

*Organisation for Economic Co-operation and Development
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**INSOLVENCY SYSTEMS IN ASIA: AN
EFFICIENCY PERSPECTIVE**

SYNTHESIS NOTE

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November 29-30, 1999
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Synthesis Note

Summary and Objectives

The OECD, the World Bank, Australian Treasury/AusAID, and APEC organized a meeting on *Insolvency Systems in Asia: An Efficiency Perspective*, which was held in Sydney, Australia, on November 29-30, 1999. Approximately 80 policy makers, members of the judiciary, private sector practitioners, insolvency experts, and academics from 14 Asian countries (excluding OECD Member countries), 9 OECD Member countries, and international organizations attended the meeting over the two days.

The primary purpose of the meeting was to bring together senior policy makers and experts from the Asian region and OECD Member countries to report on recent developments in insolvency reform and to discuss and recommend measures to strengthen insolvency systems. In addition, the meeting provided an opportunity to present and discuss the current effort by the World Bank to develop a set of principles and guidelines on building effective insolvency systems. The World Bank expects to release an initial exposure draft of the principles and guidelines in the first quarter of 2000. The participants were also advised about a proposal before the United Nations Commission on International Trade Law (UNCITRAL) to conduct work on the legislative aspects of domestic insolvency systems. Lastly, the meeting was intended to serve as a platform for launching a multi-disciplinary, multi-faceted dialogue forum to deepen dialogue and to coordinate future activities in the area of insolvency reform in the region.

In December 1998, the OECD commissioned country studies on the insolvency systems of Indonesia, Korea, Malaysia, the Philippines, Singapore, and Thailand, as well as a comparative report analyzing the insolvency systems of the foregoing countries. In addition, a separate study of India was commissioned in September 1999. These reports, along with the World Bank draft background paper on building effective insolvency systems and the presentations, served as the bases for the meeting and helped to stimulate lively debate in the general discussion segment of each session. During the conference, the panelists candidly discussed and analyzed insolvency from multiple perspectives, focusing not only on legal and economic issues but also addressing political, social, and cultural concerns. In each session, the general discussion served to flesh out the underlying issues and enabled participants to share their countries' unique concerns and perspectives.

In the concluding session, the participants expressed a strong desire for a continuing dialogue on insolvency reform and urged the sponsoring organisations to remain active in this area.

Conclusions and Recommendations

A number of important issues pertaining to insolvency and related areas were discussed during the meeting. On the basis of these discussions and the recommendations provided by the experts, the following conclusions may be drawn:

An efficient and effective insolvency system is pivotal for long-term economic recovery and growth.

A well-developed insolvency system is a critical component of every well-functioning market economy. It facilitates smooth reallocation of resources into more productive uses for firms that

cannot be returned to profitability through a restructuring and provides firms suffering from temporary financial difficulties with valuable “breathing space” to redeploy resources in an orderly way, thereby maximizing going concern value and preserving jobs. The predictability and discipline fostered by an efficient and effective insolvency system also builds confidence among credit providers, resulting in reduced borrowing costs. In contrast, the absence of a well-functioning insolvency regime may precipitate capital flight, exacerbate production losses, and decimate enterprise value by giving debtors perverse incentives to engage in strategic behavior and to otherwise frustrate creditors. Some experts have concluded that deficiencies in the insolvency system were a primary factor that contributed to the financial crisis in certain countries.

The regional financial crisis that began in 1997 shook the economies of many countries and caused tremendous social, political, and economic dislocations. It also exposed numerous weaknesses in the region’s insolvency regimes. In response, governments in the region have exerted substantial efforts to implement reforms to expedite restructuring of financial institutions and businesses and to restore soundness to the economy. Since the inception of the financial crisis in 1997, governments in the affected countries have:

- Established asset management companies to deal with the non-performing loans of financial institutions;
- Created special agencies to accelerate restructuring of financial institutions and businesses;
- Introduced new legislation to modernize and improve the insolvency system and related areas; and
- Reformed existing insolvency institutions, including introducing or enhancing the utilization of rehabilitation procedures and creating special bankruptcy courts or divisions within the general court system.

