Principles of Corporate Restructuring and Asset Resolution

Ruth Lane Neyens

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Principles of Corporate Restructuring and Asset Resolution

Ruth Lane Neyens*

Table of Contents

I. Introduction
II. What is "Asset Resolution" and Why Is It Important?
III. Prerequisites for the Development of an Enabling Framework for Asset Resolution, the Role of Government
   A. Speed Is of the Essence
   B. Comprehensive, Consistent Approach
   C. Recognize the Losses
IV. Essential Elements of an Enabling Framework for Asset Resolution
   A. Credit Culture
   B. Supervision and Regulation
   C. Legal Framework for Creditor Rights and Insolvency
   D. Informal Workout Procedures
   E. Capital Market Development
   F. Credit Bureaus
   G. Link with Fiscal/Macro Economic Stability
V. Implementation of Asset Resolution Process
   A. Asset Resolution Entities
   B. Asset Sales vs. Corporate Restructuring
   C. Special Incentives and Powers
   D. Equity Holdings
VI. Principles for Effective Asset Resolution (Including Corporate Restructuring)
   A. Creating an Enabling Framework for Asset Resolution
      1. Principle 1—The Role of Government
      2. Principle 2—Speed Is of the Essence
      3. Principle 3—Comprehensive, Consistent Approach
      4. Principle 4—Recognize the Losses

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B. Elements of an Enabling Framework for Asset Resolution
1. Principle 5—Credit Culture
2. Principle 6—Supervision and Regulation
3. Principle 7—Legal Framework for Creditor Rights and Insolvency
4. Principle 8—Informal Corporate Workouts and Restructuring
5. Principle 9—Capital Markets
6. Principle 10—Credit Bureaus
7. Principle 11—Fiscal/Macro Economic Stability

C. Implementing the Asset Resolution Process
1. Principle 12—Involve the Private Sector
2. Principle 13—Asset Resolution Vehicles
3. Principle 14—Asset Sales
4. Principle 15—Corporate Restructuring
5. Principle 16—Special Incentives and Powers
6. Principle 17—Equity Holdings

VII. Bibliography

I. Introduction

Like death and taxes, bank failures and systemic financial sector distress appear to be facts of life in the industrial world, as well as developing and transitional economies. Since the late 1970s, 112 episodes of systemic banking crisis have occurred in 93 countries, with an additional 51 borderline crises recorded in 46 countries (Caprio, Klingebiel 1999).

These periodic episodes of financial distress are costly to governments and taxpayers alike. On average, these costs have amounted to 12.8 percent of the national GDP with the percentage still higher (14.3 percent) in developing countries. But in many countries, the costs are much higher. Argentina and Chile spent as much as 40–55 percent of their GDP to resolve their crises in the early 1980s, and the recent East Asian crisis is expected to cost in the vicinity of 20–55 percent of their GDP (Honohan, Klingebiel, 2000).

But these numbers do not tell the entire story. They do not include the indirect costs, or human costs, incurred. Examples include the loss of, or delays in accessing, deposits; lack of credit; higher interest rates charged to cover the losses on nonperforming loans; lost wages as a result of layoffs in both the financial and corporate sectors; and the opportunity costs associated with forgone investments. The burden falls disproportionately on the poor as taxes are increased, incomes reduced, job opportunities lost, and badly needed infrastructure and social programs are reduced or eliminated.

The effects (and costs) may not be limited solely to the country experiencing the crisis. In a global economy, financial instability can be easily transmitted to neighboring countries or more distant trading partners.

The importance of limiting the costs of the crisis through quick resolution has long been recognized. But in practice this has proven difficult. It is now some four
and half-years since the onset of the Asian crisis, and economic recovery in each of the
three crisis countries continues to be hampered by the lingering effects of the crisis.
While, in general, weak and insolvent banks have been closed or otherwise resolved,
financial systems remain weak in many countries, intermediation is low, and corporate
debt restructuring and asset disposition remains slow. Authorities continue to look for
ways to speed up the process.

Key factors in delaying the resolution process, and thus increasing the cost of the
crisis, have been the lack of an enabling framework to support asset resolution, and an
understanding of the proper application of the tools available. While each country faces
a unique set of circumstances, including differing legal and institutional frameworks,
the number of alternative approaches is limited, and the application of certain basic
resolution features is universal. This paper attempts to provide broad guidance on the
specific issue of asset resolution, through the development of principles to guide the
resolution process. Section II defines asset resolution, and provides an overview of its
importance within the context of resolving either a single weak institution, or multiple
institutions during a financial crisis. Section III looks at the prerequisites for developing
the supporting framework necessary to support asset resolution. Section IV identifies
the essential elements of an enabling resolution framework. Section V discusses issues
surrounding the implementation of the asset resolution process. Section VI concludes by
suggesting a set of principles to guide an effective asset resolution process.

II. What is “Asset Resolution” and Why Is It Important?

To the general public, when a bank is closed or recapitalized, the problem is solved.
But to the authorities, the problem has just begun. Suddenly they are faced with having
to liquidate, or wind up the estate of the failed bank in an orderly manner. This requires
them to “resolve” or reduce to cash, in a timely fashion, the assets of the failed institution
in order to recoup the costs incurred in honoring the government’s deposit guarantee,
and to provide payments to other creditors if any surplus remains.

What do these assets consist of? Broadly speaking, they can be defined as: the deposit
and product franchises; liquid instruments, consisting of cash and readily marketable
securities and bonds; loans—both performing and nonperforming; and other assets such
as real estate, equipment, and other miscellaneous assets on which the bank may have
foreclosed. Partnership interests in various projects, may also be included in this category.

For purposes of this paper, it is assumed that the intervening authority has moved
expeditiously to transfer the deposit franchise, and as many other assets as possible, to
another institution (purchase and assumption). There will, however, be a core group of
distressed assets that remain. These are assets, which due to the level of their impairment,
the purchasing institution is unwilling to assume, even with the protection of appropriate
guaranties or warranties.

In the case of an individual bank failure, the number of the assets involved may be
small and markets are functioning. Thus, the resolution process may be handled without
creating undue distortions in the market. But in the case of systemic crisis, the num-
ber of impaired assets surpasses the capacity of the existing resolution system. The level
of dislocation within the market, makes it difficult to value assets appropriately, and
asset sales may further depress market conditions. Economic stability must be restored
before investors are willing to enter the market. The legal framework for creditor rights and insolvency (including corporate reorganization) and out-of-court workouts, must be developed and implemented. Many corporations and their loans must be restructured before they can be sold. Furthermore, at each stage of the process, powerful, politically well-connected vested interests are likely to intervene, in an attempt to stop the implementation of an effective resolution process. All of these difficulties combine to impede and block the resolution process.

