Corporate Debt Restructuring: The Missing Link in Financial Stabilization

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Topics

• Corporate Sector Vulnerabilities and Crisis;
• Why Corporate Restructuring;
• Corporate Restructuring in Asia;
• Lessons from Corporate Restructuring in Asia;
• Requirements for Effective Corporate Restructuring in a Systemic Crisis; and
• Toward a Market Based Approach to Corporate Restructuring
Corporate Sector Vulnerabilities Contribute to Systemic Crises
Asia- At the Center of the Crisis: The Corporate and Banking Sectors

Thematic Points of Corporate Finance Practices

- Rapid Increased in Fixed Assets Financed by Debt
- High and Rapid Increase in Leverage
- Reliance on Unhedged Foreign Denominated Debt
- Low and Declining Return on Capital Employed
  - Low and Declining Debt Service Capacity
  - Unsatisfactory Economic Value Added
- Leading to Increase in Financial Fragility
Rapid Increased in Fixed Assets Financed by *Debt* ....

**FIGURE 2  AVERAGE CHANGE IN TANGIBLE FIXED ASSETS, 1992–96**

Corporate debt was excessive in the most seriously affected crisis countries

Debt to common equity ratios of nonfinancial corporations, 1988–96

Source: World Bank
...while returns on assets slumped in 1995–96

Return on assets for nonfinancial corporations, 1988–96

Source: World Bank
Low and declining debt service capacity...

**FIGURE 3 AVERAGE INTEREST COVERAGE RATIO, 1996**

Note: Ratio of operating cash flows (operating income before interest, taxes, and depreciation) to interest payable on loans.
### Table 1: Standard & Poor's Rating Requirements for Financial Ratios, by Rating Level

<table>
<thead>
<tr>
<th>Ratio</th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest coverage ratio</td>
<td>20.3</td>
<td>14.94</td>
<td>8.51</td>
<td>6.03</td>
<td>3.63</td>
<td>2.27</td>
</tr>
<tr>
<td>Funds from operations/total debt</td>
<td>116.4</td>
<td>72.3</td>
<td>47.5</td>
<td>34.7</td>
<td>18.4</td>
<td>10.9</td>
</tr>
<tr>
<td>Pretax return on capital</td>
<td>31.5</td>
<td>23.6</td>
<td>19.5</td>
<td>15.1</td>
<td>11.9</td>
<td>9.1</td>
</tr>
<tr>
<td>Operating income/sales</td>
<td>24.0</td>
<td>19.2</td>
<td>16.1</td>
<td>15.4</td>
<td>15.1</td>
<td>12.6</td>
</tr>
<tr>
<td>Long-term debt/capital</td>
<td>13.4</td>
<td>21.9</td>
<td>32.7</td>
<td>43.4</td>
<td>53.9</td>
<td>65.9</td>
</tr>
<tr>
<td>Total debt/capitalization</td>
<td>23.6</td>
<td>29.7</td>
<td>38.7</td>
<td>46.8</td>
<td>55.8</td>
<td>68.9</td>
</tr>
</tbody>
</table>

*Note: Ratios are calculated as three-year (1994–96) medians.
Source: Standard & Poor's Ratings Service 1997.*
Why Corporate Restructuring?
Links between corporate and bank restructuring

• Corporate restructuring is the mirror image of financial sector health-- one is not possible without the other;
• In both cases, the government has important roles to play;
• A coordinated approach to corporate and bank restructuring is needed.
Bank Restructuring Can Provide a Lever for Corporate Restructuring

- Financial institutions restructuring is an integral part of the corporate restructuring process
- Stringent capital and provisioning, insider rules, and large exposure limits promotes corporate restructuring.
- Banks can play a leading governance role in inducing corporate restructuring.
Lessons from Asia: Institutional Arrangements for Corporate Restructuring
## Synopsis of Institutional Arrangements Adopted for Corporate and Financial Restructuring

<table>
<thead>
<tr>
<th></th>
<th>Voluntary corporate workout</th>
<th>Asset resolution company</th>
<th>Agency for bank recapitalization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>Jakarta Initiative</td>
<td>Indonesian Bank</td>
<td>Indonesian Bank</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Restructuring Agency</td>
<td>Restructuring Authority</td>
</tr>
<tr>
<td>Korea</td>
<td>Corporate Restructuring</td>
<td>Korea Asset</td>
<td>Korea Deposit</td>
</tr>
<tr>
<td></td>
<td>Coordination Committee</td>
<td>Management Corporation</td>
<td>Insurance Corporation</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Corporate Debt Restructuring</td>
<td>Danharta</td>
<td>Danamodal</td>
</tr>
<tr>
<td>Thailand</td>
<td>Corporate Debt Restructuring</td>
<td>Financial Sector</td>
<td>Financial Restructuring</td>
</tr>
<tr>
<td></td>
<td>Advisory Committee</td>
<td>Restructuring Authority,</td>
<td>Advisory Committee</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Asset Management</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>Corporation (for non-</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>bank financial</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>companies)</td>
<td></td>
</tr>
</tbody>
</table>

