Systemic Corporate and Bank Restructuring in Financial Crisis

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I. Introduction

This essay will focus on a dilemma with which many countries in Asia have been wrestling for the past eighteen months—how to restart economic activity when a vast proportion of your companies and financial institutions are illiquid or insolvent as a result of the crisis. This analysis will focus primarily on corporate restructuring. Both corporate and bank restructuring are in the title, however, as this author believes that in crisis, the two cannot be treated separately. It is worth noting at this stage that an integrated approach to bank and corporate restructuring is a key premise behind the Asian Growth and Recovery Initiative, as announced by President Clinton and Prime Minister Obuchi last fall. While there is ample literature on systemic bank crises in the United States, in Latin America, and elsewhere in the world, until recently, little academic work had been done on the link between systemic bank and corporate restructuring. This essay is not an economic analysis and will not come close to offering solutions to this incredibly complex problem. It will merely throw some questions into the mix that have confronted law practitioners in a policy environment. Hopefully more research will be done in this area soon, since the well-being of many people depends on it.

II. Legal Infrastructure

This essay is meant to build on the remarks made by the General Counsel of the U.S. Treasury, Ed Knight, last February. Those remarks stressed the increasing importance of a "Legal Infrastructure" in the new global market—a key theme underlying discussions on this topic. Today's market for development finance is no longer the near-exclusive province of governments, commercial banks and international financial institutions. Instead, as countries have privatized and liberalized, radically diverse kinds of borrowers, including financial institutions, companies, local and central governments, raise funds directly from a diverse

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group of international creditors, ranging from large pension funds and investment houses to retail buyers. The instruments used to raise money are also diverse and complex—marketable securities have overtaken bank loans in many instances, and equity investment has increased dramatically, while asset repackaging and derivatives of all sorts have become standard tools in public and private debt management. These are the players and the instruments at workout tables today.

For businesspeople, policymakers and their lawyers—for that matter, for anyone with a pension plan or a bank account—this means that the body of law relevant to their activity has expanded and become more diverse. As part of the policy response, domestic insolvency and secured transactions issues are now addressed in high-level official fora. Finance ministers are delving into the minutia of one another's domestic debt contracts. And, as has been said so many times, financial sector regulatory issues have come under intense scrutiny in emerging markets and major financial centers alike.

Recent financial crises have given a new impetus to ongoing law reform initiatives, mostly to the second model, described by Professor Salacuse, focusing on financial and commercial law. Since 1997, crisis-affected countries in Asia have enacted dozens of laws and regulations in a challenging political environment in order to facilitate foreign investment, improve transparency and corporate governance, rationalize tax and accounting rules, overhaul bank and securities regulation, establish new insolvency and debtor-creditor regimes, and many others. Revamping legal texts and forming new agencies, however, are at best a partial answer for developing countries confronted with today's capital flows.

A "legal" response to globalization and its crises is necessarily also a complex cultural, political and social response. As many of the authors in this Symposium have said, it must be an inclusive response. After a new law is passed, it needs local lawyers to explain it to local constituencies, and local judges to interpret and enforce it. After a new agency is established by decree, it needs a staff and a clientele who understand and buy into its mission. Building the required level of trust and support can take years. With all constituencies on board, implementation will take decades and surely will not go as expected. Humility, flexibility and a clear vision of short- and long-term goals of reform are necessary equipment.

The world of corporate and bank restructuring in the aftermath of a financial crisis is a microcosm of these issues.

III. Systemic Insolvency: Defining the Problem

When a single firm is insolvent, it can work things out with its creditors privately or apply to an official forum for bankruptcy protection. In a functioning insolvency regime, viable firms can be distinguished from nonviable ones, with the latter facing a real threat of liquidation, where creditors share the proceeds in some established order of priorities. Creditors' balance sheets may take a hit, but for the most part, survive. There is an analogy to this process in the banking sector, with a complex regulatory overlay and more government involvement, including deposit guarantees, to protect the system.