However, large stocks of non-performing loans exact a heavy price. First, they weaken the repayment ethic. As borrowers see their banks closed, or others default without penalty, they follow (strategic defaulters). Experience has shown that “if left unresolved, nonperforming assets can deepen the severity and duration of financial crises, and complicate macroeconomic management.” A large stock of non-performing assets locks up scarce financial capital in non-productive projects and impedes the resumption of efficient intermediation that is vital for economic recovery.

It is this critical linkage between the banks and the corporate sector, which has been too often overlooked in the discussion of asset disposition. One school of thought has held that the banks transmit their problems to the corporate sector. As institutions weaken and fail, the flow of credit is reduced, creating a “credit crunch.” Borrowers suddenly find themselves cut-off from financing, and are unable to purchase new raw materials or invest in new projects, thus contributing to the slowdown in economic activity.

This view, tends to regard the corporations as innocent victims decimated by the sudden onset of a currency crisis. Thus, much of the initial response to the crisis will focus on ensuring the availability of trade flows, providing mechanisms to ensure the availability of foreign currency, relieving the “credit crunch,” and the design of forbearance programs, to provide corporations with breathing room in which to recover.

While individual bank failures can usually be traced to fraud, poor management, and poor choice of borrowers, systemic crises don’t just happen. They may be triggered by an external shock (for example currency devaluations, sharp increases in interest rates, drop in demand), but research reveals that the causes of systemic crisis are deeply rooted in macroeconomic factors, such as policy mistakes, particularly as it relates to deregulation within the financial sector, poor regulation and supervision, inadequate risk management, and poor governance both in the financial and corporate sectors, to name a few (Sheng, 1996). In East Asia, it is apparent that the traditional government-business ties, the predominance of state banks, the common ownership of conglomerates (borrowers) and their banks, inadequate corporate governance, and the lack of transparency in accounting and other information flows, all combined to create the crisis which has devastated the region.

In a systemic crisis, it is apparent that the contagion works the other way. The corporate sector is already weak. Weak and ineffective supervision and regulation, has allowed banks to engage in a prolonged period of financing low-margin or loss making

2. See The FDIC and RTC Experience, Managing the Crisis, for discussion of the effect of bank failures in rural communities.
enterprises. Corporate profitability and returns on investment are typically low, leverage is high, and interest coverage is deteriorating. As the strength of the banks' loan portfolios is a derivative of corporate earnings, all banks will have weak portfolios, and there are few "good" borrowers. Proper intermediation and the return to sustainable economic growth can not begin, until these weak performers are weeded out, the corporate sector returns to health, and the banks begin to intermediate to economically viable projects.

This failure to recognize the linkage between the corporate sector and the banks, and to develop appropriate policies to deal with both in the context of systemic crisis, lies at the heart of many asset resolution problems. Simply put, the financial system cannot function properly without a strong, vibrant corporate sector. Merely resolving weak and insolvent banks is not sufficient. An enabling framework to support the asset resolution process must also be created and implemented. Without an ability to cleanse the stock of bad loans through liquidation or restructuring, the stock of bad loans will remain, the flow of new nonperforming assets is likely to continue, economic growth, and ultimately macroeconomic and fiscal stability will remain at risk.

III. Prerequisites for the Development of an Enabling Framework for Asset Resolution, the Role of Government

Government must take the lead in developing a climate for effective asset resolution. As only the government has adequate financial resources to recapitalize the banking sector, it should have the determining say in the design of a resolution process to minimize the fiscal burden. But, just as governments do not make good owners of banks, they also do not make good asset restructuring decisions. These should be left to the private sector as borrowers and creditors. The government's role, therefore, should be restricted to providing the coordination and leadership necessary to create a sound enabling framework, that supports the intermediation of scarce resources to economically viable projects, provides a liquidation and rehabilitation mechanism for distressed borrowers, and promotes the safety and soundness of the financial sector through strong supervision and regulation. In addition, the framework must be efficient, inexpensive, transparent, predictable, and accountable.

A. Speed Is of the Essence

Financial sector problems do not disappear with the passage of time. Ignored, they continue to grow and losses mount. Given the amount of lead-time necessary to build an effective framework, governments should begin to put the framework in place well before the onset of any crisis, to ensure that the principles and tools of asset resolution are fully functioning when needed. If this work has not begun, governments must be prepared to engage in serious reform efforts as soon as the first signs of crisis appear. This willingness, known as political will, is likely to be the single most important determinant of the speed and success of the resolution process.

B. Comprehensive, Consistent Approach

Asset resolution involves the redistribution of wealth and control. Therefore, the design of an effective asset resolution framework will determine how the costs will be
shared between the government (taxpayers), owner/investors (both domestic and foreign), and lenders. While the framework generally rests on a comprehensive set of principles, including a strong rule of law which favors contract enforcement, broad based corporate ownership, insolvency procedures favoring rehabilitation, rather than liquidation of distressed corporations, and an informal work out process, the exact design of each of these elements will be dependent on each country's unique circumstances, and the political tradeoffs required to build a consensus approach. The difficulties involved in gaining this consensus, should not be underestimated. When governments are weak, lack clear mandates, and are subject to pressures from powerful vested interests, the resolution process can be expected to stall.

As important, if not more important, than a comprehensive approach, is consistent application of the chosen approach. Borrowers, lenders, and investors want the assurance of predictability. Their willingness to enter into a restructuring, investment, or purchase transaction is based on assumptions regarding their treatment under the framework. If the rules of the game are constantly changing, or are applied in an inconsistent manner, asset resolution will be prolonged, and the value of the assets will deteriorate accordingly.

C. Recognize the Losses

Asset resolution requires the recognition of losses and results in the redistribution of wealth and control. Assets removed from distressed banks are among the most impaired in the system, and should be marked to market quickly, to avoid the perception that they represent a stock of "hidden wealth."

This loss of value is difficult for the public, bankers, and government officials alike to grasp. Many of the borrowers are prominent members of the elite, highly visible corporations with many employees, or "trophy assets," such as major hotels/resorts or office buildings. It seems counterintuitive that these obligations are now worth a small proportion of their face value.

But nonperforming loans (NPLs), are loans on which the borrowers have stopped making payments. The reasons for default are varied. Borrowers may simply walk away from their obligations if there is no legal means to enforce contracts. Or the borrower may have gone out of business. Some feel that defaulters have an unfair advantage, so they also default, to level the playing field. Many believe that they are relieved of their obligation to repay when their bank is closed. Still others feel no obligation to repay as the "loan" represented a "gift" or "fee." In most cases though, borrowers default because their income stream or cash flows are not sufficient to meet their obligations. As a result, they will redirect their cash flows to those payments which are necessary for survival, for example wages, inventory purchases, and the like. When a borrower's cash flow has been interrupted on a permanent basis, the loan is deemed to be impaired. That is, its realizable value (the amount anticipated to be collected from all sources) is less than its face or stated value. Nonperforming loans, therefore, represent loans that will not be collected in full.