Source: IMF, 1999
Score card: In Asia, corporate restructuring has been slow, and focused more on financial rather than operational/organizational restructuring (Data as of end-99, more progress since then)

Corporate Debt Restructuring Applications/Cases Resolved

<table>
<thead>
<tr>
<th>Country</th>
<th>Restructuring “Completed”</th>
<th>Applications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>57 (1%)</td>
<td>4,251</td>
</tr>
<tr>
<td>Thailand</td>
<td>104 (14%)</td>
<td>721</td>
</tr>
<tr>
<td>Korea</td>
<td>102</td>
<td>80 (78%)</td>
</tr>
<tr>
<td>Malaysia</td>
<td>66</td>
<td>15 (22%)</td>
</tr>
</tbody>
</table>

Corporate Debt Restructuring Book Value of Debt (USD Billions)

<table>
<thead>
<tr>
<th>Country</th>
<th>Restructuring “Completed”</th>
<th>Applications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>3 (13%)</td>
<td>25</td>
</tr>
<tr>
<td>Thailand</td>
<td>6 (15%)</td>
<td>40</td>
</tr>
<tr>
<td>Korea</td>
<td>15 (50%)</td>
<td>31</td>
</tr>
<tr>
<td>Malaysia</td>
<td>9</td>
<td>3 (35%)</td>
</tr>
</tbody>
</table>

Source: Malaysia and Thailand 12/99, Korea 9/99, Indonesia 8/99; various Corporate Debt Restructuring Agencies

Source: Haworth and Binamera, KPMG Barents
Lessons in Corporate Restructuring

• Why is the pace of corporate restructuring slow?
• What are the open issues
Analysis: The unwillingness of sellers to recognize the true extent of their problems (and to part with overvalued assets) is the main reason corporate restructuring is not progressing faster.

Many assets were grossly overvalued when the crisis hit and have deteriorated further in the past two years...

- Many of the companies in the region invested heavily in different ventures (real estate, manufacturing, infrastructure, etc.) without focus on true competitive advantage and economic value added.

- When the crisis hit, it was a shock to see that assets were of much less than expected; currency collapses exacerbated the issue for many borrowers who loaned in USD and other foreign currencies.

- Because of less transparency and accountability, owners of these companies continued to run their businesses in perhaps a less than ideal manner.

- Many of these companies have now been transferred to government owned asset management companies, and we witness declining values.

...few are willing to take the responsibility for huge losses if the assets are disposed off at “true market value”

- Loss of face of company owners, bankers and government officials is a critical factor in the slow recognition of losses from asset sales.

- The pressure to deny the extent of the problems is immense due to the social impact of multiple closures of large enterprises.

- Unrealistic expectations of “recovery” so that the problem will work itself out are not only slowing the process of restructuring but placing additional costs on the various parties.

- Superficial financial restructurings with favorable repayments and low interest rates are masking the problems and delaying the recognition.
Analysis: The slow pace of corporate restructuring is linked to the uneven efforts to introduce/implement the appropriate mechanisms...

Mechanisms used to promote corporate restructuring...

♦ Government assistance to borrowers
♦ Government intervention as facilitators and mediators of debt restructuring
♦ Asset management companies
♦ Corporate Debt Restructuring Agencies to encourage voluntary workouts

...are most effective when

♦ Banks are forced to deal with their bad debts
♦ Restructuring is pursued to established legal and judicial channels with a high degree of integrity (bankruptcy, legal systems, etc.)
♦ Market mechanisms for the disposal of assets in a transparent manner are in place

...but uneven efforts by the various countries has resulted in few restructurings

♦ Governments provided assistance to banks but in return, often got limited (or no) commitment to restructure the enterprises
♦ Governments have set up debt restructuring agencies in some countries (Korea, Indonesia), but their mandate was not strong, and the progress is slow and muddled
♦ Asset management companies have been set up and their ability to restructure corporations has not been demonstrated
♦ Attempts to introduce comprehensive bankruptcy laws have been hampered by the judicial process and have yielded mixed results
♦ Vested interests, the close relationships between borrowers, lenders and governments has delayed true restructuring in many cases
Requirements for effective corporate restructuring in a systemic crisis
Effective restructuring of distressed companies in a systemic crisis requires

- Strong legal protections for creditors and an ability to impose losses on debtors;
- An efficient framework to support out-of-court corporate restructuring efforts;
- The government must be ready to impose losses on the shareholders of local financial institutions and to force the resolution of over-valued assets;
- There must be flexibility and readiness to lay off excess workers and to accept foreign control over companies;
- Significant tax, legal, and regulatory impediments to corporate restructuring must – barring other public policy considerations– be eliminated;
- A central body should be responsible for driving financial sector restructuring and making adequate corporate restructuring a condition for bank recapitalization;
- Sufficient professional capacity to conduct due diligence, structure and negotiate workouts, conclude asset sales, and manage converted equity;
- Crisis efforts to resolve immediate corporate distress should be supplemented with other measures to promote long-term corporate health–e.g., Improvements in financial disclosure and audit standards, corporate governance practices, and cross guarantees.
The Korean Case
At the time of crisis

