, we consider adherence to the following principles as crucial to the success of current and future debt restructuring efforts.

    a) **Objectives:** Comprehensive debt restructuring should aim to transform and reduce debt in a timely manner to restore solvency, reduce leverage, and restore credit to viable firms, as well as to improve the banking system's capacity to provide financial intermediation. It should also aim to restore profitability of corporations and banks through operational restructuring that includes improved business strategy, management, accounting systems, credit assessment and approval of techniques.

    b) **Choice of debt restructuring framework:** Specific situations and circumstances call for specific debt restructuring frameworks that may range from government mediation, the use of government schemes, bank recapitalization, and the use of asset management corporations. Economies should establish appropriate frameworks suited to their own needs and circumstances, in order to effectively achieve the objectives mentioned above. However, we believe that within these options, maximum private sector participation and minimum direct management by government should be ensured. A description of various frameworks is presented in Annex 1.

    c) **Linking government assistance to necessary measures.** Where government plays a major role, it should link its assistance to concrete measures that promote the objectives of comprehensive corporate debt restructuring. Examples are providing incentives for banks to separate viable from non-viable enterprises and addressing bank recapitalization and corporate debt restructuring in an integrated and transparent plan.

    d) **Macroeconomic stability.** A stable macroeconomic environment is needed to provide debtors and creditors, as well as potential investors, with the required level of certainty to value and close transactions. Whenever needed and appropriate, governments can also establish schemes to

create a stable environment for debt negotiations, reduce foreign exchange risks for debtors, and allow for lower interest rates on foreign debt than debtors could get on their own.[1]

e) **Tax and regulatory regimes.** Tax and regulatory disincentives to debt restructuring, such as taxes that penalize debt forgiveness and loan-loss provisioning and obstacles to the use of debt-equity swaps, should be removed. However, governments should ensure the consistency of the overall tax and regulatory framework when introducing these changes.

f) **Procedures for creditors' decision making.** Past experiences of countries that have undertaken debt restructuring show that less than unanimous creditor approval of reorganization plans is important in speeding up the process. Governments and monetary authorities should review the legal framework to see where appropriate reforms can be undertaken in relation to this. They can use moral suasion to effect creditors' agreement on a set of principles governing such procedures. Workable frameworks for rational and equitable creditor decisions in the region should also be studied for ideas on how key principles could be applied.[2] Examples of such principles are the following:
   i) collaboration among creditor banks to act in the interest of all stakeholders;
   ii) creation and use of comprehensive, accurate and up-to-date information (e.g., through credit bureaus) shared among all parties as basis for decisions on the corporation's future; and
   iii) combining the recognition of seniority of claims with an element of shared pain.

g) **Bankruptcy procedures.** Workable bankruptcy procedures represent a very important aspect of the process of resource reallocation to more efficient enterprises. They ensure the timely liquidation of nonviable enterprises and that credit is not absorbed by such firms. They also provide incentives to work out debt outside a formal restructuring framework.

   Within Asia, there are wide disparities and differences in the quality and procedures of the bankruptcy system. In general, Asia lags behind the US and Europe in the quality and efficiency of bankruptcy procedures. Among the institutional factors accounting for this situation in one or more Asian economies are antiquated bankruptcy laws, corrupt legal systems, the lack of expert lawyers and judges in the area of bankruptcy law, and subsequent lengthy and costly legal procedures. These problems must be addressed through reforms to speed up the process of restructuring and recovery.[3]

h) **Corporate governance.** This is an area requiring immediate attention. Effective corporate governance is necessary both in encouraging managers to restructure debt and in promoting profitable operations, which will help in avoiding the need for future debt re-scheduling. Director liability laws are important to promote good corporate governance. Such laws need to place the burden of responsibility of corporate governance on both executive and non-executive directors in a way that ensures decision-making in the interest of all stakeholders.