When assets are sold, the investors are purchasing a stream of payments. Unlike the example above, they do not merely sum up the aggregate amount of the expected payments to arrive at the purchase price. Instead, they project the cash flow (net of expenses) to be generated from the underlying asset, and apply a discount factor reflecting their
desired return, given the perceived risk of the investment. This figure is substantially below either the face, or realizable value of the asset, and represents a permanent loss of value to the seller.

If asset resolution is to proceed in an orderly manner, the government must be prepared to accept its share of the losses. Adoption of an investor-oriented approach to asset valuation provides a more realistic indication of the likely sales prices. It also provides a benchmark against which to evaluate sales proposals, and the effectiveness of the resolution process, as well as minimizes the criticism of “fire sales.”

IV. Essential Elements of an Enabling Framework for Asset Resolution

A. Credit Culture

The best defense is a good offense; a strong, vibrant financial sector is built upon a strong credit culture or body of practices which ensure sound lending. These practices rest on the recognition, that both the lender and the borrower are using the depositors’ funds. Both the lender and the borrower, therefore, assume a fiduciary responsibility to ensure that, prior to entering into a transaction, both parties are reasonably certain that the loan can, and will, be repaid. This requires a due diligence process to establish the capacity to repay; documentation of the financial, legal and other contractual terms associated with the loan; post disbursement monitoring of the loan to ensure its continued performance; and finally, a process to deal with problems and conflicts if, and when, they arise (Corrigan, The Culture of Credit, 2001).

Most bank failures are caused by bad loans. The internal culture of these banks is weak. They routinely enter into lending transactions without a proper understanding of the risks involved. They fail to identify and analyze multiple sources of repayment for each transaction. They fail to document the loan properly, particularly with respect to their security interest in collateral. Once the loan is made, they fail to monitor its repayment (including properly recording all payments), and the on-going financial condition of the borrower. Finally, after a default, they fail to take firm action to ensure repayment.

Supervisors should require every bank, to have and adhere to, a written credit manual that details the basics of its culture. At a minimum, this policy manual should contain the bank’s mission statement; define the types of loans that a bank will make, as well as those that they will not make (for example speculative purposes, gambling, and illegal activities); outline their credit approval process, as well as the post disbursement monitoring process (including standards for credit files), and the steps that must be taken when loan repayment is in jeopardy. Many banks also include an outline of the minimum standards of loan documentation. The purpose of all loans should be clearly documented, and an analysis performed to establish the likelihood of repayment. While formal credit analysis relies heavily on the application of quantitative techniques, the basics can easily be captured in an assessment of the 5 C’s of Credit: Character, Capacity, Collateral, Capital, and Conditions (See Box 1).
Box 1: The Five C's of Credit

Character: This factor deals with the integrity of the borrower. Does the borrower have a history of meeting its obligations in a timely manner? How has he reacted to past adversities—does he run away, or does he work to correct the situation? Does he live within his means? Or, is his lifestyle above his earning capacity, reflecting a possible improper use of funds? Credit Bureaus or reporting agencies can be very helpful in establishing a borrower's repayment history.

Capacity: Does the borrower earn enough to ensure loan repayment? Is the borrower's free cash flow sufficient to repay? Care must be exercised to determine the true cash flow of the borrower, as accounting treatments can generate reported profits well in excess of the borrower's internal cash generation.

Collateral: All collateral is valuable when given, but worth substantially less when repossessed. Among the questions to be considered here are: what is the likely disposition value of the collateral (based on an investor-oriented approach to valuation)? What steps must be taken to repossess or gain control of the collateral, how long will it take, and what will it cost? Many times when a thorough analysis is done, it is clear that the collateral offered will not provide the bank with the protection it needs. Additional collateral, often in the form of a personal guarantee secured with the pledge of additional specific assets, will then be taken.

A word of caution regarding guarantees. In many countries, personal guarantees are regularly taken without any thought being given to the value or collectibility of the guarantee. In the cases of owners and managers of closely held corporations without significant outside assets, the guarantee is worthless if the company defaults. Guarantees, therefore, must be subject to a rigorous analysis of their actual value in times of distress. Particular attention should be paid to the total amount of debt that the individual/corporation has guaranteed. If the guarantees are extensive, there may be little likelihood or ability to honor them if all are called simultaneously.

Capital: This C refers to the equity base of the corporation or transaction. How much does the borrower truly have at stake? Obviously, the more the borrower has at risk, the greater his incentive to repay the loan. The multiplier effects of leverage are well known, as are the downsides.

Conditions: Finally, this refers to a more macro assessment of the economic environment in which the borrower operates. Are sales and revenues likely to grow? Is the currency likely to be stable? Are raw materials abundant, and at an affordable price? What other external factors, including regulations and changes in the operating environment, could have a negative affect on repayment, and how likely are they to occur?

All extensions of credit should be approved by more than one individual. This is to ensure that there is an independent assessment of each transaction. Many banks use committees, and others work on an independent signature system, in which multiple parties are required to sign based on their delegated loan authorities, and the complexity of the underlying transaction. While a committee provides an opportunity for joint discussion, peer pressure may lead to less than optimal decisions. The signature system was designed to avoid this. It must be clearly recognized that the success of this system also depends on the integrity of the individual decision makers. In order to ensure greater integrity within the system, many banks have moved to separate the lending or relationship management functions, from the underwriting or credit approval functions.
Under this approach, the lending officers are responsible for identifying loan opportunities and for maintaining the relationship. The underwriter, and those approving the loans seldom come in contact with the customer. Instead, the approval of a loan is based solely on an analysis of the borrower's financial information and other objective data, obtained from independent sources.

Two additional functions within a bank are required to support and reinforce a strong credit culture: loan review and workout departments. Loan review performs an independent audit function, routinely reviewing loans to ensure that they have been extended in accordance with the policies and procedures of the bank; that they meet the quality standards desired on an ongoing basis; and that the documentation has been properly executed. They also validate the classification and level of provisioning required for a loan. The results of their audits can provide management and owners with an important early warning signal of potential problems, so that corrective actions can be taken before the problems warrant supervisory intervention.

Bankers routinely take risk, and it is inevitable that some loans will fail. When this happens, the loan should be turned over to specialists within the bank for resolution. These individuals are well versed in the formal and informal procedures and practices for loan collection. To be successful, management must have made the decision to terminate the relationship with the borrower, and to accept the losses, if any, inherent in the resolution process.

