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Approaches to Corporate Debt Restructuring in the Wake of Financial Crises

Thomas Laryea

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Legal Department[1]

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Prepared by Thomas Laryea

(In collaboration with an Inter-Departmental Working Group)

Authorized for Distribution by Sean Hagan

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Author's E-mail Address: tlaryea@imf.org

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Executive Summary

The global financial crisis has distressed the corporate sector in a number of countries, affected both by a tightening of credit and weaker consumer demand. As countries now move from the initial crisis containment phase, a period of sustained corporate debt (and operational) restructuring can be expected in order to repair corporate balance sheets and to realign the corporate sector to the post-crisis economy. The insolvency law is one important tool to support orderly corporate debt restructuring. But insolvency law solutions are not sufficient to address the scale of debt distress that can be expected to arise in the wake of a financial crisis. A key policy question is how to calibrate government intervention, including focused insolvency law reform, to spur the debt restructuring process.

This paper starts from a discussion of the economic case for moderated government intervention in debt restructuring in the nonfinancial corporate sector. It then draws on lessons from past crises to explain three broad approaches that have been applied to corporate debt restructurings in the aftermath of a crisis. From there, it addresses challenges in designing and implementing a comprehensive debt restructuring strategy and draws together some key principles.

I. Introduction

1. Corporate debt restructuring can be difficult at the best of times. This difficulty has been heightened due to the effects of the recent global crisis that has presented some unprecedented debt pressures in corporate, household and financial sectors, evolving also into sovereign debt pressures.

- Debt deleveraging has taken place on a global scale as financial institutions, corporates and households are forced to reduce their debt burdens.
- The write down of assets and concerns of counterparty risk have driven liquidity pressures on banks and other financial institutions.
- Financial distress in the banking sector has constrained credit to corporates and households.
- Economic downturn has reduced corporate revenues and household incomes.
- Reversals in capital flows have further constrained liquidity and exacerbated exchange rate pressures.

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- Exchange rate depreciation in some countries with high incidence of FX denominated debt has accelerated defaults in the corporate and household sectors. Conversely, the effect of contractionary policies, motivated by the objective of maintaining the nominal exchange rate in some countries, has reduced debt servicing capacity.

- Governments may have both institutional limits (e.g., EU rules limiting state aid) and fiscal space constraints on intervening to resolve private sector debt problems. Furthermore, large scale intervention by governments—e.g., involving the injection of liquidity and assuming or subsidizing private sector debt—has the potential to lead to unsustainable public sector debt burdens.

2. The experience from past crises, such as in Latin America and Asia, provides some lessons for designing strategies for debt restructuring in the nonfinancial corporate sector. The recent financial crisis, however, has presented a combination of factors that exacerbate the challenge of calibrating policy responses:

Global dimensions—given that the effects of the crisis are simultaneously felt around the world, alternative sources of financing have been limited and policy coordination has been rendered especially challenging, while at the same time more imperative.

Severity—the scale of financial dislocation and the pace of developments have stretched both institutional capacity and the effectiveness of legal and policy tools that may have been reasonably efficient in other times.

Complexity—financial innovation (e.g., in the form of structured financial products) and the role of non-bank financial institutions have layered further complexity to the incentive structures and the legal instruments that have a bearing on debt restructuring.

3. Corporate debt restructuring can be an important component of economic adjustment programs supported by the IMF: current examples include the programs in Iceland and Latvia. Private debt restructuring may be needed to revive medium term productivity and growth, thereby supporting a country's balance of payments adjustment. Furthermore, high levels of private debt can negatively impact public debt sustainability with the potential transfer of private debt to government balance sheets. In such circumstances, the contingent government liabilities relating to private debt could inform a judgment that a country's *public* debt is unsustainable. In order for the IMF to lend to a country in such circumstances, debt restructuring would need to take place to restore medium term sustainability.[2]

[2] The IMF's financing of economic programs is generally subject to the requirements in the IMF's Articles of Agreement that: (i) the IMF's financing be used to assist member countries to resolve their balance of payments problems and (ii) adequate assurances be in place that the IMF will be repaid. See Article V, Section 3(a). The monitoring of debt sustainability is also relevant to the IMF's exercise of its surveillance mandate over each IMF member country's exchange rate policies, under Article IV of the IMF's Articles of Agreement.

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4. As signs of recovery from the depths of the crisis appear and countries move beyond the initial crisis containment phase, the impetus for corporate debt restructuring will increase. While it is too early to identify conclusions from the current debt restructuring strategies in countries such as Iceland and Latvia, this note draws from past experience to offer some guidance on core principles to be adapted to the evolving country cases.[3]

II. Economic Case for Government Intervention in Corporate Debt Restructuring

5. Systemic crises inherently entail financial dislocation due to shifts in relative prices, disruptions in access to credit and likely contraction in output. This dislocation can have major effects on the balance sheets and profitability of the corporate sector (with a corresponding strain on the cash flow and capital of the banking sector). Sustained weak demand creates excess capacity in the economy leading to inefficient employment of, and over time attrition in, human and financial capital.

6. At a broad level, government intervention—at least in the form of corrective macroeconomic policies—will be needed to address these economic imbalances. Beyond this, the government may let corporate debt restructuring proceed without special intervention above the level that would normally apply in the legal and institutional framework or debt restructuring process. Such an approach, however, may have several drawbacks:

- More court cases would likely arise than can be handled even by countries with the highest institutional capacities and the most efficient legal systems.
- Market failures can inhibit the debt restructuring process. For example, attrition problems can plague voluntary loan workouts, with delays that are optimal for the individual negotiators but not for the economy as a whole. Rather than recognize and address unsustainable debt problems, firms and their creditors may instead attempt to ride-out the crisis in the hope that economic recovery will eventually bail them out.
- The resulting risk of damage to the credit culture and proliferation in unproductive "zombie" companies (tolerated by lax creditors) can present a drag on economic recovery.

[3] Most of the country cases that have been the subject of systematic study arise in the emerging economies. In contrast, corporate debt restructuring in some advanced economies may to a greater degree encounter issues of financial innovation, such as the restructuring of debt embedded in structured financial products or covered by credit default swaps, which are not specifically addressed in this note. Furthermore, the idiosyncrasies of restructuring of debt of quasi sovereign entities, as has been highlighted in the recent or on-going restructurings of Naftogaz (Ukraine) and Dubai World—and which straddle corporate and sovereign debt restructuring principles—require specific analysis and are not addressed herein.

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7. At the same time, government intervention could commonly involve distortions. Factors to be balanced include:

- If intervention involves government financing, it should be constrained by the degree of fiscal space available and its potential negative impact on public debt sustainability.

- In addition to the immediate budgetary costs, second order costs down the road may include inefficiencies associated with government intervention preserving non-viable firms and excess capacity, thereby hindering adjustment in the economy necessary to sustain productive growth.

- Furthermore, a concern of government intervention is that it would invite moral hazard in terms of the prospect of government bailouts promoting irresponsible risk-taking.

8. On balance, the enduring lesson from country experience is that in the wake of systemic crises, some degree of government intervention has occurred to jump start and sustain corporate debt restructuring. In addition to variation in political choices, the level and modalities of government intervention would depend on the dimensions of the debt problem, the capacity of debtors and creditors to burden-share losses, and the legal tools and financial resources available to the government.

