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The London Approach and Corporate Debt Restructuring in East Asia

WHEN THE FINANCIAL CRISIS hit East Asia in the fall of 1997, corporate debt in Indonesia, Malaysia, South Korea, and Thailand had reached high levels. The mechanism that precipitated the crisis was simple: capital outflows meant that investors and creditors suddenly called in the loans that they had been aggressively pushing on the East Asian corporate sector for years. Companies in the region found themselves unable to repay their debt for a variety of reasons, including mismanagement, unsound financial practices, lack of accountability, and excessively high leverage. Local currency devaluations made it harder for local companies with debts denominated in foreign currencies to repay loans. This led to a stampede, and as more creditors and investors called in their loans, the "cascade effect" threatened to bankrupt the entire economy. Had this situation not been resolved, it would have had vast and unpredictable consequences for the social welfare, economic development, and political stability of the region.

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The attempt to establish sound insolvency and bankruptcy regimes, however, was not an adequate response to the crisis. The laws enacted and programs put into effect will undoubtedly assist in limiting the impact of future crises, but they were not established in sufficient time to stem the crisis of 1997–98. Company failure sometimes occurs because a company is unable to resolve temporary or other financial difficulties, even though the company's longer-term viability and solvency may be sound. Forcing troubled companies into liquidation, especially if the crisis is caused by macroeconomic circumstances beyond their control, represents a major cost to the economy. It is also a market failure, which can cause or amplify financial instability. Finally, unnecessary liquidation represents a welfare cost in the form of unemployment and misallocation of capital.

Liquidation and court-supervised restructuring were not viable alternatives for the Asian crisis countries; what was needed was an out-of-court, voluntary debt-restructuring process that would have made it possible to distinguish good assets from bad and thereby preserve a particular country's industrial capacity. The countries of the region, however, had no experience with such processes. The crisis called for rapid answers, and the East Asian countries looked to existing models for corporate debt restructuring. Frameworks for corporate debt restructuring have been developed only recently, in the wake of the debt crises of the 1980s in developing countries and the recession of the early 1990s in the United Kingdom and in the United States. Great Britain, in particular, developed a set of guidelines and nonbinding rules—the London Approach—that had positive results during the 1990s.

This paper compares the London Approach with the corporate debt restructuring frameworks developed in East Asia (which, to a certain extent, drew and built on the former), evaluates the approaches taken in different countries, and draws lessons for countries facing similar challenges in the future.

The London Approach

During the mid-1970s, when the United Kingdom entered a period of industrial recession with high inflation, commercial banks had to quickly establish workout units and internal policies in order to deal with a rapidly increasing number of bad loans. The banks, however, had little experience with workouts. Insolvency legislation was outdated and did not provide tools for voluntary restructuring, including protection of new money and processes limiting the ability of a small group of creditors to block a workout settlement between the majority of creditors and the company.

Under these circumstances, the Bank of England chose to become actively involved in individual company workouts. The Bank's main objectives were

—to minimize losses to banks and other parties incurred from unavoidable company failures, through coordinated and well-prepared workouts,

—to avoid unnecessary liquidations of viable companies, through their reorganization and the preservation of employment and productive capacity, and

—to prevent immediate failure by ensuring the provision of interim financial support to companies.[1]

The involvement of the Bank in company workouts was possible because its governing statutes did not limit its activity to a narrowly defined role. In fact, the Bank's policy was entirely unconnected with banking regulation. Companies trusted the Bank to be impartial, independent, and confidential. In many cases, the Bank would call the participating banks together and, in the absence of a lead banker acting on its own, arrange for one of the major lenders to assume that role. The Bank could and did insist on immediate actions such as payment of wages, thus preventing the premature liquidation of companies resulting from a "renegade bank" calling in its loans. Other steps, such as agreements on new money, special arrangements for prioritization of debts, or changes in company management, were undertaken with the Bank's guidance.

During the 1970s U.K. supervisory authorities were prepared to intervene in corporate workout situations without the Bank of England committing any of its own funds. Following the election of more market-oriented governments in the United States and the United Kingdom, long and sustained economic growth during the mid-1980s, and fundamental changes in the financial industry,[2] the Bank reviewed its policy on corporate workouts. It decided to reduce its direct contact with companies in

1. Kent (1997).

2. The demand for new corporate finance instruments (for example, hedging, leveraged mergers and acquisitions, and complex syndications), which were financed with short- and medium-term facilities, resulted in high debt ratios. At the brink of the 1989 economic downturn, many U.K. corporations experienced severe liquidity problems as a result. Further, the multiplicity of banking relationships created management problems for borrowers that tried to develop workout solutions.

difficulty, leaving the task of developing restructuring strategies to the private sector. The Bank saw its new, reduced role as that of diplomat and catalyst—to motivate the parties involved in a restructuring to work toward a mutually agreeable workout solution.[3]

After consultations with the banking community in the United Kingdom, the Bank decided in the early 1990s not to formalize its restructuring framework (now popularly termed the London Rules) out of concern that foreign banks might challenge strictly formalized rules in court.[4] In addition, the framework had to remain flexible and adaptable. The Bank therefore chose to define and communicate the framework concerning the conduct of corporate workouts informally—through speeches—rather than through formal policy documents.