B. Supervision and Regulation

The role played by weak and ineffective supervision in the creation of financial crisis is well documented. However, supervisors and regulators also play an important role in the resolution process. Tighter standards and enforcement procedures, the introduction of forward looking loan classification and provisioning, and the mandated establishment of loan workout departments, all contribute to stopping the flow of new bad loans. Corporate restructuring and asset disposition can be encouraged and facilitated through the development of proper regulatory treatment. Rules defining the classification and provisioning of restructured loans, the valuation and treatment of collateral, and other assets received in payment of obligations, and limits on holding periods for equity received in the course of loan restructuring, are but a few examples of the ways in which supervisors and regulators can facilitate the resolution process. In effect, they can provide borrowers and lenders alike, with certainty regarding the definition or guidelines of proper credit relationships in the post crisis environment, allowing corporate restructuring and asset resolution to proceed.

C. Legal Framework for Creditor Rights and Insolvency

Asset resolution is dependent upon an efficient, transparent, reliable and predictable system to enforce credit claims. If an effective mechanism to enforce contracts and hold borrowers responsible for their obligations is lacking, borrowers have no incentive

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to cooperate in the resolution process, and scarce capital resources remain locked in nonproductive ventures. The very threat of a court ordered or supervised liquidation may induce borrowers to restructure their obligations directly with their lenders. An efficient and reliable system of enforcing creditor rights and managing corporate distress, also promotes financial discipline and reinforces prudent lending, by providing an orderly mechanism for nonviable entities to exit the market, and for the rehabilitation of distressed, but viable businesses. Key features of an effective system include:

1. **The enforcement of unsecured rights.** For the credit system to function, unsecured creditors must have the ability to enforce their rights to payment through a timely and inexpensive process. This process should provide for the transformation of the debt to a judgment, or court order for payment, including provisions for an expedited process for obtaining a judgment, where both parties acknowledge the debt; the seizure of property prior to completion of the court process through the posting of a bond or other collateral; and a swift hearing process to determine the appropriateness of the seizure, and provide for the return of the goods (or an equivalent monetary value), if necessary.

2. **The creation, recognition, and enforcement of security interests.** Prudent credit granting requires that each extension of credit have more than one source of repayment. In most cases, this will require taking a security interest in some type of collateral. While in many cases the collateral will consist of land, the legal system should provide an easy, and cost effective method, of obtaining security interests in all types of assets, moveable and immovable, tangible and intangible, possessory (stocks, bonds, and other financial instruments) and nonpossessory, including accounts and notes receivables, and the proceeds thereof, inventory, property, plant and equipment (including after acquired property), as well as intellectual property rights. Collateral interests will require notice and registration systems to put other lenders on notice regarding the existence of prior liens. To facilitate asset resolution, collateral interests must be fully transferable, and enforcement procedures should provide for the prompt realization of a secured lender’s rights in its collateral. Prompt, reliable and predictable enforcement of security interests encourages consensual debt resolution practices, and promotes higher recovery value by providing investors with greater certainty.

3. **An insolvency regime that provides for the timely, efficient, and impartial resolution of debts through either the liquidation of nonviable business or restructuring of viable entities.** Insolvency regimes should aim to maximize the value of a firm’s assets so as to provide higher distributions to creditors and reduce the burden of the insolvency. This requires that the legal framework supports the rehabilitation or restructuring of an insolvent enterprise as a “going concern,” without reliance on inter-company guarantees or other support. Essential elements of a rehabilitation regime include the imposition of a standstill on collection efforts of all creditors; the extension of new credit on a priority basis, subject to proper monitoring of the debtor’s cash, and the development of a restructuring plan based on a thorough assessment of the viability of the business. In addition, it should provide for the equal treatment of similarly situated creditors, the establishment of clear, but reasonable, deadlines for most actions that occur within the proceedings, allow the transfer of ownership to creditors in partial settlement of their obligations, and contain
a method by which an appropriate majority of creditors can vote to accept a reorganization plan.

The use of the term reorganization or rehabilitation is somewhat misleading. Although the process may lead to greater value for the creditors, it does not require that the firm be preserved or left intact. Indeed, most restructuring plans contain one or more of the following elements: the liquidation or sale of some or all of the company's assets to a third party; removal and replacement of some or all of the corporation's management; and a compromise of the debt owed creditors. Reorganization proceedings seldom result in the full repayment of the corporation's debt. Instead, they provide the mechanism to transfer most, if not all, of the owners' equity to creditors, unless the owners are prepared to inject new capital to prevent creditor losses.

4. **Strong institutions and regulations to ensure the integrity of the insolvency system.** An effective insolvency system apportions the losses resulting from corporate failure. It also provides oversight and dispute resolution functions within the context of a reorganization proceeding. Thus, if its protection and counsel are to be sought, its institutions and operations must be seen to be of the highest integrity. Judges must be well trained in the complexities of financial and business arrangements, and in commercial and financial standards and practices. They must be free of conflicts of interest and bias, as well as seen to be objective and impartial. Regulations governing the operations of the judicial system should be based on firm rules and regulations that provide ready access to court records, hearings, debtor and financial data, and other public information. Even the slightest perception of corruption and undue influence must be avoided.

D. **Informal Workout Procedures**

In addition to a formal insolvency regime, effective asset resolution requires an informal system that allows debtors and creditors to resolve their differences in a consensual manner, without recourse to the judicial process. Formal bankruptcy proceedings can be costly, time consuming, undermine public confidence in the firm, place a large administrative burden on the debtor, and run the risk of loss of control. Many firms, therefore, choose to renegotiate their debt directly with their creditors, without recourse to the formal system. What is needed is a set of rules or practices to govern the conduct of all parties during the negotiation process.

Many countries have adopted a variation of the so-called "London Approach." In practice, the renegotiation process begins with the formation of a creditor's committee (or steering committee, if there are a large number of creditors) composed of those institutions with the largest credit exposure to the borrower. The committee

4. Each of the East Asian crisis countries adopted a version of the London Approach tailored to meet its specific circumstances.

5. In cases where the bank group is unusually diverse, committee membership may be designed to ensure that the divergent interests are represented. Multiple committees may be formed to represent the interests of large numbers of similarly situated lenders (i.e., unsecured, secured, bondholders, etc.).
then, is responsible for conducting the negotiations with the borrower, developing an acceptable restructuring plan, and communicating both with the debtor, and the other creditors. It may retain professional advisors (legal, accounting, investment banking, and the like) to assist in the development of a plan.

Amongst the first actions typically undertaken in the restructuring process, is the negotiation of a clearly defined short-term standstill period, during which the creditors agree to take no action to enforce their claims. This provides a measure of stability to both the company and its creditors, and allows both sides to concentrate on developing an acceptable restructuring plan, without fear of the destabilizing effects of enforcement actions.