- Government intervention in debt restructuring may be minimal where the number of corporate defaults is small and the macroeconomic consequence is limited. In that context, the government may need to facilitate mediation between debtor and creditor interests by setting guidelines or establishing an institutional framework for facilitating negotiations and enforcing agreed resolutions.

- In a deeper crisis involving massive corporate defaults, government intervention would likely need to go further, extending to intervening through a range of legal, regulatory and financial tools (subject to fiscal space) in order to support corporate debt restructuring as part of an economic adjustment program.

III. Approaches to Corporate Debt Restructuring[4]

9. Key objectives of comprehensive corporate debt restructuring strategies following a financial crisis have been to support an economy-wide recovery through: (i) facilitating the exit of nonviable firms (i.e., firms without a reasonable prospect of achieving sustainable

[4] This section draws from: "Corporate Debt Restructuring in the Wake of Economic Crisis," by Sean Hagan, Elliot Kalter, and Rhoda Weeks-Brown, in *Managing Financial Crises: Recent Experience and Lessons for Latin America,* IMF Occasional Paper No. 217, 2003, pp. 84-100; and *Managing Systemic Banking Crises* by David S. Hoelscher and Marc Quintyn, IMF Occasional Paper No. 224, 2003.

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profitability);[5] and (ii) enabling the timely restructuring of debt and access to sufficient financing to sustain viable firms.

10. Corporate debt restructuring can take many forms directed to the debt and capital structure of a firm; it can include debt reschedulings, interest rate reductions, debt-for-equity swaps and debt forgiveness. To be successful in securing the longer term viability of corporates, debt restructuring will often be accompanied by operational restructuring addressing the structure and efficiency of the firm's business through closures and reorganization of productive capacity.

11. A point of departure in designing corporate debt restructuring strategies in the context of a financial crisis should be to recognize the distinction between the crisis containment phase and the subsequent debt restructuring phase. During the height of a financial crisis—typically involving an uncertain macroeconomic path, falling asset prices and frozen credit markets—judgments on individual firm viability necessary to inform debt restructuring are virtually impossible. Any attempts at debt restructuring during this phase tend to be marginal, involving measures such as extension of repayment terms and waivers of payment defaults. Such tinkering at the margins cannot address deeper problems of debt structure and overhang.

12. The focus of policy measures in the crisis containment phase should be to establish a reasonably predictable macro path, including through restoration of the banking system. This would provide an economic platform for debt restructuring to take off in earnest and to be sustained through the debt restructuring phase, which would in turn further support economic recovery. While there is no bright line between the crisis containment and debt restructuring phases, the effectiveness of policy responses are generally enhanced by attention to the different priorities and feasible objectives in these two phases.[6]

13. While measures in the debt restructuring phase would evolve, three broad categories of approaches to corporate debt restructuring in the aftermath of a financial crisis can be identified, distinguished by varying degrees of government involvement. The categories reflect the center of gravity of the measures from case by case market solutions to across the board government-determined solutions, or an intermediate approach between the two.[7]

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[5] In addition to firm-specific inefficiencies, the effects of a general contraction in demand following a crisis can render a corporate "non-viable."

[6] For a broader discussion distinguishing financial crisis containment measures from other policy responses, see Anna Gelpern, "Financial Crisis Containment," 41 *Connecticut Law Review*, 493, 2009.

[7] For another classification of approaches to corporate debt restructuring in the aftermath of a crisis, referring to "government centralized" and "decentralized" approaches and identifying most countries as engaging in elements of both approaches, see Stijn Claessens, "Policy Approaches to Corporate Restructuring Around the World: What Worked, What Failed?" in *Corporate Restructuring: Lessons from Experience*, ed. by Pomeleano and Shaw (Washington: World Bank), 2005.

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- A *case by case, market-based, approach* has been used in which private sector debtors and creditors are generally left to determine the nature, scope and terms of the burden sharing on a case by case basis and principally relying on market solutions (e.g., Hungary and Poland in the 1990s, Korea, Malaysia, and Thailand in the late 1990s).[8] While this approach is essentially market-oriented, the government would still have an important role through implementing legal reforms to encourage timely market-driven restructuring. Furthermore, fiscal support (if any) in this approach would be on an indirect basis through support of the financial sector (e.g., use of public funds to recapitalize domestic banks that meet certain soundness requirements, and thereby strengthen the capacity of those banks to absorb losses within debt restructuring).

- An *across the board approach involves* direct government involvement that determines the method and distribution of burden sharing among relevant parties. Under this approach, the relevant solutions are generally applicable across the board to all economic agents in the pre-specified category, regardless of individual factors (e.g., Chile, 1982, and Mexico, 1983).[9] There are two alternative characteristic features of this approach. The first is direct fiscal support to corporates, which could range from a predetermined amount of support for specified purposes (e.g., to protect against foreign exchange rate risk), to tax and other fiscal-related incentives for firms that engage in restructuring (See Box 1). The second is a legislatively mandated absorption of losses by creditors; such a strategy should be avoided given the risks of legal challenge and undermining the credit culture of a country.[10]

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[8] The common characteristics of these country cases were: (i) virtually all corporate and household debt was held by domestic banks and most, if not virtually, all the corporate debt was in domestic currency; (ii) legal reforms focused on improving insolvency procedures and removing impediments to corporate debt restructuring, such as strengthening collective rights of majority creditors; and (iii) the immediate fiscal costs ranged from 6 percent of GDP (Poland) to 20 percent (Korea) and 44 percent (Thailand) financed mainly by the issuance of government bonds. See "Corporate Debt Restructuring in the Wake of Economic Crisis," by Sean Hagan, Elliot Kalter, and Rhoda Weeks-Brown, in *Managing Financial Crises: Recent Experience and Lessons for Latin America,* IMF Occasional Paper No. 217, 2003, pp. 84-100. Classification of the Korea and Thailand debt restructuring strategies are borderline between case by case or intermediate.

[9] The common characteristics of the Chile (1982) and Mexico (1983) cases are: (i) corporate debt was mainly held by foreign creditors and/or denominated in U.S. dollars; (ii) no major legal or regulatory reform was undertaken; and (iii) no use of market-based restructurings by recapitalized banks or a government asset management company. See "Corporate Debt Restructuring in the Wake of Economic Crisis," by Sean Hagan, Elliot Kalter, and Rhoda Weeks-Brown, in *Managing Financial Crises: Recent Experience and Lessons for Latin America,* IMF Occasional Paper No. 217, 2003, pp. 84-100.

[10] The approach adopted by the Argentine government during the 2002 debt crisis is analogous. The government introduced an asymmetric pesification of bank balance sheets, which required dollar-denominated assets to be converted into pesos at par, while dollar-denominated liabilities were converted at an exchange rate of US$1 = Arg$1.4. In addition, the government introduced an asymmetric indexation of assets and liabilities, under which deposits were indexed to the CPI, while certain loans were indexed to wage inflation. Although the government

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Box 1. Direct Government Subsidies

Governments have resorted to direct financial support to distressed sectors in order to cushion the effects of wide scale debt distress. Experience has been mixed with such government action to absorb losses in this manner which effectively shifts the debt burden to government and taxpayers; i.e., such action entails debt substitution, rather than restructuring.