   An essential element of good corporate governance is the disclosure of timely and accurate information on all material matters regarding the financial situation, performance, ownership, governance of the company, level of top management compensation, as well as the release of

[1] *Mexico provides an example of such a scheme when it established FICORCA (Foreign Exchange Risk Coverage Trust Fund) in 1983. The main incentive that the trust fund offered to corporations was that it can swap their foreign debt for new peso-denominated debt with a government-guaranteed exchange rate and extended maturity of 8 years together with a 4-year grace period. About US$12.5 billion worth of debt by some 2,000 corporations were restructured under FICORCA. Although the government assumed foreign exchange rate risk, it eventually made large gains with the maturity extension of the rolled-over debts and the appreciation of the peso.*

2 *Bankers' associations in the region can provide information on guidelines for equitable creditor decisions. The Hong Kong Association of Banks, for example, can offer information on this matter.*

3 *Studies of the cases of Mexico in 1995 and of several transition economies show that the absence of effective bankruptcy procedures slowed down the restructuring process in these countries.*

properly-audited statements. It is important for the accounting fraternity to accept a greater degree of responsibility with regard to these matters, and for audit firms to exercise their proper roles and responsibilities in promoting good corporate governance.

However, large differences in levels of development preclude the immediate application of a single set of corporate governance criteria to all APEC members at this point in time. Within the short term, more than one set of criteria could be used to take this reality into account, while measures are undertaken to facilitate the accelerated graduation of less developed economies to higher standards of corporate governance, and the eventual use of only a single set of criteria.

i) **Financial sector reforms.** To facilitate corporate debt restructuring, appropriate financial sector reforms should also be put in place. These reforms should have the following objectives:

   i) to ensure that banks have adequate capital in accordance with international standards so as to have the leverage to write off debt without a consequent widening of spreads and to deal with large creditors on equal terms;
   ii) to ensure that banks have incentives to work out debt; and
   iii) to ensure an arms-length relationship between banks and their borrowers.

j) **Market liberalization.** External resources can be harnessed to speed up the debt restructuring process and to strengthen the financial and corporate sector against the recurrence of systemic banking crises. Liberalization of laws and regulations governing foreign ownership to widen possibilities for foreign investors to acquire equity positions in domestic corporations and banks that are undergoing restructuring could be beneficial.

k) **Capital market development.** Inadequate debt and equity market infrastructures contributed to the outbreak and spread of the financial crisis in Asia. They also pose significant obstacles to financial sector recovery. It will be difficult for banks to lend as they rebuild their capital bases, and securitization of bank portfolios will grow as banks shed their assets. Capital market reform is therefore important for banking sector reform to take root and to create transparent and deep capital markets to complement bank lending as a source of capital.

A ROLE FOR REGIONAL COOPERATION

3. Corporate debt restructuring efforts of individual economies can be greatly strengthened through regional cooperation, especially given the huge costs of re-capitalizing domestic financial institutions.[4] We believe that collaboration within the Asia-Pacific Economic Cooperation forum (APEC) and other multilateral frameworks can provide valuable capital and expertise to promote debt restructuring and recovery. Among various possibilities, we endorse the following:

   a) **Regional or multilateral schemes to promote bank recapitalization.** Such schemes could combine the resources of government agencies, international financial institutions, and the private sector to provide funds for injecting equity into banks and for various programs to take loans off their books. Government agencies and international institutions could take up various roles in these schemes, such as providing equity investment and loan guarantee programs. Funds can be raised from international capital markets with the issue of new debt securities collateralized by underlying assets such as government bonds, bank loans, and commercial papers. Among these schemes are ABAC's proposal of using collateralized bond obligations (CBOs) and the proposed Asian Financial Market Recovery Fund.

