

Resolution of Financial Distress: An Overview

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1. Introduction

Recent financial crises involving the corporate and financial sectors in emerging markets, especially in East Asia in 1997-1998, have raised important questions on the proper role of the government in preventing and alleviating financial distress. Actions by governments to assist specific companies and financial institutions raise equity issues, as they require future taxation to service the additional public debt. There is also a concern that private sector entities will come to expect such assistance in the future and may behave in imprudent ways, leading to future crises. On the other hand, no action by the government may mean that significant sections of the economy remain distressed over a long period of time, with large and socially unacceptable losses in output and employment. This dilemma has led to the search for arrangements that would, with some automaticity, trigger orderly processes for the resolution of systemic financial distress. This search is paralleled by a review globally of the framework for resolving financial distress at the individual corporation level, with many countries revising their bankruptcy and related laws.

Broadly in a systemic crisis, the government's role lies, first, in defining rules that would lead to efficient private restructuring efforts and, second, in providing direct assistance where the private initiatives prove insufficient to resolve distress at acceptable output losses. Neither role is obvious, however. There have been intense debates, for example, on whether excessively

debtor-friendly or creditor-friendly regimes aggravate financial crises. An equally disputed area is whether direct support helps the resolution of a financial crisis or merely accelerates the coming of the next crisis.

Another dimension is that financial crises allow governments to introduce reforms that are otherwise stymied by political interest groups. Thus, while the resuscitation of ailing companies and banks is of paramount importance to policy makers in times of financial distress, such periods also provide a window of opportunity to pass legal and judicial reforms that enhance the long-term growth path of the economy. Examples of such reforms are the passage of improved bankruptcy laws in South Korea, Thailand, and Malaysia in the wake of the financial crisis, and the formation of specialized bankruptcy courts in Indonesia and Thailand.

This book deals with the principles and practical approaches to addressing the difficult public policy trade-off in systemic corporate and financial sector crises and the lessons from the evolving bankruptcy framework around the world. It brings together research on recent public policy initiatives on rules for distress resolution or market-based restructuring. The book also includes papers that discuss the direct role of the government when these contractual and market-based methods are not sufficient. Finally, an analysis of the scope for political economy windows is included.

In this overview chapter, we summarize the main findings of the thirteen papers in the volume, as well as the findings of some other recent studies of insolvency reform. We first discuss the role of insolvency rules in a market economy. Considerable new research on insolvency has been conducted in recent years independently of the crises in emerging markets. This literature provides important guidelines for the long-term development of bankruptcy rules

and procedures. However, while a critical complement to other initiatives, bankruptcy processes have played a limited role in the emerging market crises because of the extensive scale of the problem and the time required for bankruptcy rules and institutions to become effective in economies where they have only recently been introduced.

This leads to the second set of papers that consider approaches to deal with systemic financial distress. In particular, a number of papers study the government's role in facilitating resolution of financial claims through out-of-court arrangements that substitute for effective bankruptcy procedures. Other papers consider market-based restructuring through facilitating mergers and acquisitions, including through permitting a greater role for foreign investors. Finally, where neither bankruptcy procedures—including those specially directed to dealing with systemic distress—nor market-based restructuring through takeovers of distressed firms are adequate, the government will often step in by assuming the financial losses of distressed firms and banks. In that context, the role of asset management companies and other forms of government support are discussed.

2. Insolvency Regimes: current interest and principles

Insolvency regimes represent the balancing of several objectives, including protecting the rights of creditors, which are essential to the mobilization of capital for investment and working capital, on the one hand, and obviating the premature liquidation of viable enterprises, on the other hand. In most countries the framework for dealing with insolvency has evolved over time as the balance of political power between various interests has changed, along with the structural transformation of the economy. As a consequence, bankruptcy regimes differ

considerably, even among developed countries. Thus, even in countries with close socio-cultural affinities and economic ties such as the U.S. and U.K., there are significant differences in the basic treatment of the debtor.¹ Insolvency provisions, therefore, appear tailored to the situation of the country and the circumstances in which it finds itself, especially in times of systemic financial distress.

