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**INSOLVENCY SYSTEMS IN ASIA: AN
EFFICIENCY PERSPECTIVE**

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*Insolvency Resolutions and Debt Workouts: Thailand's
Experience*

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Mr. Chairman, respectable panelists, and distinguished participants:

I would like to thank the OECD, the World Bank, APEC, and the Australian Treasury for jointly hosting this spectacular conference. I also thank for their kind invitation to the Financial Sector Restructuring Authority of Thailand to participate in the conference.

The Asian financial crisis, which erupted in 1997 and caused shockwaves across the region, plunged the financial and business sectors in affected countries into a complete turmoil. Currency downhill, liquidity shortage, business collapse and insolvency were prevalent during the crisis peak. Since then *insolvency or bankruptcy* has become the common word for the region and it is expected to remain so while we are all transiting to the new millennium. Before further discussion, let me briefly touch on a few definitions. During a financial crisis, problem firms are faced with different degrees of distress. Various status of a financially distressed firm can be described as follows:

- *Technical insolvency* : A firm is considered technically insolvent if it can not meet its due obligations. Technical insolvency is often caused by lack of liquidity.
- *Insolvency in bankruptcy* : A firm is essentially insolvent when its book value of total liabilities exceeds the market value of its assets.
- *Legal bankruptcy* : A firm is legally bankrupt if it is filed for bankruptcy under the law.

Insolvency resolutions: Liquidation versus Rehabilitation

When there occurs a financial distress, an insolvent firm should be handled properly and orderly under an insolvency law. The objective of an *insolvency law* (or in many countries referred to as bankruptcy law) is to protect and maximize value for the benefit of all parties concerned as well as the economy in general. This objective however is obviously pursued during rehabilitation, where such value is maximized by allowing a viable enterprise to go on. In designing an insolvency law, many countries need to address and resolve insolvency issues through the implementation of both *liquidation* and *rehabilitation* procedures. As a result, although the insolvency laws in various countries may differ in some respects, I believe that now most countries address the insolvency problems by including or even incorporating *both* liquidation procedures and rehabilitation procedures in their insolvency laws.

While *liquidation* emphasizes on an orderly wind-down of an enterprise, *rehabilitation* procedures in contrast are designed to give an enterprise some

breathing space to recover from its temporary liquidity problems or from its overindebtedness. Besides, a rehabilitation attempt could also give the enterprise an opportunity to *restructure and reorganize* its operations and its relations with creditors. Although liquidation and rehabilitation procedures are viewed as somewhat distinct from each other, there are in fact substantial overlapping and linkages between them, both in terms of working procedures and their implications on business financial resolutions.

In general, insolvency procedures require two essential elements. The first is a *legal* framework that specifies the rights and obligations of parties concerned, while the second is an *institutional* framework that implements these rights and obligations. Legal framework is usually in the form of bankruptcy law and related laws, while institutional framework is represented for instance by bankruptcy court as well as other out-of-court bodies (such as the Corporate Debt Restructuring Advisory Committee in the case of Thailand, which I will elaborate later). In other words, financially distressed firms can attempt to solve their problems either *informally* or *formally* under the guidance of a bankruptcy court or other specific body.

At this point I would like to briefly touch on the role of Thailand's *Financial Sector Restructuring Authority (FRA)*, which I represented at today's meeting. The FRA is a special government agency, set up under an Emergency Decree in October 1997 to *liquidate* the 56 closed-down finance companies. Given with a clear liquidation mandate, the FRA is now in the completing process of selling those companies' assets, handling their liabilities and creditors claims, and filing for their bankruptcy in court. The financial crisis has necessitated the Thai government to establish new laws as well as new institutional infrastructure to handle insolvency and related issues with regard to liquidation, rehabilitation and debt workout. To be in line with the topic today, I would like to elaborate *more* on the subject of business rehabilitation and debt workout *rather than* that on liquidation.

Formal in-court procedures

One blessing in disguise from the Thai financial crisis has been a serious attempt to implement extensive legal reforms to expedite domestic financial and business restructuring. Laws in connection with bankruptcy and foreclosure procedures have thus been substantially amended. Under previous legal regime, bankruptcy was the only solution for an insolvent business. Thailand's *Bankruptcy Act B.E.2483 (A.D. 1940)* was adopted with the chief purpose of setting legal framework to wind down the operation of an enterprise through bankruptcy proceedings. Therefore in the past, there was only one result of proceedings under the Bankruptcy Act in Thailand, and it was the *total liquidation* of the enterprise. Besides, there existed no specialized bankruptcy court, and bankruptcy process was conducted through civil court.