In many countries around the world, certainly in many countries in Asia, however, "bankruptcy" has carried considerably more stigma than it has in the United States. Furthermore, in many legal systems, the completion of a bankruptcy process does not extinguish debts or afford the debtor an opportunity for a fresh start. In business communities where reputational concerns are paramount, it is not hard to see why formal bankruptcy or even debt collection litigation was a rarity. Financial difficulties have been resolved for the most part quietly, in private negotiations. Against a background of steady growth, this approach generally worked to prevent isolated failure from spreading through the economy.

This picture changes dramatically in crisis. To provide a better understanding of the magnitude of the shock that some Asian economies experienced in the last eighteen months, this essay offers a few numbers. According to World Bank estimates, in September 1998:

- Seventy-seven percent of Indonesia's companies were illiquid and sixty-five percent were technically insolvent.
- Nonperforming bank loans were about thirty percent of GDP and nonperforming assets (including various forms of nonbank credit) neared forty percent.
- In Korea, fully half of the firms were illiquid and about forty percent were insolvent.
- Nonperforming bank loans were about twenty-five percent of the GDP and nonperforming assets, a whopping sixty-four percent.
- In Thailand, the picture is similar: sixty-five percent of the firms were illiquid, twenty-three percent were insolvent. Nonperforming loans were at about twenty-eight percent of the GDP and nonperforming assets at about forty-one percent.

Not even the best insolvency system in the world can handle this volume of failure, exceeding many-fold what we saw in the U.S. Savings and Loan crisis, where indicators comparable to those cited above remained in the low single digits.

The crisis brought with it a drop in demand, collapsing asset prices and a sharp rise in liabilities, owing in part to direct, unhedged private borrowing in foreign currencies and a sharp rise in domestic interest rates. The effect of these developments was magnified by the fact that, prior to the crisis, firms had accumulated debt many times exceeding their equity. For example, leverage ratios for large firms in Korea often exceeded 500 percent.

In Indonesia, the currency dropped from 2,000 rupiah to the dollar to 8,000 and then 15,000, rising back to 10,000 all in a matter of months. In the fall of 1998, a relatively stable time by crisis standards, domestic interest rates were hovering around seventy percent.

A recent trip to Jakarta serves as an example of the instability discussed above. I was in Jakarta just before a mild upswing in the rupiah—between the time I charged my hotel bill to my credit card and the time I received my credit card bill, the amount went up by a third. Imagine the impact of such fluctuations on the corporate sector, where estimates of cross-border debt exposure have ranged between $65 and $85 billion (not including trade finance)—about half of Indonesia's total external debt. Even these figures understate the problem, since many Indonesian companies borrowed in foreign currency from Indonesian banks.

Consider this, as a result of the currency fluctuations, a hypothetical good company selling perfectly respectable widgets for rupiah saw its debt multiply eightfold at the height of the crisis. At the same time, most customers could no longer afford the widgets. Assuming the best intentions on the part of debtors and creditors, the extent and uncertainty of the currency's fluctuations (it could halve or double in a month) made it virtually impossible to make business plans to retool a firm for a different product or customer base. At the same time, a hypothetical good bank had to pay depositors astronomical interest rates, while its corporate borrowers could not afford to pay back their loans. Even where corporations could afford to make payments, why would they bother? When they have no hope of getting new money to keep operating, servicing local bank debt suddenly looks like a waste of precious cash. Consider also the bank's own debt exposure, which increased dramatically as the currency dropped and the interest rate spiked. In this situation, many banks effectively stopped lending to companies and went into the business of buying government obligations paying high interest rates.

This example illustrates an extreme, theoretical case in one country. Good companies, well-run banks and well-intentioned debtors and creditors are not always the norm. Furthermore, the shape of the crisis and debt profiles differed considerably by country. Indonesia's situation was distinct in that its debt problem was largely brought about by direct, unhedged cross-border borrowing by its companies. To a lesser extent, in Thailand as well, foreign creditors were a large part of the corporate debt picture. By contrast, in Korea, most corporate borrowing went through domestic banks, which in turn raised money abroad. In Thailand, a large portion of nonperforming assets was in the real-estate sector, giving rise to somewhat different problems. In Korea, most of the corporate debt was owed by the top sixty-four conglomerates, or chaebol, with even greater concentration among the top five. Likewise in Indonesia, large, diversified conglomerates played a big role. In Thailand, by contrast, about half the corporate debt was owed by small- and medium-size companies.