During this period, the company must have access to adequate cash flow and liquidity. In many cases, a moratorium on payments (principal and/or interest) is provided to ease the pressure on the debtor. New money may be made available to the company, to ensure its continued operation. While a formal insolvency proceeding is likely to contain provisions for the extension of these funds on a “super priority” basis, such protection is seldom provided under the general corporate law. In practice, however, most creditor groups will agree on an informal basis, to allow a priority lien on collateral, and grant a priority repayment status to any creditors willing to extend interim working capital. Careful monitoring of the debtor’s cash position, together with the preparation and approval of cash budgets, is generally required.

In return, the debtor agrees to provide access to timely and accurate information on its finances, operations, and future business prospects. In general, the reporting requirements are similar to those imposed in a formal proceeding. Given that there may be a level of distrust of the borrower, most committees will insist that its professionals verify the information.

The debtor also agrees to develop a “good faith” restructuring plan. By their nature, restructuring plans are “unacceptable” to creditors. Therefore, to be seen as a “good faith” effort, the plan must be reasonable, and must accurately reflect the borrower’s financial situation. It must treat similarly situated creditors equally, and in accordance with the seniority of their claims. Most importantly, it must provide an outcome for creditors, that is at least as good as the treatment they could expect to receive in a formal bankruptcy proceeding.

A complete agreement amongst the creditors is generally not possible. So informal workout proceedings require that the creditors agree amongst themselves that they will be bound by a majority decision. The percentage of approval required is likely to vary, but in general, should reflect the voting requirements of the bankruptcy law.

In some cases, even though the creditors are in agreement with a restructuring proposal, the company will be forced to file a bankruptcy proceeding. Examples could include the necessity of voiding or canceling certain classes of contracts (usually leases), or the need to take advantage of certain tax treatments available only in a formal proceeding. In these cases, the company and its creditors may agree to a “pre-packaged” bankruptcy proceeding. In this case, the reorganization plan has been pre-approved by the creditors, and it is usually submitted to the court shortly after the filing of the bankruptcy petition. In this way, the proceeding causes minimal disruption to the company’s business activities, and is generally concluded within the period of the automatic stay.

Although at the outset of an informal workout process, the creditors agree to consider a restructuring proposal, there is no assurance that an acceptable proposal can be found.
Either party may fail to act in good faith, or the depth of the company’s problems may make reorganization impractical. It is important, therefore, to have the discipline provided by the threat of a formal bankruptcy process. When bankruptcy is seen as effective, and the outcome can be predicted with a good degree of certainty, it serves as a powerful incentive for the parties to continue to negotiate, and tends to result in the conclusion of restructuring transactions that are viewed by all parties involved as “fairer.”

**E. Capital Market Development**

Financial systems that are totally dependent upon banks are inherently unstable. Banks accept short-term deposits, but many borrowers need long-term funds. This means that banks have trouble maintaining their liquidity positions, and if crisis hits are likely to be forced to call in lines to meet depositors withdrawals. A robust capital market provides access to badly needed equity, and longer-term financial instruments. It can also serve as a buffer to help damper financial distress. Firms are able to draw on the equity markets when their banks are distressed, which allows them to continue to operate, and even expand, without dislocation. By providing access to equity, markets lower the overall leverage within the corporate sector.

Markets serve another valuable function, that is to ensure greater levels of transparency, thus providing a credible mechanism to value firms. Markets require routine publishing of financial data, and securities firms are expected to provide a level of due diligence regarding the firm’s prospects and valuation. The presence of outside shareholders leads to improvements in governance within the corporate sector. Markets, however, are also subject to fraud and manipulation, thus appropriate regulation and supervision is required to protect the investors.

**F. Credit Bureaus**

Credit reporting bureaus collect and disseminate information regarding both consumer and corporate repayment histories. Given that past practices serve as a good indicator of future behavior, this knowledge serves as the cornerstone of sound lending practices. In more informal economies, repayment histories are well known within the small community in which borrowers operate. As commerce expands, an individual or entity’s repayment history becomes more difficult to ascertain. A credit bureau serves to preserve that history, and make it available to all who extend credit.

In many countries, repayment histories are kept within the central bank. However, bank secrecy laws may prohibit public access to this information. Furthermore, in many countries official institutions or agencies are held in low regard. Credit bureaus owned and managed by the private sector may be a better alternative. To be effective, the credit bureau must be seen to be independent, and with appropriate safeguards to ensure that the information is not subject to abuse and misuse. It must be accurate, easy to use and inexpensive to access. This is of particular importance for small entrepreneurs, as it may provide the only information on which they can base credit decisions, regarding suppliers and others to whom they extend credit.
G. Link with Fiscal/Macro Economic Stability

The role of sound fiscal policies and macroeconomic stability in economic recovery is well known. Borrowers, lenders, and investors all require stability to assess and price risk correctly. In climates of falling exchange rates, rampant inflation (or deflation), or rising interest rates, corporate restructuring and asset sales will be difficult, if not impossible.

What is less focused on, however, is the link between unresolved assets and economic stagnation. A large overhang of nonperforming assets ties up capital resources which could be put to more productive use elsewhere. As more and more of the banking system's resources are concentrated in NPL's, financial intermediation slows. Funds are not available to finance new, viable projects. Growth slows. Economic recovery cannot take place until the burden of the unresolved loans is removed from the system, and banks begin to lend again.

V. Implementation of Asset Resolution Process

Once a crisis has started, the authorities must move quickly to begin the resolution process. If the enabling infrastructure is already in place, they will be able to focus on fine-tuning and designing a strategy to speedily resolve the NPLs, in a manner which achieves a high recovery rate with minimum disruption to asset markets. To do this, assets will need to be resolved in a variety of ways. Four factors in particular will determine the success of the program: (1) public perception of how the program is designed and administered; (2) consistency in the rules and their application; (3) the ability to transfer assets, free and clear of contingent liabilities; (4) and the ability of creditors and investors to achieve meaningful control over restructured entities (Corrigan, 2001, Disposition of NPLs).

Much attention will be focused on the design and administration of any resolution program. In particular, the public will be watching to see what signals the government will send. Is the government serious about resolving the problems? Will the equity interests of owners be diluted, control transferred, and the remaining losses allocated equitably among creditors? Or, will it be as usual, with powerful, vested interests continuing to be protected? Is the operation of the program transparent, and does it provide adequate safeguards against opportunities for corruption or other irregularities? Does it establish new standards for, or otherwise ensure, sharing of timely, accurate information on a borrower's financial and business operations, and prospects? Is the program based on an adequate legal framework and rule of law? Will it be enforced? The answers to these questions will, in large part, determine the level of cooperation from borrowers, and the interest of investors, particularly foreign investors.