It was in April 1998, just a few months after Thailand's financial crisis had severely deteriorated, that the amended bankruptcy law (*Bankruptcy Act No.4 B.E. 2541*) finally came into effect. Major changes included the adoption of a new "business reorganization proceeding" aimed at achieving the *financial rehabilitation* of insolvent companies. The new proceeding bears the similarity with that under US Bankruptcy Code's Chapter 11 and British Insolvency Law. In effect, the new

bankruptcy law allows insolvent businesses to be restructured and obtains protection from bankruptcy or foreclosing actions for up to five years, referred to as *automatic stay* (or a freeze on debt service/payment as well as on legal attempt to seize debtor's assets). The new law would allow for the business of a debtor to be carried on and rehabilitated rather than liquidated as under the old law. It thus preserves the debtor's business as a going concern under new terms in accordance with the reorganization/rehabilitation plan. Furthermore, the business reorganization could enhance creditors' receipt within reasonable period while the old law took up to 10 years to finish a case. It is noted that in the very same year of 1998, similar amendment and revision on bankruptcy and related laws were also made in Korea and Indonesia to support business rehabilitation attempt.

Besides the above-mentioned amendment, *additional* improvements and changes to the Thai bankruptcy law (known as ***Bankruptcy Act No. 5 B.E. 2542***) were made in March this year. Major change is in Section 94(2), which gives the right for a creditor to claim repayment of new loans to a debtor's business. Under the previous bankruptcy rule, a creditor could not file a claim for loans made to a debtor if the creditor had been aware of the debtor's insolvency. This latest rule, which preserves the creditor's right, would therefore encourage creditor to extend further funding to sustain the debtor's business. The amendment also categorizes creditors into various groups to facilitate the passage of a submitted reorganization plan.

Meanwhile another law to provide an important infrastructure to accelerate business reorganization and bankruptcy proceeding in Thailand also came into effect in April this year. The ***Bankruptcy Court And Bankruptcy Procedure Act*** has enabled the establishment of a long-awaited Bankruptcy Court in June this year. It is believed that in the near term, the new Court would effectively create an infrastructure in speeding up business reorganization and corporate debt restructuring endeavor in Thailand although its progress might be somewhat slow in the initial period due to the lack of experienced judges and legal personnel in the area of business reorganization and bankruptcy. So far after a few months since its inception in June this year, the bankruptcy court has handled over 200 insolvency cases (involving an amount of about Bht 6.3 billion), and about 14 reorganization cases (involving a huge amount of Bht 39 billion). This in-court procedure attracts mostly large business cases as it contains the legal *automatic stay*. So far almost 10 reorganization cases have been concluded, including the case of Alphatec Electronics' Bht 19 billion debts.

Out-of-court procedures

In many industrialized countries, bankruptcy courts and bankruptcy proceedings play a vital role in rehabilitating and reorganizing business. However, countries that suffer from high level of non-performing loans (NPL) might need additional mechanisms to accelerate debt workout *or* debt restructuring. In Thailand, where the mountain of bad debts are threatening its economic recovery prospect, along with formal in-court debt workout procedures, a *formal* but *out-of-court* mechanism was created. Specifically the ***Corporate Debt Restructuring Advisory Committee (CDRAC)*** was formed in June 1998 under the auspices of the Bank of Thailand and representative groups from the private sector (which include Board of Trade, Federation of Thai Industries, Thai Bankers' Association, Association of Finance companies, and Foreign Banks Association). Similar institutions for the

functions were also set up in 1998 by the Indonesian and Malaysian governments. Specifically they were the Indonesian Debt Restructuring Agency and Malaysia's Corporate Debt Restructuring Committee. Also in Korea, a Corporate Restructuring Coordination Committee works under the powerful Financial Supervisory Commission (FSC), which was established in 1998.

The Thai CDRAC worked as a special out-of-court mediator to restructure the debt of target groups of businesses proposed by members of CDRAC. During the initial stage, they were principally large businesses. However, after one year of operation, the scope of target groups was expanded in June 1999 to include small businesses as well. As debt restructuring was rather new to Thailand, CDRAC had to design the framework for corporate debt restructuring as a guideline for businesses to *work out* their debts. CDRAC thus created a *Bangkok Approach* as its debt workout framework, based on the well-known out-of-court **London Approach**, which encompasses the following 5 basic ideas :

- No "legal effect" (whereby legal court procedure does not apply)
- "Standstill" of existing financial facilities (sometimes referred to as *automatic stay*)
- Appointment of a lead bank or steering committee to lead the process and discussion
- New loans extended during the restructuring process to receive either priority or fair treatment status
- Trade creditors to be excluded from incentives under the restructuring scheme, which focuses only on creditors that are financial institutions

In principle, debt restructuring can be conducted in several different forms as follows:

- By reducing outstanding principal or *haircut*
- By reducing interest rate
- By extending repayment period or maturity extension
- By swapping debt for equity
- Or the combinations of above