In spite of differences among regimes, it has become clear that a working insolvency regime is an essential part of a market economy. The absence of adequate insolvency regimes in the East Asian crisis economies, a surprise to many, considerably complicated and slowed down the process of corporate restructuring. For years, these economies had grown rapidly and institutional reforms to deal with corporate distress were not high on the list of policy makers' priorities—though bankruptcy codes were better developed in Malaysia and South Korea than in Indonesia and Thailand. The attempts to institute and refine bankruptcy mechanisms following the crisis led to a broader reevaluation of the goals of the insolvency mechanism in a market economy (most forcefully expressed by Joseph Stiglitz in this volume). The East Asian financial crisis triggered much work in international fora on developing guidelines for bankruptcy regimes.² One of Stiglitz's contributions is to turn the discourse away from whether bankruptcy codes are fair or not to the important question of what behavioral incentives they create. What matters to creditors most is that there be clarity concerning what happens

¹ The U.S. Bankruptcy Act of 1800 was largely a copy of the English Statute of Anne. Today, the British system favors the creditor and results in relatively more liquidations while Chapter 11 of the U.S. bankruptcy code is more debtor friendly and leads to more reorganizations under the control of incumbent management. Recent changes in the British bankruptcy law have, however, moved it closer to the U.S. law. For details, see Westbrook (this volume).

when debtors default. As long as insolvency rules are predictable, lenders will charge an interest rate commensurate with the risk involved. And debtors in turn end up with access to capital while paying the fair cost.

When the legal rights of creditors are well protected, the access to credit of firms expands substantially, as does the breadth and depth of debt markets (La Porta and Lopez-de-Silanes, this volume). This is because the laws protect creditors from expropriation by the managers and controlling shareholders of firms. A simple way to reward creditors in insolvency is to respect the absolute priority of claims in bankruptcy or restructuring, i.e., senior creditors are paid first, then junior creditors, followed finally by shareholders if any residual remains. At the same time, a number of papers have pointed out that if shareholders receive nothing in bankruptcy, managers, acting on behalf of shareholders, will attempt to delay or avoid bankruptcy, including undertaking high risk projects when the corporation runs into financial distress. For this reason, Hart (2000) makes a case for preserving some portion of firm value in bankruptcy for shareholders, even when absolute priority would not leave any residual value for the owner.

There are many dimensions on which insolvency procedures can be compared and Stiglitz provides a very useful taxonomy of these dimensions. An important consideration is whether the law provides for an automatic trigger when a company needs to file for bankruptcy. The purpose of automatic triggers is that they can alleviate the loss of value associated with managers or major shareholders delaying the bankruptcy decision. Such a trigger was

² See for example the World Bank effort on Effective Insolvency Regimes; Principles and Guidelines, part of the Global Insolvency Laws project at www.worldbank.org/legal.

introduced in Hungary in 1992 with the effect that more than 5,000 companies entered bankruptcy in a single year (Gray, Schlorke, and Szanyi, 1996). While in the long run it spurred institutional building in the courts and the trustee profession, the adoption of the trigger mechanism clogged the courts for a number of months and made difficult the separation of viable from unviable firms. The trigger was subsequently removed in the 1997 bankruptcy reform. A trigger mechanism of a different type was introduced in the revision of the Thai bankruptcy law of 1999 (Foley, 2000). If the debtor owed a group of plaintiff creditors more than one million Baht, the main creditor had to petition for bankruptcy. While the trigger itself was well defined, the next step in the bankruptcy procedure—the determination of insolvency—was not. In particular, nine presumptions of insolvency were set forth in Section 8 of the Bankruptcy Act 2483. These proved to be a toll order to fill, with the result that few bankruptcy cases were initiated even after the revised law came into force. The Thai example points to the necessity for complementarity of various laws and procedures that underlie the insolvency regime.

The next important question in the adoption of a bankruptcy law is who can file for reorganization or liquidation, the weight given to the debtor, the creditors (bank loans, trade financing), the company's management, and the other stakeholders in preparing reorganization proposals, the ability of management to stay during the reorganization, whether an automatic stay of assets exists. La Porta and Lopez-de-Silanes (this volume) show that each of these features affect the access to credit significantly across countries, e.g., the ability of managers to hold onto their positions adversely affects creditor rights and is associated with less access to external finance.