Elements of this approach have involved direct government financial support through FX insurance and subsidy schemes and purchase of bad assets. For example, the Mexico government (1983) provided foreign exchange cover to help the corporate sector settle external arrears to foreign suppliers and provided refinancing and foreign exchange cover for private sector external debt, and a capital injection to nationalized banks. This scheme took place within a comprehensive rescheduling of public sector debt-servicing obligations that provided Mexico with significant cash flow relief. In Chile (1982), the government and the central bank provided direct subsidies to corporations and households and to some solvent banks through the exchange of foreign currency debt-service payments at a preferential rate, limited purchases of non-performing loans from banks, and interest rate subsidies for household mortgages. The Chilean government financed these transactions mainly by issuing zero-coupon bonds.

In addition, the Indonesia Debt Restructuring Agency (INDRA) was designed to enable debtors and foreign creditors who reached debt restructuring agreements that met certain requirements to eliminate exchange rate risk on future debt service payments. The scheme was not successful—it was used only once—principally because of distrust of government involvement.

- *An intermediate approach* has been applied that relies on case by case negotiations, supported by government financial incentives, bolstered by legal and regulatory reforms, and establishment of public entities to galvanize debt restructuring (see, e.g., Mexico 1995, Indonesia 1998).[11]

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compensated domestic banks for direct losses arising from the asymmetric pesification and indexation (totaling around Arg$56 billion), substantial indirect loses were suffered by the banks due to the loss of depositor and borrower confidence and the collapse in financial intermediation. Also, legal challenges by depositors followed, with some successful in obtaining court orders releasing deposits at market exchange rates. The substantial litigation risks and damage to Argentina's financial system and perceptions of credit worthiness underscores the aversion to countries adopting such forced restructuring techniques even in the most extreme cases of financial crisis.

[11] The common characteristics of these cases were: (i) the corporate sector carried high levels of both domestic and foreign currency debt, with government involvement aimed mainly at the foreign debt; (ii) the complexities of the balance sheets led to the creation of several government led mediation entities, as well as schemes for direct corporate debt relief; (iii) legal reforms to bolster the credit enforcement institutions and culture were pursued, but with mixed results; and (iv) there were nonetheless sizeable fiscal costs (20 percent for Mexico and 55 percent for

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14. Without exception, all country experiences of wide scale corporate debt restructuring have been mixed and have involved lengthy and difficult processes. While any approach needs to be tailored to the circumstances of a country—including macroeconomic conditions, composition of debt and legal/institutional framework—the experience with corporate debt restructurings in the aftermath of systemic crises indicates that a properly designed intermediate strategy would generally be expected to make the best use of limited fiscal resources and avoid shifting the burden of restructuring unsustainably to creditors.

15. The intermediate approach would tend to be more effective than the case by case approach in optimizing debt restructuring where the scale of the debt distress is beyond the capacity of the court system and the market place to resolve in a timely manner. The advantage of the intermediate approach over across-the board solutions is that it seeks to leverage private resources (such as they exist) and to contain dead weight losses implied by full across the board interventions. Notably, the substantial reliance on across the board measures in the Chile and Mexico strategies proved costly to public debt sustainability and contributed to the need for sovereign debt restructurings to restore the public sector balance sheets. Furthermore, across the board measures, without distinction based on firm viability, would disadvantage more efficient firms and dampen procompetitive forces in the economy.

16. However, in determining whether an intermediate approach is preferable in any given strategy, the dead weight losses of full across the board interventions need to be weighed against the inefficiencies from the potential grid-lock faced where the number of debt default cases is substantially higher than the institutional capacity can handle. Countries could also adopt more than one approach in parallel, for example, an across the board approach for categories of SMEs (due to the number and small size of claims) and an intermediate approach for larger corporates.[12]

IV. Design and Implementation of a Corporate Debt Restructuring Strategy

17. Tailoring a corporate debt restructuring strategy to individual country circumstances requires attention to a number of key factors: (i) policy coordination; (ii) analysis of data to assess the dimensions of the debt problem; (iii) consideration of reform of the legal and institutional framework for enforcement of credit, particularly the corporate insolvency law; (iv) government support to facilitate out-of-court restructurings; (v) potential innovations to facilitate voluntary standstills; (vi) careful assessment of the rationale for government

Indonesia), financed by government bonds. See "Corporate Debt Restructuring in the Wake of Economic Crisis," by Sean Hagan, Elliot Kalter, and Rhoda Weeks-Brown, in *Managing Financial Crises: Recent Experience and Lessons for Latin America,* IMF Occasional Paper No. 217, 2003, pp. 84-100.

[12] For example, in Indonesia, an across-the-board approach was implemented for the restructuring of SME debt held by IBRA, whereas the approach for larger corporates was intermediate.

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financing (if any) to individual firms; (vii) consideration of different treatment for SMEs; and (viii) coordination with financial sector restructuring, particularly with respect to banks.

18. ***Policy coordination.*** A debt restructuring strategy, relying on a combination of government intervention and a market based solutions, requires significant coordination of different policies to be effective. Coordination is required in assessing the dimensions of the debt problem in the corporate sector (and the relative strains on the household and financial sectors) and then in designing responses that meet the most pressing needs for the economy as a whole.

19. Macro policies are an essential feature as they bound the feasible timing of debt restructuring and guide key judgments on individual firm viability. For example, reduction in interest rates can spur refinancing, which can provide debt servicing relief (but the risk of re-inflating asset bubbles and unsustainable accumulation of debt needs to be held in check). Also government guarantees, involving the use of fiscal policy, will often be part of the policy consideration and can be designed to complement restructuring through targeting guarantee schemes to loans that have been restructured and where the debtor is able to meet the new terms. (See Box 2)

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Box 2. The Use of Government Guarantees to Support the Corporate Sector

With the corporate sector hard hit by the global financial crisis in many countries, and access to finance reduced in the context of heightened bank risk aversion, many governments have introduced new or extended existing government guarantee programs to the corporate sector. Although these programs may differ in terms of their scope (participating institutions and sectors eligible) and terms, their underlying purpose is to provide corporates with financing resources that would have otherwise have been difficult to obtain and/or to lower financing cost. While rarely the main objective, credit guarantees could be used to complement corporate debt restructuring, for example, where eligibility for the guarantee is tied to restructured debt.

Credit guarantees, as such, can be a useful policy tool to help overcome instances when banks become highly risk averse or are unwilling to lend owing to expectations of larger future losses. From the government's perspective, credit guarantees can also be a less costly form of intervention relative to direct subsidies, as only a portion of the guarantees is expected to be called. Furthermore, credit guarantees are usually preferred to direct or directed lending as banks involved can more accurately price the credit risk and have established networks to reach potential borrowers.

That said, there are a number of potential pitfalls and risks associated with extending credit guarantees that should be mitigated to the extent possible through their design.

- *Moral hazard:* if the guarantee rates accorded by the government are in full, banks have less incentive to assess risk, increasing the probability that the guarantee will be called. Moral hazard can be limited by setting the government's portion of the risk well below 100%, though sufficiently high to ensure the facility is utilized (countries generally apply coverage rates in the 60-80% range). Fees, preferably based on observable risk characteristics (i.e., CDS spreads), can also be charged to defray fiscal costs.

- *Adverse selection:* this can occur as banks have an incentive to extend guaranteed loans to their worst-performing customers to rollover existing loans. To avoid such behavior, monitoring of customer selection by the government is needed, and by ensuring borrowers are performing or otherwise have a good track record of observable credit characteristics. In addition, collateral should be commensurate with the risk profile of the loan, while recovery by the government should be proportional to the guarantee coverage.