Despite the sweeping changes undertaken by governments in the region, the conference participants expressed concern regarding three inter-related areas. First, many measures introduced to date have been intended primarily to deal with the systemic crisis facing these economies. While these measures have helped certain economies to recover from the crisis, they serve only as a first step to a well-functioning insolvency system and policy makers should not be led into thinking that the reform effort is complete. In fact, the conference participants noted that, in many countries, the necessary basic insolvency rules still do not exist and the institutional infrastructure remains underdeveloped. Hence, additional reforms are still required to build a strong and enduring insolvency regime.

A related concern regards the pace and depth of corporate restructuring. While change is occurring very rapidly and governments have established special agencies (such as the Corporate Debt Restructuring Committee (CDRC) in Malaysia, Corporate Debt Restructuring Advisory Committee (CDRAC) in Thailand, and the Jakarta Initiative Task Force (JITF) in Indonesia) to facilitate out-of-court restructuring, progress has been slow and the restructurings undertaken so far have not been very successful. Participants noted certain debtors and creditors have engaged in “band-aid reconstruction” by only rescheduling debts without attempting real restructuring. In addition, certain participants question whether the newly created asset management companies promote or impede the required long-term restructuring.

Finally, the participants feared that the rapid recovery of certain affected economies could weaken the political resolve for a deeper, sustained insolvency reform effort and stressed that it is therefore essential for insolvency reform to remain at the top of the political agenda. To ensure that insolvency reform remains a priority, the conference participants urged international organizations such as the OECD, World Bank, APEC, and ADB to continue to be active in this area.

There is no "one-size fits all" solution.

It cannot be overemphasized that there can never be a “one-size fits all” insolvency system. An insolvency system will function well only if it accurately reflects the special characteristics of the country within which it operates. Insolvency systems will therefore embody different policy choices on procedural and substantive laws, including the allocation of risk among all participants, and should take into account the strengths and limitations of the institutional infrastructure, level of economic development, social traditions, and legal structures. For example, certain cultures may be more inclined to negotiate (rather than to litigate) to resolve disputes. In other countries, concern for social stability is heightened. In many Asian countries, stigma is attached to bankruptcy and debtors who declare bankruptcy suffer adverse social and reputational consequences. In addition, some jurisdictions may find it necessary to establish specialized bankruptcy courts to enhance predictability in judicial decision making. Lastly, the institutional infrastructure in many developing countries is weak and due to the intense competition for the limited pool of funds among various government organs, it may not be realistic to expect a significant increase in funding to strengthen the institutional infrastructure of the insolvency system. However, while an insolvency system must be designed to address such idiosyncrasies, weaknesses, and lack of resources, all insolvency regimes must contain certain fundamental features (as discussed below). In other words, a country’s special characteristics (particularly cultural concerns) should not be emphasized to such an extent that the effectiveness of the insolvency system is sacrificed.

The notion that there is no “one-size fits all” model lies at the heart of the World Bank effort to design a set of principles and guidelines on building effective insolvency systems. When completed, the World Bank principles and guidelines will serve as flexible core guidelines that will assist countries to benchmark their insolvency systems.

Notwithstanding the considerable flexibility in designing a well-functioning insolvency system, certain core features are essential to all insolvency regimes.

Despite the latitude in designing an insolvency system, all insolvency systems must contain certain core characteristics. First, all insolvency systems must strive to be *efficient*. A major component of efficiency is speed, which is critical when a company is teetering on the edge of bankruptcy as the loss of time resulting from procedural delays and strategic behavior can decimate going-concern value and destroy any possibility for a successful rehabilitation. Speed may be achieved through measures such as imposing time limits and spelling out clearly the responsibilities of all parties. Yet care must be taken to ensure that the proceedings, whether liquidation or rehabilitation, are conducted on the basis of accurate information, meaning that sufficient amount of time must be given to independent third parties to prepare assessment reports. Thus, while speed is crucial, accuracy must not be compromised in the process.

Furthermore, the conference participants stressed that an efficient insolvency system should provide not only well-functioning formal mechanisms but should also allow and facilitate out-of-court restructuring, which are often speedier and more cost-effective and which will ensure that scarce judicial resources are utilized sparingly and only when absolutely necessary.