The London Approach provides general guidance to banks and other creditors on how to react to a company that faces serious financial difficulties. This guidance, however, is not statutory, and the Bank does not have enforcement powers. The London Approach recognizes that banks and other parties act in their own self-interest. However, by encouraging the parties to observe certain rules for restructuring, it seeks to avoid unnecessary damage and to foster solutions that benefit all parties involved. The key features of the London Approach are as follows:

—Principal creditors must be willing at the outset to consider a nonjudicial resolution to a company's financial difficulties rather than resorting to formal insolvency procedures such as liquidation, administration, or a company voluntary agreement, and without recourse to other enforcement procedures such as receivership or administrative receivership.

—As part of this consideration, creditors must commission an independent review of the company's long-term viability, drawing on information made available by, and shared between, all the likely parties to any workout.

—During the period of the review, the company's bankers holding debt should agree to maintain the company's facilities in place, effectively an

3. The principles of the London Approach do not apply to troubled or insolvent banks, since insolvencies intrinsically present unique problems—both for banks themselves and for the central bank in its capacity as supervisor of the banking sector.

4. The term "London Approach" was used until the early 1990s, when David Lascelles published an article in the *Financial Times,* terming the Bank of England's new policy approach the "London Rules." See "Fortunes Vary as Recession Bites," *Financial Times,* November 29, 1990.

informal standstill sufficient to preserve the confidence of suppliers and customers by allowing the company to continue to trade normally.

—Drawing on the independent review, the company's main creditors should work together to reach a joint view on whether, and on what terms, a company is worth supporting in the longer term.

—To facilitate these discussions, a coordinating or lead bank may be designated, and a steering committee of creditors formed.

—In addition to maintaining existing credit facilities, it may be necessary to allow the company to supplement its existing borrowing with new money in the event of an immediate liquidity shortfall. New money may be provided on a pro rata basis by all existing lenders, by specific lenders with priority arrangements, or by releasing the proceeds of asset disposal subject to priority considerations. Other principles during this critical period of financial support include the recognition of existing seniority of claims and the sharing of losses on an equal basis between creditors in a single category.

—If creditors agree that the company is viable, the creditors should move on to consider longer-term financial support, including an interest holiday, extension of loan maturities, further lending for working capital, and conversion of debt into equity.

—Changes in the company's longer-term financing need to be conditioned on the implementation of an agreed business plan, which may well involve management changes, sales of assets or divisions, or even the takeover of the company.

The London Approach does not guarantee the survival of a company in difficulty. Regulatory authorities do not intervene and, because of its voluntary nature, the London Approach can only be effective as long as it is supported within the banking community.

The London Approach was instrumental during the recession of the early 1990s. Many companies survived only because their banks, bondholders, and other creditors sought and achieved a collective solution for the financial restructuring of viable businesses. The Bank has been actively involved in more than 160 restructurings since 1989. However (and more important), many more workouts have been effected by using the principles of the London Approach without the Bank's direct intervention. When successfully applied, the London Approach preserves value for creditors and shareholders, saves jobs, and safeguards productive capacity.

Is the London Approach Replicable? The East Asian Crisis and Corporate Restructuring

The East Asian countries naturally turned toward the London Approach when it became obvious that a general scheme for corporate debt restructuring was needed to pull their economies out of financial crisis. However, a detailed assessment of the frameworks developed in this region show several divergences from the London Approach that are relevant for similar endeavors in the future. In each country, the structure was adapted to meet local conditions and needs. The relationship between business and government, the nature of corporate debt, the extent to which debt was denominated in foreign currency, how much debt was held domestically—all influenced the particular framework adopted.

Corporate Restructuring Frameworks in East Asia

The crisis that hit East Asia in 1997 unfolded against a complex background. The region's economies were (and largely remain) characterized by high concentration, an intricate corporate structure with multiple links between governments, banks, state-owned companies, and the private sector, which frequently created "crony economies" riddled by special interests and corruption. The crisis triggered a wave of large-scale financial and corporate restructuring. None of the countries in the region had either the experience or the resources to conduct such restructuring on their own and all of the economies ran a very real risk of collapse.

In the absence of efficiently functioning systems to resolve financial claims, governments in all the crisis countries have instituted out-of-court mechanisms to encourage financial settlements. As a first step, the governments instituted rules and guidelines for voluntary restructuring, building directly on the London Approach. In Thailand, a framework of principles and timelines for voluntary workouts (the "Bangkok Rules") was promulgated in September 1998. In South Korea the government reached a series of agreements with the chaebols—the country's leading conglomerates—under which the chaebol owners and senior managers committed to take significant steps toward better corporate governance and to reduce their debt through divestitures, concentration on core businesses, and mergers of subsidiaries. In early 1998 the chaebols agreed to a restructuring program based on five elements:

—improving transparency and corporate governance by adopting international accounting and reporting standards, appointing external directors to corporate boards, and strengthening shareholder rights,

—eliminating cross-debt payment guarantees among subsidiaries,

—improving the financial structure of the conglomerates by lowering of debt-equity ratios (the Korean government set the upper limit at 200 percent), and liquidating unprofitable businesses and assets,

—concentrating on core businesses, and

—strengthening the accountability of controlling shareholders and managers.[5]

The Korean government and Korea's president committed to implementing these agreements and intervened several times to speed up restructuring of the chaebols. On December 7, 1998, President Kim Dae Jung met again with the heads of the top five chaebols and reached agreement on a twenty-point action program that followed the principles and the objectives agreed upon in the preceding accords.