- *Effectiveness and transparency:* the facility should have a specified expiration date, clearly defined objectives (i.e., to address credit rationing) and related criteria (i.e., type of borrower, size of the facility and its funding, individual limits, extent of government coverage, description of the guarantee fee, individual loan duration, currency of denomination, and budget treatment). Regular information on the guarantee facility and the portfolio of guaranteed loans should be published.

- *Cost control and budgeting:* the size of government guarantee facilities has to be consistent with fiscal sustainability. To this end, default rates should be set conservatively and updated periodically to reflect changes in credit risk. Furthermore, to ensure transparency, the credit guarantee fund should be included in the budget and reported according to the International Financial Reporting Standards.

This Box was drafted by Peter Kunzel (MCM)

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20. Cohering the different relevant policy aspects would be enhanced by a debt restructuring committee with inter-agency representation, including from ministries of finance, economy, and justice, central banks, and financial sector regulators, working in consultation with financial and industry participants. A public communication strategy, which in itself is an important element of building confidence and setting realistic expectations, can be channeled through such a committee.

21. ***Data are key to diagnosing the debt problem***. Data are needed to assess the relative dimension of the corporate debt problem (in absolute terms and relative to household debt problems) and the implications for creditors, in particular bank balance sheets. Information on credit quality and distribution of debt (by type of contract, borrower, and financial institution) needs to be analyzed and the impact of provisioning on the profitability and capitalization of individual banks. Experience demonstrates that obtaining reliable data relevant for a debt diagnosis can be a challenge. In any case, the temptation to make policy prescriptions in the absence of data supporting diagnosis of the problem should be resisted.

22. ***Legal and institutional reforms may be needed to underpin the debt restructuring strategy.*** Specifically, the legal and institutional framework for the enforcement of creditor claims, including, the collective enforcement of creditor claims through corporate insolvency law, is important. Absent a legal framework that at a minimum provides a credible means of credit enforcement to bring debtors to the negotiating table, wide-scale debt restructuring is extremely difficult.

23. Corporate insolvency law should be designed to achieve two broad objectives. The first is the allocation of risk among participants in a predictable, transparent and equitable (not necessarily *equal*) manner. The second broad objective is to protect value for the benefit of interested parties and the wider economy.[13] Towards these two objectives, an economically efficient corporate insolvency law would include provisions on the following:[14]

- **Indisputable entry point.** There must be a clear trigger—such as a missed payment—which can be used in practice by creditors and debtors alike to initiate insolvency proceedings.

- **Value-maximization.** The process should support business judgments that assess whether value-maximization is best achieved by exit of non-viable firms or rehabilitation of the viable. This distinction cannot be reliably determined in the abstract by legal rules, but the law should be open to facilitate and enforce market-oriented business judgments of stakeholders.

[13] See further *Orderly and Effective Insolvency Procedures,* Legal Department, IMF, 1999.

[14] For a discussion of how these principles had been incorporated into the revisions of German insolvency law in the late 1990s, see Manfred Balz, "Market Conformity of Insolvency Proceedings: Policy Issues of the German Insolvency Law," *Brooklyn Journal of International Law,* pp. 167-79, 1997.

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- **Credible and efficient liquidation.** The enforcement of market exit must be an effective option at any time.

- **Fair opportunity for rehabilitation.** The insolvency law should facilitate opportunities for firm rehabilitation (where supported by business judgments). In this regard, a number of features are key:

  i. A legal stay on all creditor (including secured creditor) enforcement actions and a corresponding stay on payments by the debtor upon commencement of the insolvency proceedings are essential to avoid dismemberment of the operating units and dissipation of assets of a firm;

  ii. The law should provide the debtor firm's management with the opportunity to submit a rehabilitation plan in order to encourage debtors to utilize rehabilitation procedures to resolve debt problems at an early stage,

  iii. The insolvency law should facilitate new financing through according such financing with a legal priority before payment of pre-existing debt; and

  iv. The law should provide a mechanism through which a rehabilitation plan can be approved by a requisite majority of creditors (while protecting the interests of dissenting creditors by ensuring that they are treated in line with similarly situated creditors and that, in any case, the plan provides dissenting creditors with at least as much as they would receive under the debtor firm's liquidation).

- **Discourage strategic behavior by creditors and debtors.** In particular, the insolvency law should not displace or redistribute prebankruptcy negotiated entitlements, such as the priority of secured credit or the subordination of equity below unsecured claims. Also, the insolvency law should provide for review of suspect (unfair) transactions within a reasonable period and impose sanctions for such transactions.

- **Leverage out-of-court practice**. In particular, the insolvency law should enforce prepacked restructurings negotiated out of court.

- **Not discriminate between foreign and domestic creditors.** Foreign creditors should generally be permitted to participate in the insolvency proceedings on the same basis as domestic creditors.[15] Bias against foreign creditors in application of the insolvency law or the debt restructuring strategy would erode international credit and investment and should therefore be resisted.

- **Address cross-border dimensions.** Insolvency proceedings of enterprises with assets and liabilities in different countries present potential conflicts among jurisdictions, resulting in inefficient delays. These problems can be mitigated

[15] A common exception is for foreign tax claims, which are normally not enforced by local courts.

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through the insolvency law incorporating generally accepted principles for coordination of courts and insolvency administrators among countries, in line with the UNCITRAL Model Law on Cross-Border Insolvency.[16]

24. Expectations of the operation of an insolvency law, however well designed, need to be qualified in the context of a financial crisis. As explained above, the insolvency law would be a limited tool in the crisis containment phase.[17] In the debt restructuring phase, the effectiveness of an insolvency law may remain compromised due to continuing market inefficiencies arising from the crisis. Furthermore, given that implementation of the insolvency law depends on the institutional framework, including judges and insolvency administrators and practitioners, the formal legal process and institutions can hardly (if ever) be expected to address the total volume of debt default cases that can arise after a crisis.[18] Accordingly, all reliance cannot be placed on the formal insolvency system.

25. Rather, a more measured objective is to establish incentives through the law that would catalyze out-of-court restructurings, to the extent possible. Especially important would be a provision enabling a court in an expedited manner to make a restructuring agreement that is accepted by a qualified majority of creditors binding on dissenting creditors. With the increase in the number and diversity of investors holding corporate debt, the ability to reliably bind-in holdout creditors has become even more critical to the success of restructuring efforts.[19]

26. Revision of other laws may need to be considered to support out of court debt restructuring in the aftermath of a crisis. These include corporate governance rules on the responsibilities of managers of a firm and the rights and liabilities of shareholders (including

[16] The UNCITRAL Model Law on Cross-Border Insolvency does not entail a substantive unification of insolvency laws, but rather sets out procedural rules to be adopted on cross-border insolvencies. The Model Law focuses on (i) access to courts by foreign country insolvency administrators; (ii) determining when legal effect would be given to a foreign insolvency proceeding; (iii) clarifying procedures for cooperation among insolvency proceedings and administrators; (iv) specifying rules for coordination between concurrent insolvency proceedings; and (v) establishing rules for coordination of relief granted in different insolvency proceedings. The Model Law has been essentially adopted in 17 countries, see http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html.

[17] See paragraph 12, above.

[18] More generally, the level of confidence in government institutions due, inter alia, to perceptions of corruption, may also affect the capacity of parties to rely on the legal and institutional framework for credit enforcement at the best of times and not least, within a crisis.