Investors require a level of certainty. A clear definition of the rules, and consistent application provides a level of confidence on which to base pricing decisions. The closer the rules are to international standards and practices, and the greater the confidence that they will be administered fairly, the higher the sale price of assets.

Investors must be able to obtain assets free and clear of intervening liens, as well as achieve meaningful control over restructured entities. The value of an asset lies in the owner's ability to obtain value from it. Any impediments to its use, including lack of transferability and inability to exercise normal rights of ownership, or otherwise enforce change within the organization, will seriously impact its price.
A. Asset Resolution Entities

When a bank fails in the ordinary course of business, the assets are liquidated in accordance with local law. In most cases, the supervisory agency, or deposit guaranty agency, will be in charge. But in the case of systemic crisis, the magnitude of the problems far surpass the capacity of these institutions, and a different solution is required.

Most crisis countries have chosen to establish one or more asset management companies (AMC) to oversee the resolution process. An AMC is an entity established for the purpose of owning and/or “managing” assets. It may be either publicly or privately owned. Its mandate with respect to the types of assets under management (banks, loans, real estate, operating companies, and equities), the scope of activities that can be undertaken (sales, corporate restructuring, billing, payment receipt, property management, and foreclosure), and its mandated time span will vary in accordance with the desires of the owners.

When an AMC is publicly owned, it may be preferable to refer to it as an asset “resolution” company. The use of the word “management” has tended to divert attention from its true purpose, which is to marshal the remaining assets from one or more banks, categorize the assets by type (performing, nonperforming, type of collateral, industry, real estate, furniture and fixtures), and then package them for sale, either individually or in pools. Assets should be brought to market on a timely basis, without undue disruption to the underlying markets, and in a manner that ensures the receipt of maximum value. This may require the restructuring of a small number of assets. Given the importance of unlocking the remaining value of nonperforming assets to economic recovery, the goal of the resolution entity should be clearly focused from the outset, on the disposition or liquidation of assets within a medium term framework, rather than the indefinite “management” of the stock of nonperforming assets for a prolonged period of time.

Most crisis countries have established one centralized, public asset management company. Some (China being the most notable example), however, have chosen to establish several public asset management companies to better focus on types of assets, provide for a better span of control in cases where the number of assets is large, or to establish better incentives for managers, through the creation of a competitive environment. Still others have chosen to let the originating banks continue to resolve the assets.

Major advantages of a centralized asset approach, revolve around the consolidation of the nonperforming assets into one institution. In cases where bank supervision is weak and ineffective, a single, new agency may ensure stronger oversight, governance, and management of the resolution process. The ultimate cost of the crisis may be reduced, as economies of scale are achieved through the consolidation of scarce resolution skills, avoidance of duplicative systems in each bank, and better ability to structure pools of assets for sale. The most important advantage of a centralized AMC, is that it reduces the potential for arbitrage in the resolution process, by severing the relation between the bank and the borrower, and by providing standardized treatment for all borrowers. A borrower with multiple lending relationships will negotiate with only one institution, thus speeding up the resolution process, and preventing the opportunity for institutions bargaining against themselves. With all relationships consolidated, the creditor gains greater leverage in the negotiation process.
Those in favor of a bank-led resolution effort, cite the benefits of reduced opportunities for political interference; maintaining the lending relationship in place, so as to provide the possible opportunity for new funding; and the reduced possibility of loss of valuable information regarding the history of the loan, documentation, and possessory collateral during the transfer process. While not underestimating the importance of these factors, it must be recognized that in many cases the relationship between the borrower and the bank is the root cause of the problem.

Box 2: Advantages of Centralized Public AMCs vs. Bank Led Resolution Efforts

Centralized Public AMC

- Oversight, governance, and management of one agency, easier than in case of multiple bank-led efforts.
- Provides the opportunity for the implementation of standardized treatment of all debtors.
- Severs the relationship between the bank and its borrowers, and allows banks to focus on returning to profitability, and the return of intermediation.
- Aggregates loans and collateral from many banks providing focal point for restructuring efforts. Provides economies of scale, which may lead to reduced resolution costs, through the consolidation of scarce resolution skills and elimination of duplicative systems.
- Large number of assets provides better opportunity to structure asset pools to create value.

Bank Led Resolution

- May be more difficult to exert political pressure against a number of financial institutions.
- Preserves information and knowledge about the borrowing relationship.
- Banks can provide additional financing, if required to consummate a restructuring.
- Allows for continued, active management of assets.
- Provides valuable training and reinforcement of resolution practices within the banks.

There is no evidence that one solution is preferable to the other. It is clear, however, that to be effective, both require a strong enabling framework which includes the ability to enforce contracts, and induce losses on borrowers and owners, and clear, consistent policies and practices, as well as a steadfast commitment to resolving the assets primarily through timely sales. (Klingebiel, 2000 and Dado & Klingebiel, 2001).

Resolution agencies are complex institutions that require strong oversight, governance, transparency, consistent policies and practices, and adequate levels of financing.

6. This is not valid in the case of publicly owned banks.
7. When there are multiple agencies, great care must be exercised to ensure that the standards, policies and practices are uniform.
The government, parliament, private sector, international financial institutions, and bi-lateral donors are all stakeholders in the process. This requires that the resolution agency's mandate is narrowly defined, well-understood, and generally accepted. It is critical that the stakeholders understand that the AMC is merely a tool employed by the government to implement its resolution policies. It should not merely set policy but implement it. Nor can it, in and of itself, assure the success of the resolution efforts. The government, itself, must set the course. Once established, the government must not interfere in the daily operations or decisions of the agency.

Given the large sums of public monies involved and the importance of the resolution efforts to economic recovery, both public and bank resolution agencies must be held to the highest standards of transparency. Best practices require:

- Uniform standards of accounting, and associated guidelines and requirements for the preparation of financial statements, subject to certification and verification by outside, independent auditors, internationally accepted accounting principles should be applied; the statements should be routinely published and available to all stakeholders.
- Uniform standards for internal management information systems, including the regular preparation of operating budgets, together with projections of expenses and revenue generation. These statements should be made available to oversight and supervisory bodies.
- Periodic standardized reports of current and projected recovery rates, together with actual cash proceeds to be received, net of all expenses associated with the recovery effort. This information should be prepared on a best, worst, and most likely case basis.
- Standard policies and procedures for asset valuation, cost benefit analysis to determine best disposition strategy, and evaluation of debt to equity swaps, bid proposals and other similar transactions.
- Standard documents and contracts to be used when executing sale transactions.
- Standardized policies regarding the information to be contained in credit files maintained, for all assets together with the requirements for prudent management of the assets (Corrigan, 2001, Disposition of NPLs).