These sets of rules and principles, however, were not sufficient to ensure the effective and efficient implementation of corporate debt restructuring. Here lies the first point of difference between debt restructuring in East Asia and the London Approach. In the United Kingdom, the central bank, whose authority and impartiality were widely accepted, was able to play the role of hands-off facilitator while debtors and creditors reached their own agreements in a business environment based on mutual trust and understanding and with clearly defined and functioning market exit and entry mechanisms. In East Asia, the business environment was altogether different. First, a significant part of industrial capacity in these countries took the form of family-owned conglomerates controlling their own banks—that is, their source of financing. A typical instance in the case was (and remains) the Korean chaebols, which had pursued a diversification policy during the 1980s and 1990s that involved them in virtually all sectors of the economy. Second, the East Asian states had a decidedly hands-on attitude toward the private sector, an attitude manifested in the large number of state-owned banks and companies, as well as by the personal holdings of reigning families. In Indonesia, for example, the Suharto family was thought to own 18 percent of the economy. Finally, regulatory authorities

5. Particularly important in this respect were agreements by controlling shareholders to place their personal wealth into recapitalization and loan guarantees. See Yoo Seong Min (1999).

had little enforcement power, and their ineffectiveness was reinforced by the absence of an independent and effective judicial system.

It was obvious, therefore, that the East Asian central banks, lacking authority, power, and experience, could not play the same role as did the Bank of England within the London Approach framework. Instead, East Asian governments put in place a vast array of ad hoc institutions to deal with financial and corporate restructuring (see p. 86, table 4-2).

These institutions, unlike the Bank of England, were given extensive prerogatives, and their power was often amplified and supported by their government's actions. In Indonesia, for example, the Indonesian Bank Restructuring Agency (IBRA) has the power to make creditors and debtors comply with its orders. In Korea, the Corporate Restructuring Coordination Committee (CRCC) set the terms for the restructuring of Daewoo Group,[6] while the Financial Supervisory Commission (FSC) used its enforcement powers to force creditor banks to extend funds and institute debt-equity swaps to twelve units of Daewoo Group under a rehabilitation plan.

Beyond their significant prerogatives, however, the new institutions have assumed an increasing financial and economic importance in their respective countries. In Korea, for example, the FSC—the agency in charge of financial restructuring—was accused in early 2000 of trying to interfere with the central bank's prerogatives when it issued remarks on the future course of interest rates in Korea.[7]

OUT-OF-COURT MECHANISMS. Generally, the special agencies in charge of corporate debt restructuring have included most stakeholders in the debt restructuring process. In Thailand, for example, the Corporate Debt Restructuring Advisory Committee (CDRAC) is chaired by the governor of the Bank of Thailand, and includes representatives from the Federation of Thai Industries, the Thai Bankers' Association, the Board of Trade, the Foreign Bankers' Association, and the Association of Finance Companies. These agencies act as facilitators of the restructuring process, providing expertise and coordinating the work of a vast array of actors. The rationale behind the Jakarta Initiative in Indonesia is fourfold:

—to introduce world-class experts to guide individual debt workouts,

—to provide the restructuring program with sufficient leverage to force parties to participate in good faith,

—to coordinate efforts with the financial restructuring agencies, and

6. See *Korea Herald,* January 31, 2000.

7. See *Korea Times,* February 7, 2000.

—to underpin the framework with an operational bankruptcy system to give all parties incentives to negotiate.

Despite some progress achieved in each of the four countries, the out-of-court mechanisms have produced mixed results, in part because they depend essentially on moral suasion. In fact, in all these countries purely voluntary mechanisms have been superseded by another set of initiatives aiming at channeling and tightening the debt restructuring process. In most countries, the government has used other tools, especially the direct control of lending to the corporate sector and the privatization of state-owned financial corporations, to accelerate corporate restructuring following the cleanup of bad assets.

Thailand's CDRAC (created in January 1999) monitors progress on six- to seven-hundred high-priority cases. In March 1999 the Bank of Thailand promulgated a model Debtor-Creditor Agreement (DCA) and an Inter-Creditor Agreement (ICA) on Restructuring Plan Votes, both of which are enforceable contracts and have been signed by eighty-four financial institutions as of January 2000. The DCA has also been signed by more than four-hundred debtors. In both cases, signatories agree to adhere to defined procedures for case entry, a six- to eight-month process for developing and agreeing on workout plans, information-sharing, development of reorganization plans, negotiation, and 75 percent thresholds for plan approval. These provide for CDRAC-arranged mediation as well as intercreditor arbitration. These agreements empower the Bank of Thailand to enforce creditor compliance through warnings and fines. Creditors are obliged to file a court petition for bankruptcy if fewer than 50 percent of the creditors agree to a proposed workout, or if a debtor refuses to grant the DCA access to all corporate data.