Lastly, achieving efficiency also means that debtors must be provided with incentives to utilize the insolvency system at a relatively early stage of financial difficulty. Debtors should be given easy access to the insolvency system by requiring only a showing of financial difficulty and should be encouraged to use the system through both sticks (i.e., insolvent trading liability) and carrots (i.e., possibility of retaining management control). The governments of Thailand and

Malaysia, in response to systemic distress, have also sought to encourage companies to utilize the insolvency system by waiving various fees and taxes in order to reduce restructuring-related costs.

Regardless of the underlying policy choices, regimes that foster *predictability* will instill greater confidence among credit providers. One expert remarked that creditors are more concerned with the predictability of their priority position rather than their particular ranking. Regardless of where a creditor ranks in terms of priority, an insolvency system that is predictable will enable such creditor to respond through a pricing adjustment. Predictability may be fostered through the adoption of clearly written rules and regulations, the creation of bankruptcy courts or specialized insolvency judges within the general court system to ensure consistent application of the law, and accountability-enhancing measures such as requiring judges to publish their decisions.

There was widespread agreement among the conference participants that the insolvency system should provide for both *liquidation* and *rehabilitation*. Liquidation proceedings will focus on an orderly winding-up of an enterprise while rehabilitation will provide the necessary “breathing space” to allow the company to reorganize and restructure. In times of systemic distress, the availability of rehabilitation procedures is especially crucial because many corporate failures resulted from sharply deteriorated macro-economic conditions rather than from poor management. In response to the systemic crisis in Thailand, the government recently amended the insolvency law to introduce rehabilitation proceedings. To protect the insolvency system from abuse, the insolvency law must provide for the possibility of conversion from rehabilitation to liquidation (and vice versa) and must not require the proceeding to start from the beginning upon conversion. This could be achieved through, inter alia, single (unitary) procedure, such as the one adopted in Germany.

While policy choices may lead to a presumption toward rehabilitation, particularly during periods of systemic distress, *preservation of a troubled enterprise at all cost is not the answer*. The markets must be allowed to work, which means that certain distressed companies must be allowed to fail. Otherwise, moral hazard will arise and lending decisions will be distorted on the implicit understanding that governments will always rescue companies that fail.

Regardless of the policy choices made, the insolvency law must delicately *balance creditor and debtor rights*. Due to a heightened concern for social stability, certain insolvency regimes are strongly biased toward debtors, which has enabled debtors in financial difficulty to invoke the protections of the insolvency system simply to delay and frustrate creditors. In the long-term, such insolvency systems may end up increasing the incidence of bankruptcies because creditors will be reluctant to extend long-term credit or any credit at all. On the other hand, regimes that strongly favor creditors may frequently cause premature dismemberment of enterprises that, given assistance and some time, can be returned to profitability.

The meeting participants also agreed that a *moratorium*, or stay of proceedings against the debtor, should be provided for in all insolvency systems. A moratorium is important because it helps to preserve the value of the distressed enterprise’s assets and business and provides the necessary breathing space to enable a company to restructure its operations. Some participants argued that a moratorium should be automatically invoked upon the submission of an insolvency petition while other participants felt that a moratorium should only be granted upon application to a court. In all instances, the conference participants believed that some form of compensation (i.e., payment of interest) should be provided to secured creditors who are prevented from pursuing their claims due to the moratorium and measures should also be taken to ensure that the underlying assets are protected. In addition, creditors who prove significant hardships as a result of a moratorium should be exempted from the stay. Such treatment is necessary and fair because the breathing space provided to the distressed debtor should not result in jeopardizing the creditor’s business. Lastly, the moratorium should not prevent criminal and other public interest proceedings, such as environmental enforcement actions, from moving forward.

Given their intimate knowledge of the affairs of the company, most conference participants would permit the *existing management* of a company undergoing restructuring to continue running the business, albeit under the supervision of an administrator. Existing management (particularly in family-controlled companies), however, should play no role in the distressed company if they are likely to engage in strategic behavior and if the proper incentives to turn the company around are not present. In any event, the administration process should be monitored closely by creditors. However, the extent of *creditor involvement* in insolvency proceedings is a matter of proper balance. On one hand, creditors are important because they are familiar with the debtor's business and, therefore, can accurately monitor the business operations and provide an informed opinion on the firm's prospects for continued survival. In addition, creditors are needed to monitor the administrator. On the other hand, extensive monitoring may be costly and the costs incurred may outweigh the benefits received, particularly for creditors with small claims and unsecured creditors who, under all scenarios, are unlikely to receive anything at all. Hence, a proper yet simple governance structure for creditors should be put in place to achieve these objectives.