How different countries combine these features to deal with financially-distressed firms depends to a large extent on the values of all stakeholders and other factors such as general contract law, securities laws, criminal laws, the availability of extra-judicial options, the institutional development of country (courts, creditors, banks, government), the diversity of claims, and the degree of informational asymmetries. International dimensions can be important, as was the case for Indonesia where the corporate sector debt was largely owed to foreign investors (Claessens, Djankov, and Lang, 2000a). The general quality of information on firm value and the development of the financial markets to absorb distressed assets are other important factors.

While a unique optimal insolvency regime does not exist, badly written codes make everybody worse off. Several principles apply in the construction of a good insolvency regime. First, the regime should deliver an ex post efficient outcome, in the sense that the highest total value is obtained for the distressed firm. Specifically, the firm should be closed down, liquidated piecemeal, sold as a going concern, or reorganized based on which of these options generates the most value to creditors, the debtor, and other shareholders such as workers. Second, a good insolvency regime should be ex ante efficient, in that it would prevent managers and shareholders from taking imprudent loans, and lenders from giving loans with a high probability of default. Imprudent behavior can be punished by a reduction in claims or by job losses of the respective parties.

How different countries deal with financially distressed firms also varies over time, as the structure of economic production and values of all stakeholders change. Westbrook (this volume) reports a general trend towards moving from more creditor-friendly regimes to more

debtor-friendly regimes. The recent changes in bankruptcy procedures around the world have been predominantly in the direction of adopting a U.S. Chapter 11-type procedures, with Argentina, Australia, Indonesia, Thailand, the United Kingdom all having legal reforms (Stiglitz, this volume). The exception to this trend is the insolvency reform in Mexico in 1998 that introduced an automatic trigger for entering bankruptcy. The move towards more debtor friendly regimes appear to be motivated by the greater focus on intangibles in the operation of firms, making it more important to preserve the ongoing value of a firm in a financial restructuring. An excessively creditor-friendly approach can result in too many liquidations.

Bankruptcy or other legal resolution techniques are not the only methods for dealing with financial distress. Economists have been proposing alternative procedures for some time. These center on versions of an asset sale or a cash auction. Cash auctions are easy to administer and do not rely on the judicial system (Hausch and Ramachandran, this volume; Hart et al., 1997). While attractive from a theoretical perspective, these proposals have not had recent followers, except for the Mexican reformers in 1998. This is because asset sales are empirically shown to fetch low prices, although this empirical evidence is mostly anecdotal (Pulvino, 1998). A further downside of the auction mechanism is its reliance on liquid secondary markets. At the same time, structured bargaining mechanisms, for example the Chapter 11 reorganization, depend on strong judicial systems. In countries where the judiciary is relatively weak, as in many developing countries, one might consider a menu of options to dealing with insolvency, where debtors can choose whether to use structured bargaining or cash auctions. In the short run, debtors may prefer structured bargaining, even though they are paying for it through higher interest rates, since creditors will adjust for the uncertain outcomes

of the restructuring process (Hart, 2000). In the long run, as old debts expire, debtors will likely switch to the cash auction procedure, as this will lower the cost of obtaining capital. Most importantly, however, offering a menu of options is likely to introduce an element of competition among alternative procedures, with the less efficient procedures being eliminated over time.

Importantly, for firms facing financial distress, legal insolvency is but one restructuring option creditors and debtor can pursue. A number of firms in East Asia after the 1997-1998 crisis chose to sell equity (and control) to foreign investors (Mody and Negishi, this volume; Freund and Djankov, 2000), or renegotiated most of their debts out of court (Fagan, Foley, and Gilson, this volume). In countries with better creditor rights and more efficient legal systems, the likelihood of filing for insolvency of financial distressed firms was higher, although firms affiliated with business groups were less likely to file (Claessens, Djankov, and Klapper, 1999). Even when the bankruptcy procedures are not used in restructuring, however, they determine to a large extent the speed and process of restructuring.