Such compulsory elements clearly signal an evolution from the voluntary London Approach, undoubtedly provoked by the absence of a functioning and reliable insolvency regime. Table 10-1 presents the results of the different approaches followed by the crisis countries.

In Korea, besides the voluntary framework agreed upon by the major chaebols, the government has used its dominant position in the financial sector to overcome the resistance shown by the chaebols' senior management to impose debt rescheduling, rollovers, and repayments. President Kim Dae Jung warned the conglomerates in May 1999 that "if [these] companies fail to show any significant effort to restructure as they had promised to do in December last year, new bank loans will be halted." The cleanup of the financial sector has been followed by a large-scale privatization program.

Table 10-1. *Voluntary Workouts in East Asia, as of September 1999*

Workout strategy	*Indonesia*[a]	*South Korea*	*Malaysia*	*Thailand*[b]
Out-of-court procedures				
All or the majority of financial institutions signed on to accord	No	Yes	Yes	Yes
Formal process of arbitration, with deadlines	No	No	Yes	Yes
Provision of penalties for noncompliance	No	Yes	No	Yes
Out-of-court restructurings				
Number of registered cases	323	104	53	721
Number of cases filed	157	93	27	406
Number of restructured cases	26	46	10	157
Percentage of restructured debt on total debt	n. a.	40	32	22
Court-supervised restructurings				
Number of registered cases	88	48	52	30
Number of cases filed	78	27	34	22
Number of restructured cases	8	19	12	8
Percentage of restructured debt on total debt	4	8	n.a.	7

Sources: Claessens, Djankov, and Klingebiel (1999); International Monetary Fund (1999).
n.a. Not available.
a. Within Jakarta Initiative framework.
b. Within CDRAC targets.

Governments throughout the region have systematically encouraged banks to establish asset management companies (AMCs) to work out nonperforming loans and maximize debt recovery. In Korea these AMCs are called corporate restructuring vehicles and have a broader purpose, since they provide resources to the banks, giving them time and capital to manage the debt restructuring processes with debtors.

CREATING INCENTIVES, ELIMINATING IMPEDIMENTS. A key aspect of government-led corporate restructuring in East Asia has been a series of statutory and regulatory enactments aimed at facilitating the restructuring of corporate debt, promoting corporate reorganization, strengthening prudential regulation of financial institutions, and creating an environment of open competition. These changes were forced through by powerful government administrations.[8] In the United Kingdom, by contrast, such structures and mechanisms had existed for decades and facilitated the implementation of the London Approach.

Korea's Securities Investment Company Law established the Corporate Restructuring Fund, initially funded with 1.6 billion won in October 1998 to improve the financial status of small- and medium-size enterprises through equity investment and debt rescheduling. Other legislative measures undertaken include the following:

—The government published revised guidelines on credit management by financial institutions to prohibit financial institutions from demanding guarantees from related companies, so-called cross-guarantees.

—The Corporate Tax Law was revised to disallow tax credits for interest payments on any corporate debt in excess of five times equity capital.

—To enable courts to evaluate restructuring applications, the Corporate Reorganization Law adopted economic criteria comparing the liquidation value of a company with its going-concern value. The amended law also simplifies reorganization procedures by facilitating the consolidation of related cases in a single process, shortening the deadlines for approval and submission of reorganization plans to between twelve and eighteen months, and reducing the grace period of debt repayment from twenty to ten years. The law establishes reorganization management committees to advise the court and major creditors.

—The Corporate Composition Law was revised to restrict the conditions for mutual settlement between a corporation and its creditors by specifying cases in which such a settlement might be undesirable. The law also disallows applications for the restructuring of nonviable corporations and strengthens the government's powers to monitor the implementation of mutual settlements. In addition, the law simplified procedures for legal composition and introduced procedural exemptions for small- and medium-size firms.

—Finally, the Foreign Capital Inducement Act was revised to liberalize foreign ownership of Korean corporations. The law also abolished the requirement for prior approval by the Ministry of Finance and Economy for large-scale mergers and acquisitions in all sectors of the economy except

8. Edward M. Graham rightly points to the key role played during the process by the Korean Fair Trade Commission, which, he argues, "emerged as one of the most powerful Korean agencies during the current administration." Graham (1999).

the defense industry. The ceiling on total foreign shareholdings in individual companies was abolished.

Indonesia, South Korea, Malaysia, and Thailand have all undertaken extensive processes of structural adjustment. Evidence of the progress of these undertakings can be found in World Bank and International Monetary Fund documents and policy instruments developed during the crisis and during the recovery phase.

THREAT OF LOSS AND MARKET EXIT MECHANISMS. A fundamental element of corporate debt restructuring is the presence of market exit and entry mechanisms, which act as incentives for companies to engage in out-of-court workouts. In East Asia, the establishment of effectively implemented bankruptcy and insolvency legislation has been critical to the restructuring process; in its absence, there would be no incentives for corporations to pursue restructuring.

In Malaysia, court-supervised restructuring continues to play an important role in complementing the government's efforts. More than forty companies so far have filed for reorganization under Section 176 of the Companies Act. Of these, thirteen have proposed reorganization plans, three of which have been approved. More than a thousand winding-up petitions have been filed.