That said, going into the crisis, the countries had in common high debt-equity ratios, a lot of short-term debt, undercapitalized and poorly supervised financial institutions, a history of bad credit decisions, nonarms-length lending, insolvency and debt collection regimes that were rarely used and ill-suited for today's commercial workouts, and an extraordinary concentration of corporate ownership. The World Bank estimated that the top ten families in Indonesia in 1997 controlled corporations worth fifty-eight percent of the country's market capitalization, with comparable figures at about fifty percent in Thailand and the Philippines, one-fourth of one percent in Korea and Malaysia, in contrast to only two to three percent in Japan and even less in the United States. This last set of figures is particularly interesting in view of recent studies indicating that implementation of bankruptcy and other commercial laws has historically been more difficult in jurisdictions with high corporate ownership concentration levels.

Of course, as many commentators have already pointed out, it takes two to tango in cross-border finance, and lots of global financial institutions lent into this environment in curious disregard or even more curious ignorance of some of its features.

Two more factors are important in this picture—first, as crisis exposed the problems in their financial sectors, governments imposed tighter prudential guidelines, which made banks all the more conservative and exacerbated the credit crunch. Second, dealing with corporate distress is made all the more difficult by the absence of a formal social safety net to help absorb job losses and soften the impact of the crisis on the poorest. Traditional safety nets, based on family and local community structures, had weakened in the decades of rapid growth, geographic mobility and industrialization. As pointed out by other commentators, the safety net provided by "lifetime employment" in the more industrialized countries could no longer be supported in crisis. On the other hand, there has been considerable and considered resistance on the part of many governments to importing foreign entitlement models of social support—different models may need to be designed.

The social costs of the crisis have been immense and well-documented in the press. There were also political difficulties—each of the three countries discussed above faced elections right about the time or shortly after crisis hit. But one can see how, even without the political, ethnic and governance overlay, the governments in the region had a daunting task ahead. Fixing the macroeconomic picture was a necessary, but by no means sufficient, element in restoring economic activity, not to mention growth.

IV. Devising Practical Solutions

Apart from fixing the macro environment, what needs to be done to get banks back to lending, and companies back to making and selling their stuff?

First, there must be a way to separate viable banks and companies suffering the effects of the crisis from those that have no hope of surviving. This task is often referred to as "triage." There must be a way to have nonviable entities "exit" the economy, preserving as much value as possible for their creditors and society in the process. Second, viable banks need to recover a capital base—whether through private recapitalization efforts, an injection of capital by the government or a combination of the two. Third, companies need to restructure and rationalize their debt profiles. Fourth, particularly where credit crunch is severe, viable companies need access to interim working capital financing at a time when domestic institutions cannot lend and foreign ones have lost their appetite for local risk. Fifth, and probably most importantly, operational restructuring needs to occur for both banks and corporations. This usually means a change in management, eliminating noneconomic capacity and restructuring operations. In the longer term for the banks, it means changing the so-called "credit culture"—the way in which credit decisions are made by lenders and analyzed by their regulators.

For both banks and corporations, operational restructuring means job loss in a social service infrastructure unequipped for this level of disruption. It often means displacing politically and economically powerful owners (recall the ownership concentration statistics cited earlier). Moreover, the task of replacing management in one insolvent firm simply cannot be replicated on the systemic scale: displacing two-thirds of the management class in a reasonably stratified society is an entirely different challenge. There are not enough managers in the country, and foreign replacements on this scale are, to put it mildly, impractical. Beyond that, operational restructuring involves breaking up monopolies and working to eliminate links between the government, the financial and the corporate sector that resulted in distorted allocation of resources and dangerously concentrated risks.

Making these changes is not merely a matter of seeing the light of economic rationality—it involves incredibly sensitive political, social, ethnic, and cultural issues. Thus, the entire gamut of operational restructuring goals takes the longest to achieve. Other objectives can be accomplished faster.

