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INSOLVENCY SYSTEMS IN ASIA: AN EFFICIENCY PERSPECTIVE

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Systemic Insolvency: A Lawyer's perspective

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Systemic Insolvency: A Lawyer's Perspective

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Systemic Insolvency: A Lawyer's Perspective

I Introduction

The problem of "Systemic Insolvency" is an essential topic at this conference. Due to a variety of causes, what began as a currency crises in Thailand in July of 1997 has resulted in systemic insolvency, in the corporate and financial sectors, in Thailand and Indonesia and, to a lesser extent, in Malaysia and Korea. It is systemic insolvency in these countries, not individual bankruptcy cases, that provides the context for this conference.

Generally, insolvency law is designed for individual cases, not for situations where entire sectors of an economy are insolvent. When insolvency is systemic, insolvency law and the judicial process are a fundamental, but not sufficient, part of the private sector restructuring process. Other tools, in addition to the laws and the courts, are necessary to facilitate private sector recovery.

This afternoon, I will survey some of the tools which have been used in the past two years to address the problem of systemic insolvency. Because the subject of insolvency law is being addressed in some detail at this conference, I will confine my remarks, for the most part, to non-judicial tools for addressing systemic insolvency. However, I emphasize at the outset that an adequate set of insolvency laws, combined with a reliable judicial system, is essential to the resolution of systemic insolvency. If the laws and the courts do not work, the other tools I am discussing will be of limited utility.

My perspective on the subject of systemic insolvency is that of a practicing lawyer, someone who has been working, on a daily basis, on private and public sector restructuring matters throughout the crises. Most of my examples will be drawn from my experiences in Indonesia, Malaysia and Thailand, the countries I know the best. I do not purport to suggest that one lawyer's view on this complex subject should be definitive. My views are, in a sense, preliminary; the insolvency crises is not yet over and there are additional lessons to be learned. More importantly, the problems of systemic insolvency are interdisciplinary in nature and the views of economists, policymakers, bankers, corporate executives and ordinary citizens are necessary to complete the picture.

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II Systemic Insolvency Generally

- As an initial matter, it should be emphasized that, even in the best of times, corporate restructurings are difficult and time consuming. In the United States, in the context of a healthy domestic economy, I have worked on complex corporate reorganizations which have taken over two years. Some of these were out-of-court; some of these involved a judicial resolution.

  However, when the insolvency is systemic, the corporate restructuring exercise becomes more challenging and lengthy.

- What is systemic insolvency?

  By systemic insolvency, I refer to a situation, for any given country which has many of the following features:

  (i) a significant number of local banks and financial institutions are insolvent or nearly insolvent;

  (ii) a significant number of foreign banks have highly impaired loan portfolios for that country;

  (iii) as a result of the difficulties of local and foreign banks (i) for a period of time, these institutions may not have sufficient capital to agree to the write-offs required by corporate restructurings and (ii) there is little liquidity, even for trade finance;

  (iv) a significant number of businesses of all sizes are insolvent or nearly insolvent;

  (v) the local currency has depreciated sharply against foreign currencies;

  (vi) the creditworthiness of the government may be deteriorating due to depletion of foreign currency reserves and anticipated expenses in recapitalizing the local banks;

  (vii) capital flight is a problem;

  (viii) there are substantially more insolvency cases and commercial disputes than the courts have the capacity to adjudicate;

  (ix) many owners of businesses believe that their business troubles are not the product of inadvisable management decisions but rather the product of flawed monetary policies by government; and

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(x) policy decisions by governmental officials regarding bank regulation, bankruptcy laws and the courts assume a greater political significance than would ordinarily be the case.

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III Three Attributes of Systemic Insolvency in Asia

- The first attribute of systemic insolvency in Asia is that we have a regional insolvency problem. It is easy to lose sight of the fact that the problems in one crises country complicate the resolution of problems in another crises country, particularly insofar as the restructuring of foreign currency debt is concerned. Further, the problems in Japanese banking complicate the problems in each of the crises countries. By way of example, if Thailand were the only country with a private sector insolvency problem, the restructuring process in Thailand would be further along than it is. Currently, the restructuring process in Thailand is hindered by the fact that many of the foreign banks in Thailand, particularly the Japanese banks, are undertaking similar exercises in Indonesia, Malaysia and Korea. The restraints on the resources and the balance sheets of these institutions have made it difficult for them to agree to restructuring proposals which involve debt-for-equity swaps or other forms of loss recognition.