The importance of complete and accurate credit file information, together with prudent management of the assets cannot be overestimated. This factor alone, is likely to have a greater impact on the value of the assets to be sold than restructuring efforts. Investors base their pricing on an estimation of the proceeds to be recovered. The more information provided, the greater the return. In a perfect world, every borrower's file would contain complete information, but when banks fail, substantial gaps are to be expected. Management must carefully weigh both the cost and feasibility of obtaining all required information in a timely fashion, against the anticipated increased returns. For small loans, it is not likely to be worth the effort, but for larger loans where the borrower is generally cooperative, every effort should be made to update the file.
Box 3: Suggested Credit File Information

Loan application and approval document.
Loan and Security Agreements.
Legal Opinion as to the validity of the transaction, and the enforceability of the collateral.
Original and current financial information on the borrower.
Original and current credit analysis.
Feasibility study and environmental report.
Current fair value appraisal report.
Current status report together with client visit memos.
Historical, as well as projected cash flow information.

Source: Arthur Andersen (1999).

B. ASSET SALES VS. CORPORATE RESTRUCTURING

Assets left in the hands of the state deteriorate. Thus, the goal of a successful resolution program, is to return the nonperforming assets to the private sector as quickly as possible. To do this, assets must be sold. Much of the controversy regarding resolution programs, revolves around the timing and manner of these sales. In cases where the assets have not been marked to market, and the illusion of value persists, the disposition process may be viewed as a dumping, or fire sale of assets, particularly if the sales are to foreign investors. All sales should be conducted through an open and transparent process, with all qualified investors provided access to the same timely and accurate information. The due diligence period should be adequate in length for the complexity of the transaction.

One of the most difficult decisions in asset resolution, is determining the proper timing of sales. Should a given asset or pool of assets be sold today, or can a higher return be achieved by waiting for further stabilization in the market? Early asset sales are necessary to determine the clearing price of the assets. Due to the uncertainties regarding the process, the nature of the assets, and the investor's ability to achieve an acceptable rate of return, this price will, of necessity, be low. Once investors are seen to be making money, competition will enter the market, and prices will rise.

To a certain extent, the timing, composition, and structure of asset sales will be driven by the market's appetite. Asset resolution companies need to think of themselves as marketing firms, and to be client (market) driven. They need to regularly survey market participants to determine what they are interested in, and then attempt to meet these needs by properly packaging their assets.

The temptation is great to hold assets, in an attempt to create value, particularly through corporate restructuring. Corporate restructuring is absolutely necessary, but the question remains "Is it better done by the public, or private sector?" There is little evidence to support a public resolution company's claim to enhanced value through restructuring. In order to be successful, the decision should be evaluated from an investor's perspective. That is, will the anticipated sales price cover the purchase price of the asset, plus all expenses incurred in holding and restructuring the asset, as well as provide for an appropriate return for the risks associated with holding the asset?

When most people look at the disposition program, they just see that the resolution agency received "X" amount at time period "t," but "X+" at time period "t + 1." They do
not factor in the time value of money, nor the cost associated with holding the asset. If a proper calculation is done, few assets will be held for restructuring. Instead, they should be sold to, and restructured by, the private sector, where the incentives for resolution, including restructuring, are better.

In those cases where enterprise restructuring is deemed appropriate, great care must be taken to ensure that the restructuring is done on commercial terms, and results in an economically viable corporate entity. The restructuring process is apt to be lengthy and contentious, as losses will have to be apportioned amongst the owners and creditors. A change in ownership and management is likely to result, and one or more noncore operations or assets of the company, must be sold to meet its restructured obligations. The temptation, therefore, is to engage in "cosmetic" restructuring. This generally involves some combination of grace periods on interest and principal payments, lowering the interest rate and/or the required principal payments, lengthening of the ultimate maturity of the loan, and providing for excessive balloon payments. Each of these features negatively impacts the cash flow of the repayment stream, and will directly lower the ultimate price paid for the loan when it is sold.

When restructuring is conducted, a public asset management company should develop and publish a set of core principals, guiding the restructuring process. These should incorporate the principles for informal workouts discussed earlier, and provide for the public asset resolution company to accept the decisions of a majority of similarly situated private sector creditors.

C. Special Incentives and Powers

In the case of systemic crisis, additional incentives to stimulate corporate restructuring may be required. Common examples include:

- Permitting immediate debt write-off for tax purposes.
- Providing tax relief on the transfer of collateral in whole, or partial settlement of debt (payment in kind).
- Rationalize the tax system with regard to debt-to-equity conversions.
- Harmonize taxes across financial instruments utilized in debt restructuring.
- Provide expedited approval process for approvals necessary to implement corporate restructuring.
- Regulatory forbearance with regard to the treatment of restructured loans.

In cases where the legal and insolvency regimes are weak, public asset resolution companies have been granted special or extra-judicial super powers. Generally, these involve an expedited process for reducing claims to judgments and confiscating assets. As they represent an infringement on a debtor's rights, they should be granted only after sufficient public debate. Additional safeguards should be provided to guard against potential abuse, including provisions for a limited lifespan for use of the powers, and additional measures to promote transparency, are warranted.

D. Equity Holdings

When corporations cannot repay their obligations, the losses must be allocated to the shareholders first. Then and only then, should creditors forgive a portion of their
debt in return for a share in the equity of the restructured entity. This technique, known as a debt to equity swap, has been widely used in the aftermath of the Asian crisis. Valuation of the resulting equity is difficult, and is seldom equivalent to the amount of debt forgiven. But more importantly, there is an inherent conflict between lenders and equity holders.

Public asset management companies are not equipped to exercise effective ownership and governance. In addition, the obligations of owners to ensure that the company is operated in a manner to ensure it can meet its debts, may in fact represent a contingent liability to the state. To the extent additional funds are needed, the state may be required to invest additional sums. They may also incur obligations to other creditors, who can prove their interest was harmed by the actions, or inactions, of the government as shareholder. When debt to equity conversion is required in the restructuring process, the interests of the lender (the loan), and the owner (the equity), should be separated, and appropriate management and disposition vehicles developed for the equity stakes, separate and apart from the loan assets.

VI. Principles for Effective Asset Resolution (Including Corporate Restructuring)

Asset resolution, is the process by which nonperforming assets removed from the financial sector are reduced to cash. This is necessary for two reasons: (1) it allows the state to recover a portion of the funds advanced to honor its deposit guarantee; and (2) nonperforming assets lock up scarce financial resources, which must be reallocated to viable enterprises to start and sustain economic recovery. As the resolution process makes explicit the losses inherent in these assets, and results in a transfer of ownership and control, it presents difficult challenges to the authorities. While successful asset resolution policies contain core elements or principles, each country's response will differ depending on its particular circumstances, macro-environment, legal and regulatory framework, and the political tradeoffs involved. The core elements or principles enumerated below, however, provide a framework for a successful resolution policy. The success of any given country's efforts to resolve nonperforming assets, will in large part, rest on how these elements are incorporated into the design of their resolution policies.