In Thailand, efforts by the government to reform the country's legal framework for insolvency, foreclosure, and secured lending have resulted in amendment of the 1940 Bankruptcy Act to facilitate court-supervised reorganization (enacted in April 1998 and March 1999), amendment of the Code of Civil Procedure on Legal Execution (enacted in March 1999), and a law establishing a Central Bankruptcy Court (opened June 1999). It is too early to measure the impact of these measures on the resolution of the current crisis.

Introduction of an option for court-supervised reorganization has provided a useful means for a supermajority of creditors (representing at least 75 percent of debts) to impose a reorganization plan on dissenting creditors. Through December 1999, thirty petitions for bankruptcy reorganization have been filed. Of these, twenty-five have been accepted and eight restructuring plans have been approved by creditors.

Indonesia, at the urging of the IMF, enacted a revision of its long outdated, colonial-era bankruptcy legislation. The law accords with international standards and practice, and judges have received significant training on its correct application, but results have been disappointing. Most bankruptcy cases seem to be decided in favor of debtors on seemingly weak legal reasoning, and allegations of corruption are commonplace. The new process has not as yet reached its stated objectives, and this has become a major obstacle to the success of the Jakarta Initiative.

The London Approach in East Asia—Limitations and Considerations

For all of its virtues, the London Approach has several intrinsic limitations. The requirement often contained in the original loan documentation for unanimous agreement among creditors for major changes slows down negotiations and gives an unjustified veto power to minority creditors. The company's main lender must agree to voluntarily support the company during the restructuring while other creditors, such as suppliers, continue to enforce their claims. Large companies frequently have operations in several countries and therefore raise their capital from very different sources. With the globalization of financial markets and the growth of alternative lenders (bondholders, insurance companies, leasing companies, among others), banks are no longer the leading provider of finance.

Because of their different market practices, cultures, and regulatory environment, it becomes increasingly difficult to reconcile the different creditors. Debt trading, which has appeared in the last decade, can be helpful for restructuring, since it allows creditors to opt out of a relationship rather than to continue to hinder the process. However, new parties entering corporate reorganization proceedings as a result of debt trading often require time to gain the necessary level of information and sometimes seek to reopen negotiation on issues that already have been agreed to. Credit derivatives, another relatively new instrument, also weaken the relationship between the original lender and a borrower in financial difficulty. With the transfer of credit risk from the original lender to another institution, the "hedged" lender has little motivation to find a restructuring solution based on the London Approach, since his potential loss may be limited.

The usefulness of the London Approach is linked to the particularities of its origins and context. The London Approach is indeed very much embedded in a set of cultural, economic, and social institutions and organizations that are peculiar to Great Britain. It relies primarily on a set of incentives to cooperate and reach a solution that themselves are linked to several specific elements, including a culture of cooperation, a commitment to justice and a system of equitable dispute resolution, the existence of a legal framework for bankruptcies and insolvency (guaranteeing the ability to exit the market), and the existence of an efficient and effective judicial system that can implement this legal framework.

Many of these elements were not present in the East Asian crisis countries. Indeed, it was the absence of such infrastructure that required the establishment of the agencies and mechanisms described above. However, the lack of an infrastructure has also severely limited the effectiveness of the voluntary approaches. The particular trust placed by all actors in the Bank of England was critical to the success of corporate restructuring in the United Kingdom: such a level of trust does not exist in most countries, and even where it does, it often reflects a country in which government intervention has traditionally been heavy-handed and in which government has been deeply involved in the corporate sector—through direct intervention, state ownership, state-owned banks, directed lending, or other means. In the East Asian countries, the close relationship between governments and corporations undermined the independence that was essential in the Bank of England's ability to implement restructuring in the United Kingdom. The differences among the program designs in the various countries largely reflect two main factors: first, the mix of domestic versus foreign debt and, second, the traditional interaction between government and business. In Korea, for example, senior government officials played a leading role in picking corporate winners, directed lending through domestic banks, and maintained a cozy relationship with chaebol owners; as a result, most of the debt is owed to domestic institutions under the control of the government. The Korean model—"Korea, Inc."—is highly centralized and government-driven, with President Kim Dae Jung playing a direct role in corporate-level and sectoral restructuring and working out debts with largely domestic, government-controlled financial institutions. At the other extreme is Indonesia, where most of the debt (about 75 percent), was owed to foreign banks, and where the relationship between the Suharto government and the business sector became the main political slogan for change. Foreign banks, which held most of the corporate debt, were not easily influenced or intimidated by the Indonesian government or its agencies, and any government involvement in corporate restructuring raised the fear of corruption and the suspicion that some crony would be bailed out at public expense. Under these conditions, early programs sponsored by the IMF expressly prohibited the government from becoming involved in corporate debt restructuring. Even after the fall of Suharto, the Jakarta Initiative was designed to minimize direct government access to corporate information and its ability to influence the outcome of negotiations. This clearly weakened the program, but the experience in INDRA, as evidenced by some highly publicized cases of corruption,[9] demonstrates that the concern was well placed.

Finally, it should be noted that voluntary, negotiated agreements work best when there are alternative, judicially supervised procedures for corporate debt restructuring (for example, statutory rehabilitation procedures, such as under Chapter 11 of the U.S. Bankruptcy Code) that can provide protection against creditors' demands. However, such court-driven procedures can be lengthy and expensive, and they are open to abuse. The difficulties are increased by the presence of foreign lenders and made insurmountable by inefficient or corrupt courts.