Two of the papers in this volume take a look at the impact of (changes in) bankruptcy regimes on the resolution of financial distress. Claessens, Djankov, and Klingebiel study Indonesia, Malaysia, South Korea, and Thailand and find that a very small share of distressed assets, less than 6 percent on average, was resolved through formal bankruptcy. Much more prevalent was the use of out-of-court settlements. This is part is explained by the slow pace of the judicial process: it took on average more than two years for a bankruptcy case to reach judicial decision in Thailand. Not surprisingly, the two countries with the most court delays, Indonesia and Thailand, instituted specialized bankruptcy courts. While the efficiency of in-court resolution improved significantly following these changes in the structure of the judiciary, few

cases still reached the bankruptcy courts. As Fagan, Foley, and Gilson (this volume) show in the Alphatec case in Thailand, most bargaining was done outside the courts.

Related to the lack of willingness to use formal bankruptcy procedures is the wealth effect of changes in bankruptcy regimes. In the wake of the East Asia financial crisis, all affected countries passed new bankruptcy legislation while Indonesia and Thailand also introduced specialized bankruptcy courts. Foley (2000) further investigates the effect of legal reform on the value of both creditors and debtors. The key question is whether such legal changes merely redistribute pending claims, or whether the value of claims of both debtors and creditors increases. He shows that values for all parties increased in reaction to anticipated events in the Thai bankruptcy process. The increase was large, with equity values increasing over 25 percent in total, following positive news. Little affected were the equity values of companies or banks associated with financially healthy business groups. The latter supports the findings in Claessens, Djankov, and Klapper (1999) on business groups acting as an alternative source of capital in East Asian countries.

There can also be general, more long-term effects of bankruptcy codes. Not only will the strengths of creditor rights determine the prevalent interest rates, but the balance can also determine the level of entrepreneurial activity (White, this volume). The more liability potential entrepreneurs face in case of default, the less likely they are to start new businesses. White provides empirical evidence on the number of start-up companies in the United States, and explains the variation across states in part on the different procedures for personal insolvency.

3. Systemic distress and corporate restructuring

Corporate restructuring is an ongoing process that separates those firms that survive and prosper from those that are overwhelmed by new challenges and flounder. Governments have only a limited role to play in such restructuring, except to ensure an economic environment in which resources can be redeployed to new uses at minimal cost. However, when distress is widespread there is a danger that it may be self-reinforcing. Several types of coordination issues arise. Firms may have low incentives to restructure because other distressed firms (and, by implication, consumers) have low demand for their products. Also, distressed firms are unable to repay debts, maintaining the pressure on financial institutions, which in turn restrict new lending that may be required to revive sectors where effective demand exists. Financial institutions may become insolvent, reducing the incentive of borrowers to repay loans. The judicial system will be overwhelmed with cases with no mechanism to prioritize which case to treat first. To break out of this vicious cycle, three approaches have been employed. We discuss them in turn.

The first strategy is to depend on *economic recovery* to release the constraint on demand, improving cash flows and the repayment ability of firms. Such recovery can be engineered by increased government spending but may be limited by fiscal constraints, particularly in times of systemic distress. The recovery may also occur if the demand for exports is buoyant, as was the case in Mexico after the 1994-95 crises and as was also the case with Korea and Malaysia following the recent Asian crisis, with both countries benefiting from rapid growth in the trade of electronics products. However, a reliance on an economic upturn may be naïve, as evidenced by the continued stagnation of the corporate sector in Japan over the last decade (Alexander, this volume).

Economic recovery by itself has proven to be insufficient in countries like Indonesia and Thailand, where more than half of the corporate sector was at one point experiencing distress. Many firms were in distress not just because of an economy-wide crisis but because imprudent investment decisions had been made in the past. The evidence shows that the distress of such firms and financial institutions persists for long periods of time, rendering the economy vulnerable to renewed financial pressures. For this reason, the next set of alternatives is a variety of *market-based measures*, which need not require any fiscal layouts. Under this approach the government set the rules under which creditors and debtors workout their claims in a decentralized manner. These rules include rules governing normal restructuring and bankruptcy, enhanced measures for resolving financial claims (through special rules or moral suasion, that supplement existing bankruptcy procedures), reduction of barriers to transfer of ownership and redeployment of resources (including more liberal foreign direct investment, mergers and acquisitions, and greater mobility in labor markets), and “super-bankruptcy” processes that, once again, change the incentives for the restructuring of claims.