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[4] *Some estimates put the cost of re-capitalizing the banks in Indonesia, Malaysia, Thailand and South Korea within the range of between US$125 billion and US$150 billion, with problem loans reaching as high as US$300 billion. These same estimates also put the amounts currently allocated by governments for re-capitalization at only 20%-40% of the total funds required.*

b) **Mobilizing financial expertise within the region.** The frequent incidence of corporate debt restructuring and financial sector reform efforts in Asia, Latin America and Eastern Europe over past decades has created a pool of experts from within the region who have been directly involved in these efforts. Many of these experts have retired from government or private sector employment and form part of volunteer groups that provide assistance to developing countries.[5] Through regional (APEC) or bilateral schemes, their experience and expertise can be harnessed to help governments, monetary authorities, regulators and financial institutions deal with the challenges of corporate debt restructuring.

c) **Regional cooperation for strengthening debt work-out expertise.** The use of technical assistance for bank work-out departments can enhance the quality and timeliness of debt restructuring, as shown by Poland's successful experience with corporate debt restructuring in the early 1990s. APEC should consider cooperative schemes to provide financial and technical support to banks' efforts in developing such expertise.

d) **Regional cooperation for improving standards of corporate governance and promoting consistency of skills in accounting firms.** There is a need for firms and financial institutions in developing economies to move up to higher standards of corporate governance. Experience of banks in the region has also shown that critical differences exist in the level of competencies from one jurisdiction to another among the major accounting firms. The competency differentials are not merely restricted to the area of corporate restructuring but also encompass due diligence. Consistency of skills is essential for these firms, which have an obligation to the business and investor community at large. Technical and financial assistance at the regional level should be made available for programs that promote these goals.

[5] *Examples of existing programs involving such experts are the United States' Financial Services Volunteer Corps and the Canadian Executive Service Organization.*

ANNEX 1. Debt Restructuring Frameworks

SCHEME	OPERATION	USEFULNESS	MAJOR PITFALLS
Government mediation	Impartial government mediator plays the role of honest broker to promote agreements between corporations and banks or between banks. The mediator can establish guidelines for financial engineering and triage, facilitate information sharing, and provide expertise.	• When debt restructuring is limited in scope. • When there is a favorable environment characterized by a credible government mediator, macro-economic stability and appropriate regulatory setting.	
Government schemes	The government provides financial incentives to facilitate debt restructuring. These may come in the form of insurance or subsidy incentives for creditors and debtors, including compensation to creditors for lengthening debt maturities and grace periods; interest rate and exchange rate guarantees; and equity injections.	• When extremely high levels of debt impose externalities, such as a credit squeeze and a cut-off of external financing. • When market or regulatory failures, such as exchange rate risk in an uncertain macro-economic environment, are slowing down the debt restructuring process.	• Politicization • Overly generous and long-lasting incentives, which could lead to large government losses.
Direct bank re-capitalization	The government uses public funds to restore bank capital that has been reduced by widespread interruption of corporate loan payments. Although re-capitalization takes many forms, the cleanest way for governments to re-capitalize banks is by buying new equity shares.	• When extremely high levels of debt impose externalities. • When market or regulatory failures are slowing down the debt restructuring process. • When banks are better qualified to work out debt. • When accompanied by measures improving bank supervision and governance, as well as specific corporate debt restructuring measures.	• Moral hazard problem: banks may gamble the new capital on risky loans expecting a new re-capitalization if the loans do not pay off.
Government asset management corporation	A government-financed asset management corporation buys bad loans, provides equity to	• When extremely high levels of debt impose externalities.	• Multiple inconsistent goals. • Politicization.

	banks and corporations, negotiates with debtors and takes an active role in restructuring. It can also serve as an out-of-court bankruptcy mechanism.	• When market or regulatory failures are slowing down the debt restructuring process. • When bank-led debt restructuring is not feasible due to poor management of banks, lack of expertise in banks to work out bad debt, a large number of debtors, and lack of corporate capacity and willingness to provide reliable financial information. • When accompanied by supporting policies in the areas of corporate governance and financial sector reform.	• Re-capitalizing banks through the asset management corporation by paying above-market prices for bad loans.

Source: Mark Stone, Corporate Debt Restructuring in East Asia: Some Lessons from International Experience [IMF Paper on Policy Analysis and Assessment, October 1998]