[19] Use of majority restructuring clauses in corporate bonds may also facilitate out of court restructurings of in those debt instruments.

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limitation of liability of shareholders and the subordination of equity to unsecured creditors). In addition, securities and tax laws may need to be addressed.[20]

27. Many countries have enacted reforms to their legal frameworks relevant to corporate debt restructuring over recent years,[21] but these laws may need to be re-tailored as a result of the changes to economic conditions resulting from a crisis. Although it could be argued that uncertainty created by law reform may stall debt restructuring while stakeholders await the outcome of the law reform process, this concern can be mitigated by advancing the law reform in the crisis containment phase during which the feasibility of debt restructuring is already limited. In any case, any attempt to change the rules or practices for credit enforcement in the middle or aftermath of a crisis is sure to be met with heightened opposition in some quarters, especially as the potential winners and losers from the changes become apparent.[22] Consequently, one cannot underestimate the level of political capital needed for governments to initiate and stay the course on even limited legal and institutional reforms that may be needed to optimize corporate debt restructuring.

28. ***Guidelines for out-of-court restructurings***. Parallel to reform of the legal framework, some degree of government involvement in supporting guidelines for out-of-court restructurings would facilitate wide scale debt restructurings. There is substantial international experience from which to draw.

29. The so-called London Approach has influenced the evolution of government-sponsored guidelines for multicreditor out-of-court debt restructurings. Under the leadership of the Bank of England, UK banks developed the London Approach as a set of informal guidelines on a collective process for voluntary workouts to restructure debts of corporates in distress, while maximizing their value as going concerns. The initiative grew from the recognition that creditors would likely achieve better returns through collective efforts to support an orderly rescue of a firm in distress, instead of forcing it into a formal insolvency. Subsequently, countries facing wide scale corporate debt distress in the late 1990's turned to

[20] For example, limitations in securities laws on debt-to-equity conversions or issuance of new equity instruments may need to be relaxed. Among the tax law impediments that need to be addressed to foster corporate restructuring are the treatment of debt forgiveness as taxable income for a borrower, ensuring that creditor losses are recognized for tax purposes and the transfer of real estate (or other assets) from a borrower to a bank's asset management company are not subject to transfer taxes.

[21] Such reforms have been influenced by technical assistance of the IMF Legal Department, in line with *Orderly and Effective Insolvency Procedures,* Legal Department, IMF, 1999. Also, law reform efforts have been assisted by the UNCITRAL *Legislative Guide on Insolvency Law* and the World Bank's *Principles for Insolvency and Creditor Rights*.

[22] Reconsideration of aspects of the insolvency law, such as the priority ranking of creditors, is likely to be especially contentious. The recent change to the Iceland insolvency law to provide depositors with a priority ranking over ordinary creditors is a notable example, albeit in a bank insolvency context.

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the London Approach as a basis to develop their own guidelines to encourage out-of-court corporate debt workouts.

30. For instance, in Indonesia, Korea, Malaysia, and Thailand, the London Approach was modified through enhancing the centralized role of government agencies to provide incentives for restructurings.[23] Furthermore, in these country cases, government enhancements were added to establish a more structured framework to support restructurings, including through (i) regulatory suasion to require all banks to sign on to the workout principles (for example, as a quid pro quo to government recapitalization); (ii) agreements to arbitrate disputes, thus avoiding unpredictable or protracted formal judicial processes; and (iii) imposition of penalties for failure to meet deadlines under the workout principles. Annex A identifies enhanced features of out of court workout frameworks adopted in a number of crisis situations.

31. Following lessons from the Asian crisis, the international federation of insolvency practitioners (INSOL International) published in 2000 the Statement of Principles for a Global Approach to Multi-Creditor Workouts. These principles build on the London Approach (but without addressing some of the government enhancements that may be needed in crisis contexts):

- **First principle:** Where a debtor is found to be in financial difficulties, all relevant creditors should be prepared to cooperate with each other to give sufficient (though limited) time (a "standstill period") to the debtor for information about the debtor to be obtained and evaluated, and for proposals for resolving the debtor's financial difficulties to be formulated and assessed, unless such a course is inappropriate in a particular case.

- **Second principle:** During the standstill period, all relevant creditors should agree to refrain from taking any steps to enforce their claims against or (otherwise than by disposal of their debt to a third party) to reduce their exposure to the debtor, but are entitled to expect that during the standstill period their position relative to other creditors will not be prejudiced.

[23] In the classic London Approach, the Bank of England played a critical role in encouraging and overseeing participation by bank creditors. In Indonesia, e.g., the Jakarta Initiative Task Force (JITF), was established as a state agency to facilitate out-of-court corporate debt workouts supported by a framework of regulatory "carrots" (such as tax relief and regulatory forbearance) and "sticks" (such as potential de-listing or license revocation). On balance, the JITF framework was relatively successful. In the absence of a credible legal and judicial system and within a difficult legal environment, it provided a reasonably predictable forum for restructuring. In addition, the Indonesian Bank Restructuring Agency (IBRA) was established to restructure and recapitalize banks, maximize recoveries from taken-over assets, and support corporate debt restructuring. While IBRA worked well in stabilizing the banking system, it performed less well in maximizing asset recoveries, and its role in supporting corporate restructuring was decidedly mixed. Inadequacy of political support was a key factor compromising IBRA's performance. (See further, Ceda Ogada, "Out-of-Court Corporate Debt Restructuring: The Jakarta Initiative Task Force," *Current Developments in Monetary and Financial Law*, Vol. 6, 2005.)

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- **Third principle:** During the standstill period, the debtor should not take any action that might adversely affect the prospective return to relevant creditors (either collectively or individually) as compared with the position at the standstill commencement date.

- **Fourth principle:** The interests of relevant creditors are best served by coordinating their response to a debtor in financial difficulty. Such coordination will be facilitated by the selection of one or more representative coordination committees and by the appointment of professional advisers to advise and assist such committees and, where appropriate, the relevant creditors participating in the process as a whole.

- **Fifth principle:** During the standstill period, the debtor should provide, and allow relevant creditors and/or their professional advisors reasonable and timely access to all relevant information relating to its assets, liabilities, business and prospects, in order to enable proper evaluation to be made of its financial position and any proposals to be made to relevant creditors.

- **Sixth principle:** Proposals for resolving the financial difficulties of the debtor and, so far as practicable, arrangements between relevant creditors relating to any standstill, should reflect applicable law and the relative positions of relevant creditors at the standstill commencement date.

- **Seventh principle:** Information obtained for the purposes of the process concerning the assets, liabilities and business of the debtor and any proposals for resolving its difficulties should be made available to all relevant creditors and should, unless already publicly available, be treated as confidential.

- **Eighth principle:** If additional funding is provided during the standstill period or under any rescue or restructuring proposals, the repayment of such additional funding should, so far as practicable, be accorded priority status as compared to other indebtedness or claims of relevant creditors.

32. Regard to the INSOL Principles remains a useful starting point in the design of out of court debt restructuring guidelines. However, where creditors are large in number, diversified beyond banks and include both domestic and international interests, coordination problems become more difficult to manage within a London Approach model: specifically, unanimous agreement among creditors and voluntary adherence to standstills can prove a major impediment to operation of out-of-court restructuring principles. Conversely, where there are only one or two creditors for each corporate debtor, some of the formalities of a London Approach model, such as the establishment of creditor committees, can be unduly cumbersome.