The common feature of these decentralized approaches, whether normal creditor-led workouts, enhanced “market-based” or super-bankruptcy approaches, is that they rely on incentives and penalties for restructuring rather than on either government fiscal stimuli (as in the case of an engineered recovery) or on the assumption by the government of financial liabilities of bankrupt firms and financial institutions. In some cases, however, where economic recovery and enhanced incentives for restructuring are insufficient, governments may face the *assumption of financial liabilities* or provide other forms of government support to shore up the financial or corporate sectors. Related is the degree to which governments should exercise regulatory

forbearance on financial institutions in distress. Where governments do expend fiscal resources and assume non-performing loans, they also seek to recover some part of those resources through centralized asset management companies (AMCs).

Economic recovery. In practice, the dependence on economic recovery, sharper incentives and tougher penalties, and the assumption of financial liabilities go together. This is demonstrated by a variety of country examples. It is thus difficult to isolate the effects and benefits of pursuing an economic-recovery-only approach. While all East Asian countries engaged, after an initial contraction, in fiscal stimulus programs, Japan is the country which has relied the most on demand-led recovery, with fiscal stimulus an important part of the approach. Alexander (this volume) describes the ongoing Japanese reforms, which so far have had mixed success, and analyzes complimentary structural reform efforts. Besides the fine-tuning of the bankruptcy codes, initiatives have been undertaken to increase labor mobility and facilitate mergers and acquisitions. Primarily, these initiatives involve the elimination of a number of restrictive rules, e.g., the type of majority required within a distressed firm's board of directors to permit its takeover or merger with another firm. Both the reported levels of bankruptcies and domestic as well as international mergers and acquisitions of Japanese firms are on the rise, though from a low base. In the short-run, these are painful to the employees of the affected firms and even to the broader economy, as they serve to depress consumer sentiment. However, such restructuring offers the best hope for the revival and long-term efficiency of the corporate and financial sectors as the fiscal stimulus approach has had few long-lasting benefits, while raising the Japanese public debt to very high levels. More generally, the scope for economic recovery alone to overcome a systemic crisis is very limited.

“Market-based” approaches. In any circumstance, the government sets the rules for distress situations that encourage the settlement of claims and facilitate the transfer of ownership and the redeployment of resources. The government’s role in a situation of systemic distress may be different from its normal functions in the degree and speed with which it acts, and the extent to which it creates (temporarily) tighter rules to encourage restructuring. And, as argued earlier, certain significant reforms (related, for example, to corporate governance, liberalization of foreign direct investment, easier mergers and acquisitions) may be undertaken during periods of systemic distress. These correct deficiencies leading to the problems, but will likely have permanent benefits as the systemic crisis recedes. This political economy of reform is not uncommon, of course, and a crisis can often be the best way to get difficult structural reform accepted.³

While there exist various ways in which governments can enhance the restructuring process, in designing the rules for restructuring the main responsibility has to be with the debtor and creditors themselves. The usual way of resolving financial distress is an out-of-court creditor-led “voluntary” workout. These voluntary workouts will differ by the type of debtor, e.g., small versus large firms, the structure of creditors, e.g., amount of secured versus unsecured creditors, and in many other dimensions. In all cases, however, the formal insolvency regime serves as the background. Debtors could always pull out of negotiations if they thought they could fare better in the formal procedure. As a result, voluntary workouts have had limited

³ Domowitz and Tamer (1997) show that the pace of legal activity in the United States from 1790 to 1994 support the proposition that legislative initiatives with respect to bankruptcy are countercyclical in nature, i.e., bankruptcy legislation is usually passed after a deep downturn in the

success in countries where formal bankruptcy was cumbersome, e.g., in Indonesia, because of deficiencies in the framework or a weak judicial system (Claessens et al., this volume).