The Asian financial crisis revealed serious shortcomings in the *institutional infrastructure* of the crisis countries, which remained underdeveloped partly due to decades of rapid economic growth when governments saw little need to strengthen the insolvency system. The conference participants argued that while a well-developed insolvency law is important for the proper functioning of the insolvency system, it is equally important that reform efforts also focus on developing a strong institutional infrastructure to implement and interpret the laws and to ensure that the system functions smoothly. The meeting participants also noted that until proper institutions are developed, formal insolvency mechanisms will only play a secondary role in most countries.

At the heart of the institutional framework is the court system. Courts should be structured to ensure their integrity and independence from political and other external pressures. To ensure that judges and administrators develop the requisite expertise in insolvency, standards to measure competence, performance, and quality of service should be introduced. These standards should be complemented by a merit-based hiring policy and continuing training and education. Transparency and accountability of the court system may be enhanced by formulating uniform operating procedures and clearly delineating the roles and responsibilities of court officials and other participants.

Unfortunately, many insolvency systems are plagued by corruption, with judges particularly vulnerable to undue influence due to their prominent position. To address this problem, the conference participants recommended the following remedies:

- Enact a self-executing law, to the extent possible, to leave a modest, clearly defined role to judges;
- Impose bright line rules to leave little discretion to judges;
- Require opinions to be published to enhance transparency and accountability; and/or
- Institute an independent body to establish, monitor, and enforce ethical standards in the judiciary.

Lastly, an insolvency system should be sufficiently *flexible* to enable creative but fair solutions to be designed. One expert stated that "the more flexible the procedure, the greater likelihood of successfully saving a viable business and maximising the return to creditors and shareholders."

Formal and informal mechanisms should complement and support one another.

Notwithstanding the importance of an effective formal insolvency regime, it is also essential to reserve a central role for out-of-court arrangements and governments should encourage and assist in the development of strong *informal* insolvency mechanisms. Effective formal mechanisms are important to prod debtors and creditors to enter into good faith out-of-court negotiations while well-developed informal mechanisms are needed simply because courts will never have adequate capacity to deal with *all* insolvencies. During the meeting, participants stressed that the insolvency system should not be too “court-centered” and that most restructurings should occur out of court, leaving courts to intervene only when there is a genuine dispute. It is, however, important to emphasize that the development of informal mechanisms must not come at the expense of developing strong formal regimes. In certain countries, the informal and formal mechanisms compete with each other, leading to the underdevelopment of formal procedures.

Since 1997, in addition to reforming the formal insolvency system, governments in the crisis-affected countries have made serious attempts to promote viable out-of-court arrangements. The Indonesian, Korean, Thai, and Malaysian governments have established special facilitating agencies to encourage and accelerate out-of-court restructuring. The role of these institutions is to act as a special out-of-court mediator in workout situations. The facilitating agencies have been effective in helping to build a consensus among creditors and debtors as to what constitutes “best practices” for informal restructuring. In addition, these institutions have helped to reduce the pressure on the court system in the crisis countries. Yet, the overall effectiveness of the facilitating agencies have been limited because they lack enforcement power to coerce debtors or creditors to cooperate and to punish parties that breach their contractual agreements. In addition, despite the disproportionate impact of a systemic crisis on small and medium-sized enterprises (SMEs), the facilitating institutions (with exception of the Corporate Debt Restructuring Advisory Committee in Thailand) mediate in only large restructurings. Lastly, the effectiveness of these agencies is hampered by the continuing problems in the formal regime. One participant commented 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.”

Insolvency reform must be accompanied by a broader set of reforms in related areas.