An alternative model to the London Approach is the Hausbank model, under which a company's main lender takes responsibility for organizing (and often, funding) a workout. This model is not easily enforceable, however, because of the growing size and complexity of workouts and the unwillingness of banks to assume such a heavy burden.

In most of the East Asian crisis countries, no such credible alternative mechanisms were operational, thus weakening the usefulness of the voluntary approach. Design features of corporate restructuring efforts in each country reflect this weakness and try to overcome it by means of different mechanisms, for example, heavy government pressure in Korea, intercreditor and creditor-debtor agreements in Thailand, and the use of special powers of seizure in Indonesia.

In Thailand, two government organizations explicitly link restructuring of corporate and financial sectors. The Corporate Debt Restructuring Advisory Committee, which is part of the Bank of Thailand, identifies which loans need to be restructured, in principle leaving the negotiation of terms to creditors and debtors. One problem is that some of these loans are being carried on the books of nationalized financial institutions; other loans are being carried by institutions that are being recapitalized by government

9. The most widely publicized of these cases—the Bank Bali scandal—broke in late July 1999, when allegations surfaced that a financial firm with close ties to then-president B.J. Habibie's Golkar party had pressured cabinet ministers and IBRA officials to repay a $120 million claim to the recently nationalized Bank Bali, taking a 60 percent commission when the claim was paid. See Jay Solomon, "The Jakarta Jumble: When Investing in Indonesia, Don't Forget Perhaps the Most Important Factor: Politics," *Wall Street Journal,* May 8, 2000. Most recently, Indonesia's attorney general detained the governor of Indonesia's central bank for alleged involvement in the scandal. "Bank Indonesia Chief Is Held in Fund Scandal," *Wall Street Journal,* June 22, 2000.

funds. How the London Approach works when one of the two parties is a government-owned entity is unclear.

A second Thai organization that links corporate and financial sector restructuring is the Financial Sector Restructuring Agency, charged with packaging and auctioning the assets of bankrupt finance companies, including both real estate and business loans. Very few of the tranches of loans have been successfully auctioned because most bids were considered too low. Concern that fire-sale prices would foment national outrage has been augmented by ongoing financial entities that were reluctant (or refused) to further write down their own assets. In the absence of a market price for old financial assets, it is difficult to price new assets, which contributes to the lack of lending and deep economic recession.

In the case of Indonesia, the Indonesian Bank Restructuring Agency (IBRA) was originally created by the Ministry of Finance as an emergency measure to preserve and resuscitate Indonesia's financial sector. By assuming the loan portfolios of bankrupt banks and the nonperforming loan portfolios of recapitalized banks, IBRA has become the single largest creditor of Indonesia's real-estate sector. A major threat to the voluntary workout process has been created by the government's need to quickly liquidate IBRA's assets in order to finance its own fiscal budget deficits. The marching orders for IBRA, then, are to recover assets as quickly as possible, with little regard to the future operations of the corporations to which IBRA is the major creditor. Indeed, IBRA's officers are paid a "success" fee dependent upon the amount and speed of total asset recoveries they can effect in the fiscal year. This time-pressure naturally has caused IBRA to be somewhat suspicious of the London Approach (implemented in Indonesia as the Jakarta Initiative), which is perceived as a barrier to achieving the agency's revenue-collection mandate, and to show little support for voluntary, out-of-court processes.

This situation is further exacerbated by the fact that so much of corporate debt is owed to foreign banks. Many of these banks are suspicious that IBRA will jeopardize their ability to recover assets from a corporation on a long-term basis and that IBRA will use its special powers to prejudice their interests.

Corporate Restructuring Frameworks: The Realities of the Social and Legal Environment

In most of the East Asian countries, commercial society is dominated by a cultural attitude that restricts dispute resolution and problem-solving to nonconfrontational negotiation and mediation. There also appears to be a distinct aversion to the use of strict legal processes (which require a somewhat rigid adherence to legal system organization, function, and methodology) to resolve commercial disputes and problems. This is not intrinsically a bad thing: if commercial disputes can be successfully resolved through negotiation and mediation, then so much the better. Trying to resolve corporate insolvencies, however, frequently implicates a multitude of interests, making it difficult to apply a collective remedial process. Failing a privately negotiated settlement, a more formal, supervised, and facilitated process should be available. An appropriate insolvency regime, which requires a well-functioning legal system with a methodology for effective operation, free of corruption and political interference, should be the last resort, but it should be available.

The purported stigma of insolvency is part of the culture of every country everywhere. Simply stated, it means financial failure, to which few persons would care to admit. Transposed to a corporation, for owners or managers the failure of the corporation represents their personal failure, and it is sometimes accompanied by peer judgment that results in business and social disgrace. One suspects that the cultural elements in many Asian countries may heighten a greater sense of stigma in relation to business or financial failure. The expression "loss of face," for example, commands considerable respect as a compelling and potentially destructive cultural influence. This problem is often a breeding ground for desperate and ill-conceived actions, which may take the form of denial, avoidance, escape, cover-up, secretiveness, or manipulation. Often it results in plain theft, sometimes collusion with cronies in the administration or the government. The effect of the stigma should not be ignored and may prove a powerful incentive to use a voluntary restructuring model.