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33. Furthermore, the application of the underlying London Approach model has been mixed in circumstances where the legal and institutional framework is less developed.[24] In the context of systemic crises where the number of cases warranting debt restructuring are large relative to institutional capacity or where the alternative of the formal judicial process is unreliable, enhancements of workout principles through a more structured framework—as illustrated in the Indonesia, Korea, Malaysia, and Thailand experiences—have been necessary.

34. ***Advancement of voluntary payments standstills.*** One dimension in which further innovation in the out-of-court restructuring models may be needed is with respect to catalyzing voluntary payment standstills. While the principle of a standstill on debtor payments and creditor enforcement is enshrined both within best practices for out-of-court restructurings and formal insolvency law, resort to case by case negotiated standstills or court imposed standstills may not be sufficiently feasible where a substantial proportion of the corporate sector is in distress. Additional tools may be warranted in extreme circumstances where the liquidity needs of the corporate sector are severe in countries undergoing the crisis containment phase, i.e., in the phase before wide scale debt restructuring can be expected to take place in earnest. The objective would be to provide corporates relief from liquidity pressures and avert firms from failing during the crisis simply as a result of the freezing of credit markets.

35. Consideration could be given to the design of a framework for voluntary standstills, in which the government incentivizes creditor participation in the standstills, e.g., through limited financial assistance. (This approach, however, would not be a substitute for macro policies to foster new lending.) The approach would be intended to mitigate the inefficiencies of individually negotiated standstills that can arise with workout guidelines and to forestall consideration of government-imposed payment moratoria in extreme cases.

36. The envisioned government-facilitated voluntary standstills could operate in the crisis containment phase, as a precursor to individually tailored standstills based on workout guidelines or debtor specific court-imposed standstills under the insolvency law that could be appropriate in the debt restructuring phase. Conditioning the operation of government facilitated standstills on the assessment of individual firm viability would not be practicable during the crisis containment phase.[25] However, the assessment of firm viability by

[24] The relative success of the original London Approach was anchored in a reasonably predictable UK legal framework on the enforcement of creditor rights and a culture of cooperation with and trust placed in the role of the Bank of England by all parties involved. Looking back at this experience, it indicates that the oversight role of bank regulatory authority was an important factor in overcoming collective action problems among bank creditors.

[25] Where their mandates and policies permit, international financial institutions could potentially play a role in contributing to such financing.

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professional advisors would be expected as soon as possible in the transition to the debt restructuring phase.

37. Payments subject to the government-facilitated voluntary standstill would not be legally written off, but would only be deferred, by agreement, to after the standstill ends. Accordingly, such a voluntary standstill would not determine the ultimate fate of the firms—this would need to be addressed in the second stage debt restructuring phase after the standstill. For some firms, the liquidity preserved through the standstill may be sufficient to enable them to emerge from the crisis as going concerns; for others, a subsequent debt and organizational restructuring will be needed; and for yet others, liquidation through the bankruptcy law would be the value-maximizing alternative.

38. While attractive in principle, design of a framework for such government-facilitated voluntary standstills is difficult. With this caveat, the following design elements merit consideration:

- **Voluntary**—Participation would be voluntary for each corporate debtor and its creditors. However, conditioning government financial support on the acceptance of the standstill by a qualified majority of relevant creditors would mitigate creditor free rider problems, by reducing the opportunity of holdouts to benefit from the forbearance of other creditors. (In contrast, forced participation through, e.g., the government imposition of payment moratoria should be avoided to the extent possible—such measures would raise legal objections and negative risk of contagion to other countries.[26]

- **Scope**—Participation in the government-facilitated voluntary standstills should be open to a wide spectrum of the liquidity-constrained corporate sector and their creditors. While eligibility should be widely cast, qualification for the standstill in each case would be determined by creditor agreement. Payments subject to the standstill need to be sufficiently comprehensive to give meaningful liquidity relief to the corporate sector. Exclusion of payments on trade financing and short term working capital may be acceptable to other creditors, in the interests of preserving the core operational capacity of the debtor firm.

- **Temporary**—An indefinite standstill would be unacceptable to creditors and would risk deferring the second-phase debt restructuring that would need to be conducted as

[26] While government-imposed payment moratoria would in principle give corporate debtors temporary relief from systemic liquidity pressures, such measures would give rise to economic distortions and cannot substitute for necessary debt restructuring. Legal limitations (e.g., the EU law rules on capital liberalization) and risks of litigation, especially in foreign courts, may constrain the legal viability of government-imposed payment moratoria as part of a debt restructuring strategy. Furthermore, to the extent that payment moratoria constitute a restriction on the making of payments and transfers for current international transactions, they would entail an exchange restriction subject to IMF approval. The definition of current payments under the Fund's Articles of Agreement includes interest and "moderate amortization of principal" on loans.

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soon as is feasible. A time period of 6 months (with possibility of limited extension) may strike the right balance to allow sufficient time (i) to rehabilitate the banking sector and for macro policies to take hold; and (ii) to afford creditors the opportunity to advance assessment of the viability of the respective corporates by professional advisors. However, in order to provide some degree of discipline on debtor behavior against dissipating assets during the standstill period, creditors would need to be able to agree to lift the standstill at any time.

- **Incentives**—To the extent that fiscal space permits, some government financing of working capital for participating corporate borrowers would be conducive for debtors and creditors. Also, participation may present creditors with the near term advantage of improving the liquidity of their debt instruments, where tradable. Downside risks of non-participation include unpredictable and lengthy bankruptcy procedures resulting in further value destruction (which might otherwise be avoided).

- **Focused legal and institutional reforms**—Positive expectations of an orderly exit would enhance effectiveness of the standstills. Accordingly, during the standstill period, reform of the corporate insolvency laws should be focused on facilitating pre-packaged restructurings that could emerge after the standstill period; specifically, to allow a qualified majority of creditors to be able to bind a dissenting minority to a restructuring agreement. In addition, governments should take the opportunity during the standstill period to advance guidelines for out-of-court restructurings.

39. ***Other Government involvement in new financing***. New financing is critical to continue the operation of a firm's business and, as far as possible, to maintain its going concern value while the firm is rehabilitated.[27] Both legal and financial considerations affect the availability of such new financing.[28]

40. One potential line of government intervention is in reform of the insolvency law to induce new financing by maximizing alternatives for according such financing with a legal priority in payment ahead of pre-existing debts. However, legal reforms to provide new financing with a "priming lien" on already collateralized assets of the debtor may in practice

[27] Such new financing is known as "post-commencement financing" when provided after commencement of insolvency proceedings. It is also known as "DIP financing" following the common term of financing provided to a debtor-in-possession (i.e., a firm whose management remains in place during the insolvency proceedings) under U.S. Chapter XI reorganization proceedings. See further UNCITRAL *Legislative Guide to Insolvency Law*, pages 113 to 118.

[28] For example, the proliferation in financing agreements of negative pledge clauses that restrict collateralized new financing has been noted as complicating negotiation of new financing in debt workouts. Also, the application of modern day financing techniques involving contingent exposures such as swaps and derivatives, where the value of positions fluctuate, has complicated the determination of "new financing" (a concept originally developed in the simple context of loan agreements). See further, Nicolas Frome, "Multicreditor restructurings in Transition Economies: Lessons from Developed Jurisdictions," available at www.sof.ebrd.com/comity/law/involve/about/matter.pdf.