- A second attribute of systemic insolvency in Asia is that the human capital available for the restructuring task is modest, relative to the size of the challenge. The approach to economic development favored throughout most of Asia for the past two decades resulted in an underinvestment in those components of society necessary to govern and sustain an advanced economy, such as the accounting profession, the legal profession, civil service and the judiciary. Consequently, deficiencies in financial reporting, corporate governance, bank supervision and legal enforcement contributed to the crises. These same deficiencies have prolonged the resolution of the crises.

- The third attribute of systemic insolvency in Asia is that it features complex relationships among the key players in the process. Let's look briefly at some of the players – and their relationships with each other.

    (i) the local bank - is often owned, directly or indirectly, by the same individual who owns the borrower that defaulted on a loan.

    (ii) the borrower - the borrower may be in the same corporate family as one of the local banks it is not paying. The borrower may have cross-guarantied the obligations of another corporation in the same corporate family.

    (iii) management – the management of a local bank or a borrower is often a principal shareholder of that entity.

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(iii) the governing party - a governing party may, directly or indirectly, own equity stakes in a local bank and a borrower.

(iv) lawmakers - many of the lawmakers who are asked to participate in insolvency law reform are themselves guarantors, directors or shareholders of insolvent banks or companies.

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Many of these relationships are not unique to the countries under discussion. They are borrowed, for the most part, from Japanese and German models of corporate governance. We could discuss at length whether these models of corporate governance are the best way to achieve economic efficiency, but that discussion should be saved for another occasion, and another conference. For the purpose of today's discussion, it is fair to say that these relationships give rise to conflicts of interest which tend to slow the restructuring process.

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IV Tools for Managing Systemic Insolvency in the Corporate Sector

A. Moratorium

Generally

- Although we have not had an official moratorium during the Asian crises, it should be recalled that President Suharto instructed borrowers, early in the crises, that if they could not pay their creditors, a "pause" was appropriate.

Assessment

- A moratorium is an extreme measure which, in most cases, will only make matters worse. It could be described as "systemic insolvency" by decree, if we define insolvency to mean non-payment of obligations. It is likely to have a negative effect on the confidence of domestic and foreign investors. Experience indicates that once obligors stop making payments, it is difficult to persuade them to recommence. This can be particularly damaging to local banks.

- In the case of Indonesia, it is possible that the "pause" contributed to strategic defaults on the part of some borrowers. However, there are so many other factors at work in the Indonesian situation that it would be inappropriate to attach much significance to the pause.

B. Foreign Exchange Availability Programs

Generally

- As a result of the crises, financial institutions in the crises countries ceased to provide foreign exchange hedging for local corporates who had foreign currency debt. The absence of any foreign exchange hedging makes it difficult for companies and their foreign creditors to make any reliable assumptions about future foreign exchange rates in their restructuring discussions. As a result, it is difficult for debtors and creditors to agree to acceptable amortization schedules, and an appropriate allocation of risk between debt and equity.

- In Indonesia, the government offered to provide foreign exchange hedging to facilitate the restructuring of foreign debt. In 1998, the INDRA program was launched to provide exchange rate risk protection for the benefit of Indonesian debtors and their foreign creditors who restructured their debt so as to qualify for the program. The INDRA program was based on a similar program used in Mexico in the 1980s called FICORCA. Broadly, a debtor and a creditor can participate in the program if the restructured loan has (i) a grace period of not less than 3 years, and (ii) a tenor of not less than 8 years.

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- The program guaranties participants the best rate of exchange, for the life of the loan, that was in effect during 1999. Currently, the rate is 6,550 IDR to the USD.

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Assessment

- Although attractive in concept, participation in INDRA has been low. This has been due to (i) the complexity of the program, (ii) inadequate marketing, (iii) concerns about Indonesian sovereign risk, (iv) concerns about the cost of the foreign exchange insurance, and (v) perhaps the view that, when the political situation stabilizes, the Rupiah will stabilize and hedging will be unnecessary. In my view, INDRA and similar programs are potentially valuable tools and, if properly designed and implemented, should be useful in the future.