Comprehensive insolvency reform must also encompass broader reforms in related areas. Measures recommended by the meeting participants included strengthening accounting and auditing standards, improving the corporate governance structure of corporations and financial institutions, and developing effective regulatory oversight. The OECD-commissioned country studies showed that deficiencies in some of these areas contributed significantly to the recent financial crisis in the region. Effective reforms in these areas will strengthen the financial system and the increased transparency will enable regulators and creditors to detect problems at an early stage. Early detection of difficulties is important as the value of a company erodes rapidly when problems become apparent. In addition, the existence of such an early detection system may help to avert a recurrence of systemic distress in the affected countries by warning policy makers of impending problems well ahead of time.

Accurate and comprehensive company-specific financial information is crucial for the conduct of commerce. At both ends of the commercial spectrum (i.e., when lenders are contemplating extending a loan and when a company is facing insolvency), reliable financial information is essential for informed decision-making. For example, lenders require accurate and comprehensive information on the borrower’s operations in order to make informed lending decisions. When a company is insolvent, the same information is also required to determine whether rehabilitation or liquidation is the best course of action. The availability of accurate and comprehensive financial information helps to reduce the information asymmetry between debtors and creditors and generates confidence among all negotiating parties.

The recent regional financial crisis revealed serious deficiencies in the accounting and auditing standards of many Asian countries. In some countries, the accounting and auditing standards

are woefully inadequate and as a result, the audited financial statements provide little reliable information. In other countries, internationally recognized accounting and auditing standards have been introduced but the adoption rate among corporations and accounting/auditing firms is low. Making matter worse is the fact that the regulatory bodies have neglected to ensure compliance with these standards.

Numerous instances of “fudged accounts” have been discovered in the course of workouts and other insolvency proceedings. In one high-profile workout, independent investigation revealed that the actual debt of the distressed company was US\$23 billion higher than the amount reported in the financial statements. Not surprisingly, this revelation threatened to thwart the entire restructuring effort. A few weeks later, it was also discovered that this company utilized a previously undisclosed offshore company to secretly transfer up to US\$7 billion to other companies in the group.

During periods of systemic distress, the government can facilitate formal and informal restructuring by permitting special accounting treatments to be used. For example, the Bank of Thailand has modified the accounting rules to allow financial institutions to reclassify non-performing loans (NPLs) as performing once a restructuring agreement has been signed. To enable debt for equity swaps to be a more viable option in workouts, the Thai government now permits equity participation by banks above the regulatory ceiling for a period of up to three years.

In addition, the combination of weak corporate governance structures in financial institutions, inadequate supervision by regulators, and industrial policies also contributed to the regional financial crisis. In certain crisis countries, weak corporate governance structures enabled financial institutions to operate without regard to the best interest of shareholders, leading to poor credit risk evaluation, non-arm’s length lending, weak monitoring of borrowers, and lackadaisical efforts to recover loans upon default. In addition, lax regulatory supervision enabled the controlling shareholders of banks to divert funds to such shareholders’ non-financial enterprises in violation of the law. Moreover, these problems were exacerbated by the pursuit of an industrial policy by certain countries, which often led to imprudent lending based on political factors rather than market needs. Weak corporate governance at the corporate level was also an important factor in the crisis, as companies were geared towards serving the interests of a few core ‘inside’ shareholders, spreading the risks to minority shareholders but keeping the control to the former. High level of leverage was a standard way to achieve such objectives.

Future Work

In the concluding session, a consensus emerged among the conference participants on the need for continuing dialogue in the area of insolvency reform. The participants stressed that it is imperative that the momentum for reform is maintained and that the sponsoring organisations continue to be active in this area. In addition, all future endeavours should attempt to integrate the work completed by other international organisations, such as the IMF, ADB, and UNCITRAL.

One suggestion that garnered widespread support is to convene another meeting in 2000 (after the completion of the World Bank principles and guidelines on building effective insolvency systems) to produce an agenda for reform from a regional perspective, to evaluate current reform efforts, and to discuss other related developments. The Indonesian participants suggested holding the meeting in their country since Indonesia seems to be experiencing the most acute problems in the region. The participants agreed that it is essential to maintain the present composition of participants (consisting of senior policy makers, members of the judiciary, academics, bankers, lawyers, accountants, and other insolvency practitioners and experts) in any future work. Moreover, it may also be beneficial to include more representatives of the corporate world (i.e., the debtor community) in all future work.