These are all problems of a human nature and surrounding environment, and they are difficult to deal with. When all of these influences are brought together—as must be done to obtain a sense of the practical difficulties—a significant barrier to the application and operation of both a formal corporate insolvency regime and informal insolvency practice becomes apparent. The "attitude" problem is difficult to overcome. Attitudes may well change over the long term as the process of globalization continues and corporate owners and directors come to understand, through an enlightened self-interest, that hiding from the realities of insolvency regimes will ultimately mean that they will lose their troubled companies. Where there is a clear problem with the court and judicial system, that problem can be overcome only by intensive reform of those institutions, which requires considerable resources and expenditure. Such cultural changes take time.

The status of London Approach–based voluntary restructuring programs in Indonesia, South Korea, Malaysia, and Thailand raises several concerns; these may be summarized as follows:

—experienced workout personnel and advisers are in short supply,

—debtor corporations and banks may be unwilling to engage advisers,

—in a few jurisdictions the insolvency law, in practice, provides an insufficient sanction to encourage the informal approach,

—informal workout initiatives have been launched at a time when, because of the effects of the economic crises, the conditions for their successful promotion are difficult,

—some type of government or quasi-governmental facilitating agency is required, and

—ongoing funding, or new money, is uncertain.

There are three main barriers to the informal approach. The first concerns, among other things, know-how, experience, and commercial knowledge. The second concerns the practical problem of providing for the immediate cash-flow needs of insolvent corporations (the problem of "new money"). The third concerns the level of sanctions that might both promote and encourage informal workouts.

There is a fourth barrier as well, not directly linked to the London Approach but rather to the overall restructuring framework. The links between corporate restructuring and financial sector restructuring are obvious in every crisis country, but the linkages between the corporate and the financial sector crises are only now being fully understood.[10] There is great need for work in the areas of integrated corporate sector vulnerability, restructuring, and risk management. The financial structure of the corporate and business sector, in combination with the policy environment (including exchange rates, interest rates, the financial sector, and capital markets) in many countries can lead to widespread illiquidity and insolvency. This destroys value, reduces growth, and increases poverty. A destabilization of the corporate and business sector can feed back and create an even more severe and widespread economic crisis. This type of crisis is becoming more widespread with larger and more volatile capital flows and

10. Gray (1999).

with liberalization programs, particularly in countries with currencies prone to sharp and sudden devaluations.

Serious problems can occur in the absence of a comprehensive, integrated corporate-financial sector focus. Linkages with financial sector and stabilization opportunities are missed. There are serious consequences for the financial sector from large unhedged foreign currency–denominated debt positions in the corporate sector and high overall debt-equity ratios. Without a corporate sector focus, on the other hand, policy recommendations may be geared to meet financial sector objectives at the expense of corporate sector growth and value generation.

Unfortunately, adequate corporate sector work linked to financial sector reform was missing in the World Bank and IMF programs in East Asia. The piecemeal approach used has been unproductive, in part the result of the inequality of power between a failing financial sector, on the one hand, and a failing corporate sector on the other. The financial sector is always at the heart of the interests of central banks and finance ministries. As a consequence, the corporate sector, when treated through voluntary, London Approach agencies, may be regarded as a problem—the source of the bad loan portfolio and a potential locus to recover money used to bail out the financial sector. Such was especially the case in Thailand and Indonesia. Difficulties in proceeding with the one impede progress on the other. This is an area where close attention needs to be paid to defining the future international financial architecture in order to prevent important policy linkages from falling between the institutional cracks.

For the London Approach to work in any individual country there must be a functioning statutory insolvency regime, and the success of any insolvency system is largely dependent upon those who administer it. If they lack the respect not only of the courts and of debtors and creditors but also of the general public, then complaints will multiply; if remedial action is not taken, then the system will fall into disrepair and abuse. This was the situation in East Asia and, according to most reports, remains so.[11]

11. Thailand's largest corporate debtor—Thai Petrochemical Industry, which defaulted on its $3.4billion debt in 1997—was declared insolvent by Thailand's Bankruptcy Court only in March 2000, more than two years after the default, and the ousting of its chief executive was bitterly contested. See Robert Frank, "Perception vs. Reality: Yes, the Stock Markets Are Booming, but While Southeast Asia's Economies Are Better, They're Far From Fixed," *Wall Street Journal,* May 8, 2000. In Indonesia, IBRA has reportedly lost eighty out of eighty-four court cases brought against debtors in 2000, prompting the recent appointment of nine outside lawyers to act as judges for a new ad-hoc commercial court. See "Jakarta Plans Special Business Court," *Financial Times*, July 3, 2000.

In addition to ineffective bankruptcy procedures, other obstacles to restructuring that need to be eliminated include tax policies that impede corporate reorganizations, mergers, debt-equity swaps, or debt forgiveness, as well as restrictions on foreigners' participation in domestic banks as investors and as holders of domestic equity. Labor laws, competition policy, and other laws and regulations need to be reformed to create a healthy and competitive business environment. A comprehensive approach requires an active government to eliminate obstacles to restructuring, to facilitate both formal and informal debt workouts, and to establish an effective new legal, regulatory, accounting, and institutional framework.[12] The challenge for policymakers is to undertake comprehensive reform that maintains pressure on all parties in a way that promotes equitable burden-sharing among borrowers, equity holders, workers, taxpayers, the government, short-term creditors, and bondholders; that restores credit to viable enterprises and confidence in the financial system; and that leads to a competitive corporate and financial system that minimizes the chances that a crisis will recur.