C. Trade Financing Guaranties

Generally

- During an economic crises, local and foreign financial institutions often cease extending credit, including trade finance. A “credit crunch” in the area of trade finance can impair or destroy certain businesses dependent on trade financing and slow an export-lead recovery.

- By way of background, in the typical trade financing transaction, a local bank issues a letter of credit for the account of a local corporate and for the benefit of a third party supplier. Because that third party supplier may be reluctant to take the credit risk of the local bank, the letter of credit is “confirmed” by a bank, usually a foreign bank, whose credit risk is acceptable.

- In 1998, Indonesia, acting through Bank of Indonesia, made a guaranty available to foreign creditors in respect of trade finance. In order to qualify for the guaranty, the foreign creditor was required to (i) use its best efforts to maintain trade finance of pre-crises level, and (ii) file monthly reports with Bank of Indonesia on trade financing. The program did not compel foreign creditors to lend.

Assessment

- The trade financing guaranty was only a modest success. It expired recently and is likely to be renewed in some form in the forthcoming months. It did succeed in making trade finance available when it would otherwise be unavailable, but the extent of participation by foreign and local banks was disappointing.

- The principal reason for limited participation was that the local banks, many of whom were near insolvency, did not want any incremental credit risk to local borrowers. Consequently, local banks did not issue sufficient letters of credit and foreign creditors, in turn, did not always fulfill

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their commitments. Additionally, the program was not marketed particularly well and Bank of Indonesia was sometimes late in making payments under the guaranty.

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- Government trade financing guaranties are a potentially useful tool, and should be considered in other situations.

D. Facilitating Agencies

Generally

- Because of the limited utility of the judicial system in each of the crises countries, organizations have emerged, with the support of the government, for the purpose of facilitating the out-of-court resolution of private sector commercial issues. I will call these "facilitating agencies".

- In Indonesia, the facilitating agency is the Jakarta Initiative; in Malaysia, CDRC; and in Thailand, CDRAC. While there are some differences in these organizations, they have the following common features:

  (i) they formulated statements of international best practices for restructurings to guide debtors and creditors;

  (ii) they provide for mediation; and

  (iii) participation by debtors and creditors is voluntary.

- In terms of differences, the Jakarta Initiative is unique in that it provides for "one stop shopping" for regulatory approvals. CDRC is unique in that it will draft a business plan for consenting participants. CDRAC involves two rather complex contractual arrangements – a debtor-creditor agreement and an inter-creditor agreement - that require, in some cases, binding arbitration and, in other cases, mandatory bankruptcy filings by creditors against companies.

Assessment

- The emergence of facilitating agencies is one of the most positive developments of the Asian crises.

- As a result of the efforts of the facilitating agencies, there is generally a consensus among debtors and creditors as to what constitutes "best practices" for out-of-court restructurings (even if these practices are not always followed.)

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- By emphasizing out-of-court resolutions, the facilitating agencies have taken pressure off the bankruptcy courts in the crises countries. Currently, these courts do not have the resources to cope with substantial and complex caseloads. However, it should be emphasized that, unless the courts reach correct decisions in the cases that are before them, the utility of the facilitating agencies will be limited because there is no apparent "downside" for a failed restructuring effort.

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- The Jakarta Initiative, in particular, has demonstrated that mediation, which has been proven to be a useful tool in the United States and Europe, is also a valuable tool in Asia for out-of-court commercial settlements.

- Although I remain concerned that the CDRAC process in Thailand will result in an excessive number of bankruptcy cases, it has, to date, probably increased the pace of private sector workouts in Thailand.

- The facilitating agencies have not achieved their full potential. In some cases, the demand for services has vastly exceeded available resources. For example, in Indonesia, the demand for mediators initially exceeded the number of qualified mediators available to those seeking assistance. In other cases, programs offered by a facilitating agency have not been properly funded or developed. For example, in Thailand, CDRAC has only recently launched a mediation program and the scope of it is modest relative to the potential of mediation.

- Facilitating agencies should do more to address the problems of small and medium sized businesses.