Private sector restructuring may also be stymied by the lack of (equity) capital and barriers to the mobility of resources. Where past owners are unable to deal with the problems, transfer of ownership to new owners may offer the best solution to maintaining some of the value of the resources employed. Also, financial distress can signal that resources may also be better used in other sectors of the economy. The crisis in East Asia and the poor Japanese growth performance have revealed the rigidities to resource mobility in these economies. As part of their reform following the financial crisis, governments have undertaken several steps to facilitate capital mobility, some to allow transfer of assets to settle claims and some that have longer-run implications for increased efficiency of operation. In particular, foreign investment regimes have been liberalized and mergers and acquisitions made easier (Mody and Negishi, this volume; World Bank, 2000).

Mody and Negishi show that in the crisis countries of East Asia, mergers and acquisitions have focussed heavily in the non-tradable sectors, where distress has been most pronounced. These include wholesale and retail trade, transportation, real estate, and financial sectors. Concerns have been expressed that acquisitions by foreigners may represent “fire-sales,” representing a net transfer of wealth from the crisis economies (Krugman, 1998). Though the evidence is not conclusive, Mody and Negishi argue that the jump in mergers and acquisitions in the East Asian economies represents a shift from a relatively autarkic policy

economy. Berglof and Rosenthal (2000) find further evidence for the countercyclical nature of bankruptcy reform in the United Kingdom and the United States.

stance—prior to the crisis, few East Asian countries allowed entry in their financial sectors, for example—to a more open one. The mergers and acquisitions are likely to further the integration of these economies into the global economy: the high rate of mergers and acquisitions in Korea, for example, where corporate distress was the least amongst the crisis countries, demonstrates the importance of this long-term shift relative to the incidence of “fire-sales.” However, Mody and Negishi also conclude that the problems of distressed firms lies deep in past investment and financial structure decisions and hence the influence of the wave of mergers and acquisitions may only be discerned over time.

Normal bankruptcy and restructuring frameworks, even when adopted, might not be sufficient given the coordination problems and weaknesses in the institutional frameworks. First used in the Mexican crisis (Mulas, this volume) and expanded in the context of the East Asian crisis, bankruptcy rules can be supplemented with so-called London⁴ rules involving enhanced mechanisms to get creditors and debtor to agree on restructuring (Haggard; Claessens et al., this volume). Enhancements have involved encouraging all (or most) financial institutions to sign on to these out-of-court accords under regular contract or commercial law. If so, agreements reached among the majority of creditors can be enforced on other creditors without going through formal judicial procedures. Also, formal arbitration with specific deadlines has sometimes been made part of the accord. With such arbitration, an out-of-court system does not have to rely as much on the formal judicial process to resolve disputes—with associated costs and delays. And, some of the approaches have involved specific penalties that can be

imposed for failure to meet deadlines. The degree to which countries have adopted these enhancements has varied among East Asian countries, with the framework in Thailand, followed by those in Korea and Malaysia, the most conducive to out-of-court restructuring, with the framework in Indonesia the least. These differences explain in part the variations in the speed of restructuring in these countries.

The most far-reaching proposal to enhance restructuring is that of “super-bankruptcy”, a temporary tool to be used when a country faces systemic bankruptcy brought on by huge macro-economic disturbances (Stiglitz, this volume). The basic presumptions of the super-bankruptcy are that management stays in place automatically and that there is a forced debt-to-equity conversion. The existence of such a bankruptcy code will likely result in higher interest rates in normal times, especially by short-term foreign lenders, and raise the moral hazard of worse management and higher risk-taking. But, in a systemic crisis it can preserve the going concern value of firms by preventing too many liquidations and keeping in place existing managers, who most often will know best how to run the firms. An important design issue is when to call for Super Chapter 11, i.e., when is the crisis of a systemic nature, and who has the authority to call for such a suspension of payments? Political economy factors should be taken into account here as wealth is often concentrated in emerging markets and some debtors would stand to gain disproportionately from a suspension of payments (Claessens, Djankov, and Lang, 2000b).

⁴ The London rules are principles for corporate reorganization first enunciated in the United Kingdom in the early 1990s. Since the London rules were not designed for systematic corporate distress, countries have tried to tighten them in various ways.