- Large nonperforming corporate debt
  - A sudden hike of interest rates and exchange rate make the problem exposed to the surface
    * 15 out of 30 top chaebols were insolvent or the debt/equity ratio > 5:1

- Financial institutions, unprepared for initiating corporate restructuring
  - Reluctant to recognize their loss in their potentially nonperforming loans

- Inadequate institutional foundation for proper corporate restructuring
  - Improper prudential regulation: Loan classification, provisioning, etc.
  - Improper insolvency laws: very long time for dispute settlement
  - No private market for the distressed credits: No orderly option for distressed companies
  - No proper check against managing shareholders: Minority shareholders’ right, inexistent
Challenges and Limitations for the Gov’t’ Role

- Swift Action for Institution Building
  - Financial Supervision, Corporate Governance, Insolvency System
  - Improvise a market for distressed credits
  ⇒ But it takes long to make the new system work

- Market principles to prevail while pushing the corporate restructuring process to start
  - Creditor’s side: “Fair loss-sharing rule, No “free-lunch” rule
  - Debtors’ side: No “too-big-too-fail” rule
  ⇒ But gov’t was one of the interested parties due to blanket guarantees (public money required)

* Deposit of the First Bank of Korea (end-1997): 28 tr. won (more than 5% of GDP)
* Amount of bond guaranteed by two government-sponsored guarantee insurance companies (end-1997): 140 tr. won

♣ So, Gov’t opted for the step-by-step approach
Interim Stage (1998-99)

[For the Financial sector]
- 1st round of financial restructuring with the injection of public money
- Strengthen financial supervision, but some regulatory forbearance for the speedy corporate restructuring (e.g. Work-out loans)
- Let surviving financial institutions be ready to initiate corporate restructuring

[For the Corporate sector] Three differing approaches upon the company size
- **Top 5 Chaebol: Capital Structure Improvement Covenant with their banks**
  - The target of 200% debt-equity ratio (simple average) to be met by end-1999
  - Chaebol decides how to meet the target, but its implementation monitored by creditor banks
  - Failing to meet the target is subject to creditor’ collective disciplinary actions (penalty interest, no new loans and withdrawal of the existing loans)
- **6-64 Chaebol: Work-out scheme for distressed companies**
  - Work-out plan initiated by creditors based on an independent due diligence
  - Fair loss sharing: credit restructuring (creditors), depreciation of share (debtors), layoff or salary cuts (employee)
- **Small and Medium Firms: Corporate restructuring Fund**
Looking back over the Interim Stage

• CSIP for the top 5 chaebols
  – Significant improvement in debt-equity ratio, slight reduction in debt
  – Tenuous shares of governing shareholders: provoking speedy break-up of conglomerate structure
  
  \[\Rightarrow \textit{But it invites criticism of gov’t intervention}\]

• Work-out scheme
  – Even Daewoo was undertaken by the scheme
  – Some success, but still work to do
  
  \[\Rightarrow \textit{But forbearance caused moral hazard in financial institution. And small stakeholders’ moral hazard problems, too}\]
Next Stage (2000- present)

• Even stronger financial supervision: Foreword looking criteria, Credit monitoring

• 2nd round of financial restructuring: More public money, but FIs choose how to restructure themselves.

• Streamlining of Insolvency law: Prepackaged bankruptcy concept introduced and more under progress

• Strengthening Corporate Governance: Much strengthened minor shareholders’ right and more

• Emergence of a market for the distressed credits: CRV, Junk bond market

⇒ It is not a perfect system, but it is moving into a more market-friendly direction
Example: Establishment of Corporate Restructuring Funds in Korea

- Hybrid between a private equity fund and a fund investing in listed equity and debt. Confining themselves to investments in new issues of equity and debt. Are taking large minority positions in companies that will benefit from balance sheet restructuring.

- To meet the above objective, the Korean Government asked 23 Korean Financial institutions to contribute to the Corporate Restructuring Funds. KDB, the manager, raised $US1.3 billion.

- 60 firms were asked for expressions of interest

- KDB appointed Wilshire Associates to participate in the manager selection.

- State Street, Templeton and Scudder each won $US250 million in balanced mandates of debt, equity and private equity. Rothschild won a debt mandate of US$500m (which includes convertible bonds).

- Investments Guidelines are designed to meet the objectives
Main messages we leave with you: corporate restructuring is different from bank restructuring and equally important

- Many corporations, requiring diverse responses.
- Policymakers are less knowledgeable about the corporate sector.
- Loss recognition process takes longer.
- No central supervisory agency exists.
- No magic bullet for corporate restructuring…. 
- ….it requires a complimentary set of government measures and private sector initiatives.
Toward a Market Based Approach to Corporate Restructuring

SEPARATE PRESENTATION

Back to basics: critical financial sector professions and instruments required in the aftermath of an asset bubble