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be ineffectual to the extent that asset prices have deteriorated so far that there is no equity cushion available in the collateral.[29] Furthermore, even in insolvency laws effectively designed to catalyze new financing, a crisis related freeze in credit markets can price new financing beyond the means of firms.[30]

41. Should governments instead substitute for private credit markets and provide new financing on terms within the reach of viable firms? Unlike new financing from the private markets, demand for government financial support of individual firms may be highest in the crisis containment phase where determination of individual firm viability is elusive—In that context, the preceding discussion of limited government financing to facilitate standstills seeks to articulate a circumscribed framework with objective criteria. Absent such criteria, a risk is that ad hoc decision-making in selective government financing to individual firms would politicize eventual debt restructurings and add to market uncertainty potentially beyond the span of the crisis.[31] The rationale for government financing in this context is distinct from the market-based new financing, and given its unpredictable contours, it should be approached with caution.[32]

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[29] For example, this issue was encountered in the aftermath of Japan's financial crisis in the early 2000's. Although, Japanese law (unlike the U.S. Bankruptcy Code) did not explicitly provide for a "priming lien" as an additional inducement to post-commencement financing, amendment of the law would have been largely academic in the context where asset prices had depreciated so far that equity cushion in collateralized assets was not available.

[30] For example, while U.S. bankruptcy law is widely recognized as providing a highly supportive framework for DIP financing, such financing dropped off markedly, affected by the overall freeze in credit markets. While DIP financing in the United States is reported to have somewhat rebounded during the latter part of 2009, it has become more expensive relative to pre-crisis times. The fall in DIP financing in the United States has been explained by a number of factors, including the difficulties major providers of DIP financing have themselves experienced following Lehman Brothers' exit from the DIP financing market. A further factor adding to the difficulties companies face in obtaining DIP financing in the United States has been the highly leveraged position of many companies prior to the crisis, so that when they fall into trouble there is often limited collateral remaining which can be pledged as security for DIP financing. See Ben Levisohn, "Fewer Lifelines for the Bankrupt" *Business Week*, January 16, 2009; Michael Merced, "GM says financing would costs $100 billion, but many doubt it" *International Herald Tribune*, February 20, 2009.

[31] For example, this concern has been highlighted in the arguments of secured creditors, who were effectively subordinated to unsecured creditors, within the government financed rescue of Chrysler and General Motors. Notably, the U.S. bankruptcy court in approving the sale of Chrysler's assets to Fiat acknowledged: "The decision of the U.S. Treasury and Export Development Canada to fund the Fiat Transaction is a political issue that is motivated, in part, by noneconomic considerations. The Governmental Entities have made the determination that it is in their respective national interests to save the automobile industry, in the same way that the U.S. Treasury concluded that it was in the national interest to protect financial institutions." *In re Chrysler LLC* Case No. 09B 50002 p 30...See, further, Nicole Bullock, "Painful Lessons for Lenders in Chrysler Debacle" *Financial Times*, May 7, 2009.

[32] In contrast to voluntary government financing, governments may be "involuntary creditors" through corporate tax arrears. Although the short term public revenue considerations may be particularly pressing in the aftermath of a financial crisis, addressing those considerations through use of an insolvency law as a tax collection mechanism

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42. ***Differing intervention with respect to SMEs***.[33] Small and medium enterprises (SMEs) may warrant differing treatment from other firms in a debt restructuring strategy. First, given the sheer number of SMEs, the banking and court systems are unlikely to have the capacity to efficiently restructure distressed SME debt on a case by case basis.[34] Second, as SMEs are often in aggregate substantial employers of low-income individuals, failure of the SME sector may have a severe impact on low-income families, with social consequences that could further complicate management of the economic situation.

43. Separate frameworks for resolution of SME debt may include government-imposed standard restructuring terms through, e.g., specified grace periods for repayment, and schedules for interest rate reductions. Government guarantees could be used to facilitate new financing by banks under defined circumstances. Government financing directly into the SME sector may be warranted where banks are unreliable or inefficient agents for channeling financing.[35] Especially where government financial support is in play, objective diagnosis of the underlying problem remains important—in particular, the urge to approach SME distress resulting from a general reduction in consumer demand through indiscriminate government injection of credit to the SME sector should be resisted.

44. ***Relationship of Bank Restructuring to Corporate Debt Restructuring.*** [36] Notwithstanding the increased presence of non-bank financial creditors in some countries,

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may be problematic in the longer term. In particular, provisions in insolvency law that give per se priority to the recovery of domestic tax clams over other unsecured creditor claims can contribute to complacency and inefficacy of the tax authorities in general tax collection. Furthermore, the presence of the tax authorities as a priority-ranked creditor, with limited orientation towards advancing timely rehabilitation of viable firms, would tend to delay debt restructurings and dampen incentives for other creditors to engage proactively in early resolution of the debt problems. However, due to legal constraints, tax collection policy or fiscal limitations, tax authorities may legitimately prefer different instruments or forms of debt restructuring, e.g., through extension of maturities, rather than debt write-off.

[33] See, further, Adams., et al., Eds., *Managing Financial Corporate Distress, Lessons from Asia* (Washington: Brookings Institution), 2000.

[34] In this respect, SMEs share characteristics with the restructuring of household debt. On techniques for household debt restructuring, see the IMF Staff Position Note, *Principles for Household Debt Restructuring*, 2009, by Luc Laeven and Thomas Laryea.

[35] Korea's concerted response to wide scale SME debt distress during the Asian financial crisis included requiring banks to rollover SME loans due by a certain date and provide grace periods for the repayment of other loans. There were also some provisions for interest rate reductions. Larger and stronger banks were required to provide new financing. In addition, the government itself made working capital directly available to SMEs and established a number of investment funds to provide debt and equity financing for potentially viable SMEs (convertible bonds and debt-equity swaps). These investment funds were managed by foreign investment banks but financed by domestic banks.

[36] This section was drafted with the assistance of David Grigorian (MCM). Techniques for bank restructuring, including explanation of the need for a bank resolution framework distinct from the general corporate insolvency law, are beyond the scope of this note. For a discussion of such techniques and relevant considerations in normal

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rehabilitation of the banking sector remains a key priority in order to pull through the crisis containment phase and to facilitate subsequent corporate debt restructuring.

45. While corporate debt workout is in the longer-term interest of banks, they must first support their own viability and establish loss absorption capacity. The drain on bank capital due to the first wave of a crisis, coupled with the existence of a number of creditors that require some degree of debt restructuring may lead to curtailment in lending (to both viable and non-viable firms) thus exacerbating the impact of the crisis.[37] Weaknesses in the banking sector could prolong the restructuring of the corporate debt: the weaker the banks are the less likely that the corporations will negotiate to restructure their distressed debt as the latter may expect to be better off negotiating with failed rather than operating banks.[38]

46. Banks tend to prefer a market-based system of debt restructuring in order to avoid costly court-based bankruptcy procedures.[39] Typically in a systemic crisis, the incentives of the banks alone are not sufficient to secure a speedy and efficient restructuring of corporate debt. Coordination failures and externalities may inhibit progress.[40] Government's intervention in securing the availability of resources and the right set of institutional arrangements for negotiating parties is commonly required.

47. Bank recapitalization, involving some use of public funds, has been a common feature to restore capital depleted by widespread corporate defaults and to allow banks to take longer

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and crisis times, see *Overview of the Legal, Institutional and Regulatory Framework for Bank Insolvency,* by IMF and World Bank, April 17, 2009, available at www.imf.org/external/np/pp/eng/2009/041709.pdf .