To further expedite the debt workout under CDRAC, the Bank of Thailand initiated the signing of the **Inter-Creditor Agreement (ICA)** and **Debtor-Creditor Agreement (DCA)** in June this year. The ICA is a contractual accord among about 80 local and foreign financial institutional creditors, who agree to follow the procedures and decisions taken within the CDRAC resolution process. Such agreement would reinforce out-of-court debt workout of large businesses and effectively reduce disagreements among multiple creditors. Meanwhile the DCA is an agreement signed by debtors and creditors, expressing an intent to execute a restructuring agreement within a legally binding timeframe. In order to press for full participation and cooperation, CDRAC laid heavy penalties for non-compliance. Debtors who refuse to sign the DCA will be sued for bankruptcy by creditors within two months from the CDRAC mandated agreement date. Moreover under the DCA, debtors are required to provide full information as regards all their financial status and obligations. Both debtors and creditors must also have a clear timeframe to prepare restructuring plans etc. In all, the terms and conditions in the ICA and DCA are generally set up in line with the Bankruptcy Act, but they are also adjusted to fit with the *informal* debt workout practices and the objective of CDRAC.

After over a year of operation, CDRAC (as of end September 1999) has handled debt workout for a number of 702 large companies and 2,261 small companies, with total corresponding loans outstanding of Bht 1,500 billion and Bht 44 billion respectively. Out of these amounts, the debts of 117 large companies and 330 small companies, with corresponding loans outstanding of Bht 316 billion and Bht 3.5 billion respectively having been successfully restructured.

Apart from the workout under CDRAC scheme, there are also *informal* debt restructuring implementations by creditors and debtors on their own accord. So far many small cases are attracted to informal channel due to less administrative cost involved. However, since at present the attractiveness and roles of both CDRAC and in-court proceedings are increasing due to more perception of their clear guidelines, informal workout role could begin to ebb. As of September this year, total *out-of-court* workout completions (including those under informal channel and under CDRAC) were over 120,000 cases involving loans amount of Bht 762 billion.

CDRAC versus In-court proceedings

Compared to the *formal in-court* procedures, the *out-of-court* workout by CDRAC contains less procedure. Moreover, the terms and conditions under the ICA and DCA as above-mentioned could make the approval process of a rehabilitation plan more easy than that of a case filed in court. Although the *Bangkok Approach* framework and *ICA and DCA* agreements were well developed, there are still weaknesses. The critical one is the degree of enforcement, especially the power to enforce debtors to cooperate. CDRAC was set up as the mediator and not empowered to punish parties who breach the contracts through jail sentence. Its strategy was not only to push creditors as well as debtors to participate in the program but also at the same time prevent creditors to take advantage on debtors. Besides, CDRAC might not be as efficient as bankruptcy court to deal with *strategic* NPL. It can however restructure the easy cases faster than bankruptcy court since its procedure is flexible and less complicated. As regards restructuring statistics, CDRAC is seen as playing vital role in debt revamping. From an initial 42 large cases totaling Bht 116 billion submitted under CDRAC scheme early this year, CDRAC is now set to handle about 3,000 large and small cases totaling over Bht 1,500 billion.

Additional incentives for debt workout

In an attempt to accelerate debt workout and business rehabilitation, the Thai government introduces incentive measures to support both *formal* and *informal* restructuring initiatives. They include the following :

1. *Accounting standard beneficial to debt restructuring* : The Bank of Thailand allows financial institutions to reclassify their non-performing loans back to normal/performing loans once a restructuring agreement is signed among creditor(s) and debtor(s). This permission could significantly lessen banks' NPL and hence their loan loss provision requirement.

2. *Regulatory relaxation on equity ownership* : To facilitate debt-equity swap as one solution for debt workout, equity participation by banks in debtors' companies above the regulatory ceilings is now permitted for up to 3 years. Normally banks are not allowed to invest over 10% of a company's equity, and altogether over 60% of their own capital.
3. *Tax and fee relaxation* : Various taxes and fees on the transactions arising from debt restructuring (usually involving deals and transactions on collateralized properties) are exempted to lessen the cost of debt workout.

Concluding note

In conclusion, it is expected that current serious attempts by several governments in Asia would help remedy the problem of bad debts in the region (in Thailand alone, NPLs total Bht 2.57 trillion or about US\$ 66 billion, representing 45% of total loans outstanding). High level of NPL in several Asian countries is now threatening their economic recovery prospect. As elaborated, various infrastructure and mechanisms--be they legal or institutional, formal or informal -- to cope with insolvency issue through business reorganization or rehabilitation could in effect enable creditors, which are chiefly financial institutions, to reclassify non-performing loans back to *normal* loans, as well as to resume their lending activities. In consequence, this would consequently not only restore financial sector's stability, but also revive the real sector, and hence the economy in general

THANK YOU