E. Loan Sales

Generally

- During the past 15 years, loan sales have emerged as a useful technique in resolving individual and systemic insolvency situations. The most notable example is the role of the Brady Bonds in the resolution of the sovereign debt problems in Latin America and elsewhere. These instruments, which were pioneered in Mexico in 1990, converted distressed bank loans to sovereign borrowers into several types of highly liquid bonds. Currently, there are about $190 billion in Brady Bonds outstanding from 13 countries. In the United States, there is an active market in distressed loans of public companies.

- Typically, a bank sells a distressed loan to third party at a discount for cash. The selling bank can potentially benefit by (i) realizing a recovery on the loan (for internal accounting purposes); (ii) rebalancing its portfolio to reduce company, sector, or country risk; (iii) cleaning up its balance sheet; (iv) reallocating capital for more productive uses; and (v) freeing bank officers for more productive tasks than restructurings.

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- The borrower can potentially benefit from loan sales by the substitution of an old creditor with a new creditor who has a lower cost basis in the loan and who should be in a better position to agree to a restructuring.

- Deficiencies in the bankruptcy courts in Indonesia and, until fairly recently, bankruptcy laws in Thailand, have made loans less liquid and caused loans to be traded at a higher risk premium than would be the case in countries with more reliable insolvency systems.

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- Loan sales raise the difficult - and politically sensitive - issue of foreign ownership of local companies. A liquid market for loans, together with a functioning bankruptcy system, will probably result in increased foreign ownership of companies that were once domestically owned.

- Loan sales have disadvantages. The borrower is potentially at risk with respect to purchasers of loans, sometimes called "vulture investors," who hold out for a premium or make irresponsible demands. It is interesting to note that the CDRAC process in Thailand discourages loan sales on the theory that it will slow the restructuring process.

Assessment

- Although there are some disadvantages, loan sales have been demonstrated to be useful in resolving individual and systemic insolvency situations. Due to uncertainties in the bankruptcy process in Indonesia and, to a lesser extent, Thailand, this tool has not been used to its full potential in these countries.

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V Tools for Managing Systemic Insolvency in the Financial Sector

A. Exchange Offers

Generally

- In the early months of the crises, one of the greatest threats to the solvency of local banks was the magnitude of near term foreign currency obligations falling due to foreign creditors. In order to restructure these obligations, both Korea and Indonesia undertook exchange offers where these maturities were exchanged for maturities of longer duration. Pursuant to the exchange offers, creditors exchanged near term maturities of local banks for loans, guarantied by the government, of longer maturities.

- In the case of the first Indonesian exchange offer, foreign currency maturities due for the forthcoming year were exchanged for loans of maturities of one to four years at interest rates from LIBOR and 2.75% to LIBOR and 3.5%. In the case of the second exchange offer, two additional years of maturities were exchanged for loans of three to six years of interest rates from LIBOR and 2.25% to LIBOR and 2.75%. In the aggregate, $7.3 billion of foreign currency obligations were rescheduled.

Assessment

- The Korean and Indonesian exchange offers are two of the most successful restructuring tools to date. The participation of the creditors was high; local banks were given breathing room; and pressure was alleviated on the foreign currency reserves of Indonesia and Korea. The exchange offer loans are liquid, and some banks have sold them, thus freeing up capital for other uses.

B. Guaranty of Bank Obligations

- In order to calm depositors and stabilize the capital markets, governmental entities in Indonesia, Malaysia and Thailand issued various types of assurances of support regarding the obligations of local banks.

- In the case of Indonesia, an agency of the government, IBRA, issued a guaranty of the obligations of local banks. The guaranty has raised interpretative issues.

  To date, 54 banks have been liquidated; 12 banks have been taken over by IBRA; 15 banks have been recapitalized; and four state banks have been merged into one bank.

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With respect to the banks that were closed or taken over by IBRA, it is my understanding that (i) the depositors were paid in full; (ii) interbank creditors have not been paid (and this issue remains unresolved); and (iii) shareholders have not been paid. As noted earlier, foreign banks

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who participated in the two exchange offers had their foreign currency obligations restructured pursuant to two exchange offers.

- In the case of Thailand, an agency of the government, the Financial Institution Development Fund, provided a letter of guaranty with respect to the obligations of 15 Thai commercial banks, 19 foreign commercial bank branches and 33 finance companies.

  To date, the Thai government has taken over three banks and closed 56 finance companies.