A. Creating an Enabling Framework for Asset Resolution

1. Principle 1—The Role of Government

Government should restrict its role in the asset resolution process, to providing the coordination and leadership necessary to create a sound enabling framework that:

- Supports the intermediation of scarce resources to economically viable projects to stop the flow of new nonperforming loans.
- Provides a liquidation and rehabilitation mechanism for distressed banks and their borrowers.
- Provides regulatory and tax treatment that facilitates restructuring.
- Minimizes losses to the taxpayers, through prompt loss recognition and the creation of an efficient, inexpensive, transparent, predictable and accountable resolution process.
- Facilitates the ownership of assets by foreign investors.
2. **Principle 2—Speed Is of the Essence**

Financial sector problems do not disappear with the passage of time. Prompt corrective action is required to minimize the losses to taxpayers, and the dislocation of the corporate sector.

3. **Principle 3—Comprehensive, Consistent Approach**

Borrowers, lenders, and investors require a degree of certainty to ascertain asset values, and enter into restructuring transactions. A package of reforms and incentives, consistently applied, yields greater results than a “hit or miss” approach.

4. **Principle 4—Recognize the Losses**

Assets removed from distressed banks are among the most impaired in the system, and should be marked to market quickly, to enable the sales process to proceed in an orderly manner. The establishment of realistic expectations, with regard to the value of the assets, will minimize the criticism of “fire sales,” as well as provide a benchmark by which to judge the effectiveness of the resolution process.

B. **Elements of an Enabling Framework for Asset Resolution**

1. **Principle 5—Credit Culture**

A sound, vibrant financial system is rooted in a strong credit culture or body of practices, which ensure sound lending by banks, and repayment by borrowers.

2. **Principle 6—Supervision and Regulation**

Supervisors and regulators play an important role in creating a climate for asset resolution, through requiring strong credit policies and practices within the banking system, including the establishment of workout departments, and developing regulatory treatment to encourage corporate restructuring.

3. **Principle 7—Legal Framework for Creditor Rights and Insolvency**

Asset resolution is dependent upon an efficient, transparent, reliable, and predictable system to enforce credit claims. Key features of this system include:

- Enforcement of unsecured rights.
- The creation, recognition, and enforcement of security interests.
- An insolvency regime which provides for the timely, efficient, and impartial resolution of debts, through either the liquidation of nonviable businesses, or the rehabilitation of viable entities.
- Strong institutions and regulations to ensure the integrity of the insolvency system.

4. **Principle 8—Informal Corporate Workouts and Restructuring**

Most loans are best restructured by debtors and creditors cooperating within an informal, out-of-court process. This requires laws and procedures that:

- Require access to timely and accurate financial information on the borrower.
- Encourage the extension of new credit with appropriate safeguards.
Preserve the relative position of all creditors within a given class.
• Support a broad range of restructuring activities, such as debt forgiveness, reschedulings, restructurings, and debt/equity conversions.
• Provide favorable or neutral tax treatment for corporate restructuring.

5. Principle 9—Capital Markets

A robust capital market serves as an exit vehicle for lenders, by providing viable corporate borrowers access to badly needed equity, and longer-term financial instruments. Markets for the sale and trading of distressed debts, should be encouraged subject to appropriate regulation of trading during the restructuring process.

6. Principle 10—Credit Bureaus

A borrower’s repayment history serves as a valuable indicator of future performance. Likewise, the desire to avoid a poor record can be a powerful incentive to induce repayment/restructuring of past due loans.

7. Principle 11—Fiscal/Macro Economic Stability

A healthy corporate and financial sector is dependent upon fiscal and macroeconomic stability. In cases of systemic crisis, investors’ willingness to purchase assets, and the price they are willing to pay, is dependent upon their perceptions of the government’s ability to restore stability and economic growth.

C. Implementing the Asset Resolution Process

1. Principle 12—Involve the Private Sector

Assets left in the hands of the state deteriorate. Banks, particularly weak banks, may not do a better job. Assets should be quickly returned to the private sector, where the incentives for resolution, including restructuring, are better aligned.

2. Principle 13—Asset Resolution Vehicles

Asset resolution vehicles are merely tools to facilitate the resolution process. The strength of the enabling framework, rather than the choice of a specific resolution vehicle, will determine the success of the resolution process. Institutions participating in the resolution process, should be subject to high standards of governance, be independent from government influence and interference, and be accountable for their actions, to ensure that the assets are not subject to fraud, mismanagement, misappropriation, waste, or abuse.

3. Principle 14—Asset Sales

Asset resolution requires that all assets are ultimately reduced to cash through sale. Assets should be sold as soon as their value (after recognition of all carrying costs) can no longer be increased. This is often a subjective decision. All resolution transactions should be conducted through an open and transparent process, with all qualified purchasers provided access to the same timely and accurate information. Due diligence periods should be adequate in length for the complexity of the transaction.
4. **Principle 15—Corporate Restructuring**

Corporate restructuring is facilitated by the existence of both formal and informal restructuring procedures. Key elements of the restructuring process include:

- A standstill period in which the major creditors agree to take no action while they investigate the possibility of a reorganization.
- Provision of timely and accurate financial information to all lenders, to enable them to assess the future viability of the borrower.
- Availability of adequate funds during the standstill period to ensure trade credit.
- Granting a priority status to any new funds advanced during the standstill period.
- All creditors to maintain their existing positions during the standstill.
- Agreement by a majority of creditors (generally in the proportions required to confirm a formal bankruptcy plan) to any restructuring.
- Creditors to bear loss, only after full dilution of existing shareholders. Creditor losses should also be minimized by expense reductions, efficiency improvements, and sale of all loss making or nonproductive assets owned by borrower.

5. **Principle 16—Special Incentives and Powers**

In the case of systemic crisis, consideration should be given to the design of special, time bound incentives (particularly with regard to tax treatment), to stimulate corporate restructuring. In cases where the legal and insolvency regimes are weak, public asset resolution companies may be granted special, or extra-judicial super powers. As they represent an infringement on a debtor's rights, they should be granted only after sufficient public debate. Additional safeguards should be provided to guard against potential abuse, including provisions for a limited lifespan, for use of the powers, and additional measures to promote transparency.

6. **Principle 17—Equity Holdings**

There is an inherent conflict between lenders and equity holders. When debt to equity conversions are required in the restructuring process, the interests of the borrower and owner should be separated. Appropriate management and disposal vehicles should be developed for the equity stakes separate, and apart from, the loan assets.

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