With these overall objectives in mind, this essay seeks to flag a few threshold issues of policy design. I will first address sequencing. If capital is injected into banks up front, without addressing the corporate credit problem, particularly in the absence of operational restructuring and a change in credit culture, the money will go right out the door to nonviable companies, and the banks will sink again shortly. The "moral hazard" concerns are heightened. On the other hand, if corporate restructuring goes first, undercapitalized, poorly regulated banks will resist recognizing the extent of their nonperforming loans and will have difficulty contemplating debt relief that may be necessary to get viable companies back on their feet. This sequencing problem, more than anything else, points to the need for an integrated approach to bank and corporate restructuring—domestic banks need to have the ability and the right incentives to engage in commercial workouts from the start, and the implications of bank problems for restructuring for corporate restructuring must be considered at every turn.

Second, there is the role of the government in bank recapitalization. In the best of all possible worlds, viable banks could attract private capital—from either existing owners or new ones. The problem is that there are few private takers in crisis conditions. For both banks and companies at the onset of the crisis, even the best-intentioned owners find it hard to acknowledge the drastic drop in the value of their business. Initial shock and denial among potential sellers combine with extreme risk aversion among potential buyers to produce impossible bid-ask spreads. Attracting foreign capital, even assuming that there is interest on both sides, raises political issues that must be confronted in what is likely to be a tense environment.

In sum, the overwhelming likelihood is that private capital will not be sufficient to resuscitate the banking sector. The government is then faced with the unappetizing prospect of nationalizing much of its banking sector at a time when it can least afford it, while it is also trying to sever ties with the private sector that resulted in distortions leading up to the crisis.

The thorny question of ownership comes up again—normally, equity owners should be wiped out. Where institutions have been in the same family for generations or where most owners are members of one minority ethnic group, however, this move is neither easy, nor always appropriate. Furthermore, even assuming it is able to kick out the owners and the management, the government has little appetite or capacity to operate banks. Among the solutions that have been tried to date, only convertible instruments, loss-sharing and value-recovery arrangements, and management contracts have met with some success. To the extent that nationalization occurs, an exit strategy for the government, an eventual privatization, needs to be considered up front.

Note also that if banks are nationalized, the government becomes indirectly the predominant creditor of domestic corporations, and, given the debt-equity ratios, may end up de facto nationalizing the corporate sector as well.

Third, government involvement in corporate restructuring raises a distinct set of questions. While it is widely acknowledged that the systemic significance of banks justifies government involvement and taxpayer expense, the same argument is not there on the corporate side. Although in the 1980s debt crisis many governments effectively assumed the debts of their corporations, there is much less appetite for such measures in today's ideological climate.

As an intermediate step, some governments have offered exchange rate protection programs, most appropriate where the very volatility of the exchange rate makes it impossible for debtors and creditors to come up with realistic business plans. In Mexico, the Philippines and most recently Indonesia, governments in effect offered to service the restructured foreign debt of private companies, provided the debt was restructured on specified terms, and the companies paid the government a local currency equivalent based on an agreed formula. In theory, under such a program the government is not exposed to commercial risk—if the company fails to deliver the local currency, the government does not pay the dollars to the foreign creditor. While earlier programs were viewed as reasonably successful, there have been few takers for Indonesia's program to date. Reasons for this lack of popularity may include aspects of program design, the pace of rupiah's recovery and others—the jury is still out. It is interesting to note that the vast majority of companies that entered the Mexican exchange protection scheme did so in the last days of the program.

In the Asian context, another form of government involvement has been popular—a framework based on the so-called London Approach used by the Bank of England to drive workouts in the United Kingdom in the 1980s. This is a government-sponsored, out-of-court restructuring program, in which the government establishes negotiation rules, perhaps dispute resolution procedures, and uses strong moral persuasion to get debtors and creditors to negotiate constructively. A variation of this approach has been adopted in Korea, Thailand, and Indonesia. In Indonesia, the so-called Jakarta Initiative has a mediation component that has been reasonably successful in getting debtors and creditors to the table. In Korea, local banks have agreed to binding arbitration. The Thai program has stressed mediation, but has recently added an arbitration component. Regulatory facilitation is another key component of such initiatives, particularly in countries where a restructuring agreement would require many approvals from many different authorities—if the debtor reaches agreement with its creditors, rather than going to ten different ministries and waiting for months, it has a single government point of contact and an expedited procedure to obtain the necessary clearance. Some participants have observed that variations on the London Approach can fit the business style and build on the cultural strengths in the crisis-hit economies, stressing negotiation and out-of-court dispute resolution. It could also be adapted to the debt profile of the corporate sector in a particular country—for example, Korea used different approaches to restructuring large and medium conglomerates, and small and medium-size companies. Creditor diversity (foreign and domestic, banks and bondholders) presents particular challenges for government involvement—outside bankruptcy, intercreditor equity is hard to achieve and defend.