  With respect to the banks and finance companies that were closed, (i) the depositors were "paid" in full; (ii) the interbank creditors have not been paid (and this issue remains unresolved) and (iii) the shareholders were not paid.

- In the case of Malaysia, the government never issued any written guaranties with respect to the obligations of the banks, but did provide oral assurances. To date, one bank, three finance companies and one merchant bank have been taken over by Danaharta. With respect to these institutions, (i) the depositors were paid in full, (ii) the interbank creditors have been paid and (iii) the shareholders have not been paid.

Assessment

- In the case of Thailand and Indonesia, the bank guaranties were not necessarily supported by the full faith and credit of the government. In Malaysia, oral assurances of the government never amounted to a bank guaranty. Nonetheless, it appears that the bank guaranties and assurances in these countries made some contribution toward stabilizing local banks. The extent of this contribution is a subject for further study.

- Generally, in the case of banks that have actually failed and been taken over, governmental intervention has avoided the "moral hazard" of protecting the shareholders of these banks. Additionally, government intervention has protected the depositors of these banks. In my view, this is sound public policy.

- With respect to interbank claims, issues of interpretation and implementation have created uncertainty and controversy in Indonesia and Thailand regarding the scope of each guaranty.

C. Asset Management Companies

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Generally

- Generally, asset management companies are created in one of two ways. First, when a governmental entity, such as a bank restructuring agency, takes over an insolvent bank, the

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entity, by default, can become an asset management company with respect to assets held by the insolvent bank. An example of this is IBRA in Indonesia. Second, an asset management company can be created solely for the purpose of purchasing distressed loans from banks and restructuring, or selling, these loans. An example of this is Danaharta in Malaysia or KAMCO in Korea.

- Asset management companies have many of the same benefits as loan sales. They assist a troubled bank by (i) reducing NPLs in the bank's portfolios; (ii) reallocating capital for more productive uses; and (iii) freeing bank employees for other tasks.

- Because of the expertise brought to bear on the NPLs and associated assets, as well as the benefits associated with scale, asset management companies should, in some cases, be able to achieve superior returns as compared with other models of asset disposition.

- Asset management companies have potential disadvantages. Some policymakers are of the view that there is a potential "moral hazard" with asset management companies. Due to the fact of government ownership, there is a risk that officers of asset management companies will be encouraged to elevate political considerations above the goal of maximum asset recovery for the benefit of taxpayers. This may, in turn, perpetuate some of the lending and borrowing practices that contributed to the crises. Further, there is a risk that asset management companies can, if they are too large, become bureaucratic and lose their effectiveness. Finally, some policymakers are of the view that, if banks are required to retain and restructure the loans they make, it will strengthen the bank's credit culture and, in the long run, benefit of the bank in a way that loan sales to asset management companies will not.

Assessment

- Although they have disadvantages, asset management companies, if properly structured and managed, can play a constructive role in the resolution of systemic insolvency situations. The moral hazard issue should not be disregarded in the creation of an asset management company.

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VI Conclusions

- In the 28 months since the crises began, significant steps have been taken toward the resolution of systemic insolvency in the crises countries by use of such techniques as facilitating agencies, foreign exchange availability programs, trade financing programs, exchange offers, and asset management companies. We have also seen efforts focused on improved insolvency laws and judicial reform.

- Yet, to be realistic, it is my impression that few of the tools I have identified, including the most essential tool – insolvency law and the judicial system – have achieved their full potential. Consequently, much work remains in restructuring the private sector.

- I believe these tools have failed to reach their full potential largely because the approach to development favored in the crises countries for the past two decades has resulted in an underinvestment in the accounting profession, the legal profession, civil service and the judiciary - the professions needed to implement successfully the restructuring tools. Although some skilled professionals have worked diligently for the past two years in each of the crises countries, it is fair to say that the private sector restructuring effort in Asia has been “understaffed.”

- A principal task for countries in Asia going forward will be to upgrade the accounting profession, the legal profession and the judiciary, as well as laws pertaining to insolvency, corporate governance and intellectual property. This will be a long-term project that will, depending on the country, take up to a decade or more to accomplish. However, the benefits should be significant for the countries who succeed, including a lower cost of capital and stronger financial systems. This project is achievable in each of the countries we have discussed. It is another indication of the great potential of these countries.

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