The concept of the informal workout using a London Rules approach might be said to be based on a combination of the following elements:

—the fact that there is a significant size of debt owed to a number of different creditors and the present inability to service that debt,

—the attitude that it may be preferable to negotiate an arrangement for the financial difficulties of the debtor both between the debtor and the financiers and also among the financiers themselves,

—the availability of relatively sophisticated refinancing, security and commercial techniques that might be employed to alter, rearrange, or restructure debts of the corporate debtor or the corporate debtor itself,

—the sanction that if the negotiation process cannot be started or breaks down there can be relatively swift and effective resort to the application of an insolvency law, and

—the prospect that there may be a greater benefit for all through the negotiation process than by direct and immediate resort to the insolvency law.

Present experience shows that in most East Asian economies, the elements that are appropriate and relevant with regards to informal workouts are fact, availability, and prospects. Since the sanctions have not been

12. Iskander and others (1999).

demonstrated to be clearly effective, there is an adverse effect on attitude. Cultural factors, such as loss of face, may in some instances act as a motivator for a corporate owner or director to pursue a voluntary, London Rules approach to restructuring, but it is clear that in the absence of the credible threat of formal bankruptcy proceedings a great deal of intransigence is being displayed, on the parts of both debtors and domestic creditors. The public is paying a tremendous price for this intransigence, and the vicious cycle must be broken immediately though strict enforcement of existing laws, including criminal penalties where appropriate.

To ensure robustness of the private sector over the longer term, legislation must set the stage for improved performance in the marketplace. A climate of deregulation, trade and investment liberalization, and competition policy that facilitates entry and exit, in which bankruptcy law plays a key role, encourages a more robust private sector that is able to absorb shocks. In addition, appropriate government programs enhance labor-market flexibility and relieve corporations and the financial sector from being the main purveyors of the social safety net. All these factors existed in the United Kingdom, but most are in urgent need of strengthening in East Asia.

Ultimately, both creditor- and debtor-oriented systems of corporate restructuring and insolvency contain elements of optimal regimes; the issue is one of balance. Much depends on the cause of the company's problems. If these problems reflect an external shock or the short-term economic cycle, a debt-oriented approach may be more likely to ensure that viable companies are not wound up. But if they reflect mismanagement by the board of directors or an isolated decline in a company's business, a debtor-oriented approach, which effectively supports rather than penalizes bad management, carries a moral hazard and may also result in the unjustified postponement of the liquidation of nonviable companies, reducing debt recovery. No system should be designed to permit debtors to hide behind the appearance of voluntary restructuring. Clear and time-bound mechanisms must be designed that will lead to immediate liquidation and legal action against directors and other parties responsible in the event that debtors are not viable or are not negotiating in good faith.

Conclusion

Assessing the success or failure of the application of the London Rules in any given country is not meaningful without examining as well that country's total policy and legal environment. Common traits and beliefs of the society must also be examined and compared against those societies in which a voluntary insolvency process has proven successful. It is also worthwhile to study the psychological effect that systemic collapse has on the individual business owner or director. During the early 1980s, when Mexico experienced a similar economic disaster, the business community for many years refused to accept blame for their individual circumstances; it was only when the reality of the situation finally set in that corporate restructuring began in any meaningful way. This was the "lost decade," which led to greater poverty for all—shareholders and workers alike.

In this era of globalization, reforms in East Asia and elsewhere will ultimately be driven by the markets. Capital knows no boundaries, and a country's desire for investment means that it must compete in a global contest. Those countries that represent the best risk-to-return ratio on a given portfolio will be the winners, and investors will increasingly look at a country's total investment environment before committing their funds. The existence, application, and enforcement of a formal and functioning restructuring and insolvency regime will be one of the key determinants in the competition for foreign direct investment. The London Approach cannot and does not provide solutions to rescue nonviable businesses. The high cost of workouts is nearly always at the expense of the restructured company. The solution advanced by the Bank of England is to pool, rather than to grant each creditor individually tailored advisory services.

We live in a world in which restructuring is a constant and ongoing process. Steps should be taken to overcome old taboos and inefficiencies and create a smoothly functioning system that will maximize equitable burden-sharing and the allocation of risk among participants in market economies. The system should be predictable, equitable, and transparent and should protect and maximize value for the benefit of all interested parties and the economy in general. The resulting system should preserve capital and productive capacity and limit the loss of employment. Such timely action will promote social welfare, sustainable development, and political stability in the crisis country and the region.

The London Approach as applied in the United Kingdom and the many recent models in East Asia create a valuable area for further study and can be used, with great caution, in future crisis countries. Each such program will need to be carefully designed and modified, recognizing differences in the cultural, legal, and business environments of each country. Making improvements in the business environment and establishing operational restructuring and insolvency systems should not await crisis.

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