The evidence from East Asia seems to suggest that adopting a temporary Super Chapter 11 is unnecessary. While corporations and banks moved slowly to restructure outstanding debt, in the hope that economic recovery will obviate the need for write-offs (for banks) or surrendering of equity control (for large shareholders), few firms appeared to be prematurely liquidated, in part as there was often not a working bankruptcy regime. When economic recovery indeed came about in 1999, few firms were liquidated or had gone through the bankruptcy procedures, and there appears to have been no significant loss of value from not adopting super-bankruptcy rules. If anything, observers have argued that too many firms were allowed to continue to operate for too long, as was the case with several chaebol-related firms in Korea, and that equity holders bore too little of the costs of restructuring.

Direct support by the government. Injection of new government funds is the most difficult aspect of restructuring. The general principle is that governments should not be in the business of paying for the mistakes of private companies and financial institutions. However, the need to revive the economy may force the government's hand and government support can then well be part of the best or necessary approach to resolving a systemic crisis.

In particular, it will often be the case that the government has contractual obligations, e.g., to insure depositors or issue a general guarantee to stabilize the financial system and restore confidence. In such situations, a key choice that governments face is with respect to the speed of their actions. They may choose to acknowledge their liabilities but delay the injection of funds by exercising regulatory forbearance (i.e., not enforcing prudential capital requirements) on financial institutions. Or, they may choose to take the fiscal losses restructuring the banks up-front, and start with a clean slate. The experience is that forbearance, though fiscally

attractive in the short-run, can lead to mounting overall costs of rescue. Hence accepting early losses can help stop continued distress. For such a course of action to be successful, it should be accompanied by strong restructuring initiatives and complementary structural reforms, along the lines suggested earlier in the chapter, to prevent the recurrence.

A variety of approaches exist to assuming financial losses in the banking system by the government, such as directly injecting capital or subordinated debt, providing loss-sharing arrangements on some pool of assets, granting government loans or placing deposits (Klingebiel, this volume). Each has some advantages and disadvantages. More recently publicly owned Asset Management Companies (AMCs) have increasingly been used by countries. Unfortunately, the efficacy of AMCs in resolving a systemic bank crisis can be questioned as their track records have been mixed at best. Klingebiel (this volume) distinguishes between two main types of AMCs: those set up to help and expedite corporate restructuring and those established to dispose of assets acquired/transferred to the government during the crisis—rapid asset disposition vehicles. She studies seven cases, where data are publicly available. In three countries (Finland, Ghana, Sweden) the government set up restructuring vehicles. In four cases (Mexico, the Philippines, Spain and the United States) governments set up rapid asset disposition agencies. Two corporate restructuring AMCs (the exception is Sweden) did not achieve their narrow goals of expediting corporate restructuring, suggesting that AMCs are rarely good tools to accelerate corporate restructuring. Only the Swedish AMC successfully managed its portfolio, acting in some instances as lead agent in the restructuring process. Rapid asset disposition vehicles fared somewhat better with two out of four agencies, in Spain and the United States, achieving their objectives.

But even achieving these objectives with an AMC required many ingredients: professional management, political independence, a skilled resource base, appropriate funding, adequate bankruptcy and foreclosure laws, good information and management systems, and transparency in operations and processes, and, importantly, the political will of the government to address the issues. Success is also more likely if the assets acquired are mostly real estate related assets—which are easier to restructure than corporations—and the amount of assets transferred is small relative to the banking system—making it easier for the AMC to maintain its independence and not to succumb to political pressure. As always, it is important to explicitly consider political economy elements when adopting this model (Haggard, this volume).

Another, example of a different form government support is the U.S. Reconstruction Finance Corporation, the RFC (Mason, this volume). The RFC, which lasted from 1932 to 1957, loaned or invested more than \$40 billion to 5685 banks, or 40 percent of all insured banks in the United States. These banks were initially thought to be illiquid, but by 1933 it was realized that many banks had solvency problems and needed to be closed or get additional capital, so a preferred stock program was established. RTC officials' discretion to support banks was limited and to be eligible for this program, banks had to agree to limit dividends and devote earnings to retiring the stock of the bank—essentially, buying out the government's position. The RFC, whose stock was senior to all other, could also only hold a maximum of 49 percent of the equity of a bank, which meant that there had to be some private funds. While difficult to evaluate its success, the intervention appears to have contributed to a recovery of

confidence and output, till monetary tightening reversed both in 1937. The government recovered its initial capital and did not keep alive non-viable banks.