Fourth, very briefly, the issue of asset management and disposition should be addressed. Bad assets can be taken out of banks into a central, government-owned asset-management company, which would be charged with working them out and selling them. Alternatively, they can be left in banks, where workout departments would be responsible for their restructuring and disposition. Although many commentators have strong preferences on this issue, it appears that any decision must be made based on particular country circumstances.

Where the government has limited financial capacity or skill base to manage an enormous pool of assets, where there is limited political will to dispose of the assets quickly, and where the banking sector is generally clean and competent, it may make sense to avoid a centralized approach and to leave the banks with relationships to their borrowers to work the loans. Thailand has decided to follow this approach and generally the results have been mixed. On the other hand, where banks are extremely weak and, particularly where concerns over connected lending are strong, a centralized approach may make more sense. This is closer to the model chosen by Indonesia, also with mixed results. One concern with the latter approach is the power concentration in an institution that may hold a giant share of a country's assets—process transparency and accountability are critical in this context. Of course, there are no pure fact patterns to fit pure models. The uncertain record reflects, in part, the difficulty of devising appropriate hybrid solutions in a crisis environment.

A key tension with asset disposition schemes is the speed with which sales occur—on the one hand, sales must occur fast, to set price benchmarks and establish a distressed asset market. On the other hand, fire sales tend to drive down asset prices. Where wealth is unevenly distributed among ethnic groups, rapid mandatory sales may yield results that resemble dangerously a wholesale expropriation of some groups in favor of others.

Finally, legal implications cannot be overlooked; thus, a few key legal policy issues in restructuring must be stressed. Bankruptcy and foreclosure regimes are foremost among these. While not even the best insolvency system can cope with a crisis of the magnitude Asia experienced, a functioning bankruptcy and debt collection regime forms the background against which workouts are negotiated. As has been pointed out by many commentators, formulation and even content of the law matter less than ownership by the local legal community and predictable implementation. The turn-of-the-century Dutch bankruptcy law that failed miserably in Indonesia was doing reasonably well in Holland, with relatively minor modifications. Lack of local ownership, corruption and unpredictable enforcement have a very real effect on workouts and asset prices—they drive them down.

All three countries mentioned in this essay have reformed their bankruptcy regimes in the course of the crisis. Thailand amended its insolvency and foreclosure laws in early 1999. It is too early to evaluate the implementation record. The experience in Indonesia, where a new court issued some very unpredictable and controversial decisions, however, suggests that we should probably moderate any expectations on this front.

A few other substantive legal measures crucial for facilitating out-of-court workouts include a regime for prepackaged bankruptcy workouts, tax neutrality for restructuring, permitting debt-equity swaps, and liberalizing foreign investment rules, as well as certain provisions for dealing with security interests. Many of these have been enacted in Asia since 1997 and some are still pending.

V. Conclusion

In conclusion, it is clear these are very complicated problems that should be confronted in an integrated manner. In addition, any attempts at resolution should be culturally and politically sophisticated. For now, there is no uniform approach and no silver bullet—the restructuring framework must fit the needs and circumstances of the country and be able to generate the support of the many people it must help.

In this context, recent proposals for a "super Chapter 11" to deal with systemic crises are intriguing from economic and legal perspectives, but tend to sidestep the political challenge. Redistribution of property on the scale faced in today's emerging markets crises is an issue of constitutional magnitude. A reasonably detailed bankruptcy chapter will have difficulty addressing the particular circumstances of a future upheaval and is unlikely to have the level of political legitimacy necessary to deal with social problems on the scale of the modern financial crisis.