The FOBAPROA agency in Mexico (Mulas, this volume) which had both the objective of restructuring banks and recovering non-performing loans had a very mixed record. During 1996, the year following the crisis, the government started the recapitalization of the banking system which provided for banks to sell bad loans, on a 2-to-1 ratio, for every dollar of new equity invested by shareholders to the FOBAPROA trust. Such sales were generally executed on a risk-shared basis, where the selling bank retained 25% of the risk, and was implemented not as an actual sale of the asset (the loan), but as the purchase of the loan's cash flows. The program led to the transfer of the underlying cash flows for approximately \$18 billion in loans to FOBAPROA, resulting in a deterioration in the loan administration procedures and a dislocation of the asset/client relationship. Concurrent with the loan sales, several banks with severely depleted capital, whose shareholders would not commit additional fresh equity to capitalize them, were sold to foreign financial institutions. In these instances, FOBAPROA purchased the banks' bad loan portfolios, further reducing the incentives to write-off bad loans for other banks.

In the end, countries often choose a mixture of these various approaches when dealing with a systemic crisis. Of the four East Asian crises countries, for example, three employed AMCs, all have employed some form of out-of-court-systems; and most have used, after initial period, fiscal stimulus and monetary policy to foster economic growth (Claessens et al., this volume). In addition, all have enhanced their basic framework for private sector operations, including bankruptcy, corporate governance, liberalization of entry, etc. Similarly in Mexico in

1995, both an AMC as well as a more decentralized approach were attempted. In the end, it was the export led-growth that led the Mexican recovery although it did not resolve the banking problems.

As the case studies show, the weights of these various policies options will vary by country. The fact that answers have to be country-specific should not be surprising. Systemic crises differ in many dimensions: the size of the problem, e.g., the degree of non-performing loans and degree of corporate distress; the type of distress, e.g., real estate vs. corporations; the amount of foreign and domestic debt, both public and private, which limits the scope for taking on new liabilities or the difficulty in restructuring; the quality of the initial institutional framework and human resource capacity; the macro-policies being pursued; the existing ownership structures; and the political economy structure of the country. The approach has to be tailored to each specific circumstance.

4. Conclusions

Insolvency regimes are an essential part of a market economy, in cases of both non-systemic and systemic distress situations. The ability to resolve normal insolvencies efficiently allows an economy to operate more effectively. The basic requirements for a well-functioning insolvency regime, while to some extent country-specific, have been documented. Best practice is being reviewed continuously and there are important trends in global regimes towards less liquidation, more rigor in processes, and, to a lesser extent, the use of market-based resolution techniques such as auctions.

Some of the lessons on systemic restructuring have also become clear. There is a need to limit the government's role to establishing the enabling environment (insolvency, tax, accounting etc, eventually providing resources) for the private sector to do the necessary restructuring. It has also become clear that it is important to adjust the approach by the type of assets which are causing the distress. To the extent that the government directly intervenes in systemic restructurings, it should be careful on how it deals with "losers". It should not close banks without alternative financial intermediation mechanisms and a comprehensive program of bank restructuring. It ought not recapitalize too quickly banks and should try, where possible, to link recapitalization with bank privatization. Instead of focusing on losers, the government should try to support winners by providing tax relief or other support to healthy corporations, and help small and medium sized firms that are often the victim of the credit crunch following the financial crisis. This can take the form of automatic reschedulings, or tax and regulatory relief. Finally, to resolve the debt overhang that drags down the recovery, one needs to have loss-absorption mechanisms. In many cases, this will require the injection of public funds. It will then be important to design the proper incentive structures for these mechanisms. If, for example, recapitalization is necessary to restore the banking system, it will be important to link the recapitalization of an individual bank with the degree of progress it makes in restructuring its non-performing loans. Since one should not expect banks to do deep corporate restructuring, it will also be important to invite early on other investors and give them the loss-absorption mechanisms. This will often imply mixed public-private restructuring funds, where private (sometimes foreign) management runs a government-owned distress fund.

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