[37] Franks and Sussman show evidence of this for a large sample of debt workouts between UK banks and corporations. See Julian Franks and Oren Sussman, "Financial Distress and Bank restructuring of Small to Medium Size UK Companies," *Review of Finance*, Vol. 9, pp. 65-96, 2005. See, also, Anne Krueger and Aaron Tornell, "The Role of Bank Restructuring in Recovering from Crises: Mexico 1995-98," NBER Working Paper No. 7042, 1999, which draws similar lessons specifically from the Mexican experience.

[38] This may in part explain the appearance of strategic corporate loan defaulters in time of banking distress.

[39] Costs associated with diverting management time and effort away from running the firm, among other agency costs related to bankruptcy, have been highlighted by Jensen and Meckling. See Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics*, pp. 305-60, 1976.

[40] An example of a failure to achieve an efficient outcome is related to the degree of concentration of ownership claims. Dispersed claim holding by the banks makes it harder for the borrower to negotiate better terms and may lead to asset grabbing and creditor runs. Concentrated claim holding, on the other hand, may result in the bank losing interest in the going-concern value of the corporate debtor and liquidating it prematurely in order to ensure full recovery of the value of the loan. In addition, corporate debt restructuring could be more challenging in cases with material presence of non-bank financial institutions, such as hedge funds, with differing incentives from those of banks that could complicate the coordination of creditor action.

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term rational decisions on corporate debt restructuring.[41] Capital shortfalls should be based on stress tests, including conservative scenarios on the performance of loans. Subjecting the injection of public funds to some degree of corporate debt restructuring could be considered, provided that introduction of such feature does not delay bank restructuring.

48. Some additional government measures to promote bank restructuring and support the role of banks in corporate debt restructuring include:

- Government support for setting up specialized advisory and investment banking services to facilitate negotiations between banks and corporations and minimize coordination problems;[42]
- Offering tax and other financial incentives to banks (including to AMCs, see below) to expedite out-of-court debt restructuring;[43]
- Using supervisory powers to require banks to disclose claims to relevant negotiating parties; lack of transparency could otherwise delay outcomes of debt negotiations;
- Ensuring strict enforcement of existing NPL classification and other regulatory guidelines to strengthen the banks' incentives to participate in debt restructuring;[44]
- Defining a clear and concise timetable for various stages of the debt workout process. To achieve maximum participation from both sides and minimum disruption along the way, supervisory penalties for non-compliance could be imposed.

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[41] All nine corporate debt restructuring studied by Stone included some government-sponsored bank recapitalization: (Chile, 1981; Hungary, 1991; Indonesia, 1997, Korea, 1997; Malaysia, 1997; Mexico, 1981; Mexico, 1995; Poland, 1993; Thailand, 1997. See, *Large Scale Post-Crisis Corporate Sector Restructuring*, by Mark Stone, 2000. Indecisive action in the recognition of losses and recapitalization of banks has been a factor cited as prolonging the debt adjustment process in Japan during the 1990s. See, for example, Stijn Claessens, Simeon Djankov, and Daniela Klingebiel, "Financial Restructuring in East Asia: Halfway There?" *World Bank Financial Sector Discussion Paper* No. 3, 1999.

[42] An example is the Corporate Debt Restructuring Committee (CDRAC) in Thailand. In principle, such government support could be through establishing government advisory agencies or providing financial support to present or new-entrant private financial institutions offering specialized investment banking services.

[43] Attaining a low-interest rate environment could have similar implications to providing government-subsidized loans to banks to facilitate the debt workout.

[44] While not best-practice, regulatory forbearance, e.g., in the form of easing of provisioning requirements has been adopted in some circumstances to incentive restructuring of mounting nonperforming loans. Experience suggests that such forbearance may only work in the framework of a comprehensive and credible bank restructuring program that entails capital injections from bank shareholders. Nonetheless, in view of the potential for moral hazard and conflicts of interest, regulatory forbearance is risky even in the context of a bank restructuring program. Thus, consideration by banking authorities of regulatory forbearance in this context should be approached with great caution and only in exceptional circumstances.

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49. The cross-border dimensions of bank operations may complicate the design and implementation of government intervention. Capacity to exercise regulatory suasion over foreign banks and their affiliates may be limited—e.g., compromising the level of adherence to government sponsored workout guidelines. Where public financial support to the banking system is related to debt restructuring programs relieving the industrial or household sectors in one country, burden-sharing these costs among governments can present a major unresolved challenge. However, the presence of foreign participants in the banking system can in certain circumstances support debt restructuring by enhancing financial resources and technical expertise that can be put into the debt restructuring effort.[45] Finally, although a large presence of foreign owned banks may in effect result in a higher aggregate share of the adjustment burden on foreign creditors, strategies that intentionally target foreign creditors should be avoided in view of the negative effects on access to international credit and investment which could be needed to sustain economic recovery.

50. Asset Management Companies (AMCs) have been used to spearhead the restructuring of corporate debt (with a view to maximizing asset recovery and supporting rehabilitation of viable corporates overtime) as well as to support the recovery of the banking sector (through transferring out bad assets, causing banks to recognize losses and allowing banks to focus on their core business). Where AMCs are established to manage assets from open (rather than closed banks) the price for removing the assets is a critical operational issue that can delay restructurings where banks seek to avoid marking down their assets or transferring potential upside to a third party.[46] Conversely, the market valuation of assets on the AMC's books is critical to set a benchmark to measure the AMC's recovery rate on transferred assets.

51. AMCs have proved relatively more effective in corporate debt restructuring episodes when there are a large number of troubled corporations, relatively homogeneous loans, or where AMCs bring specific restructuring expertise unavailable in the banks. Openness to leveraging international technical expertise to bolster local experience is also a comparative lesson for the effective use of AMCs.[47]

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[45] In this respect, the presence of foreign banks in the Latvian banking sector appears to support the relative prospects of corporate debt restructuring in that country.

[46] AMCs should normally purchase assets at market value (or another appropriate price such as the estimated long-term recovery value). Where public resources are used to purchase assets at relatively higher prices, this provides a non-transparent public subsidy to bank shareholders, concealing the cost of recapitalization. See, further, IMF/World Bank, *An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency* .

[47] In a comparative study of AMCs in seven country cases (Finland, Ghana, Mexico, the Philippines, Spain, and Sweden), Klingebiel concludes that the Swedish AMC was relatively more successful as an agent of corporate debt restructuring due to the some special circumstances: the assets acquired were mostly real estate related (which tend to be easier to restructure that manufacturing assets), and were a small fraction of the banking system which made it easier for the AMC to maintain its independence from political pressures and to sell assets back to

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52. In terms of their institutional structure, AMCs could be government-sponsored, private, and hybrid. In general, the choice of a particular structure depends on a number of factors, including types of assets, magnitude of the problem, depth of markets, and characteristics of debtors.[48]

53. Experience with government-sponsored AMCs has been mixed due to difficulties in balancing their conflicting public and market objectives. In particular, the governance structure to ensure independence of its operations, freedom from political interference, and accountability for the AMC's performance can be a difficult challenge. The effectiveness of government-sponsored AMCs is enhanced by subjecting their operation to clear sunset clauses. The case for government-sponsored AMCs is relatively stronger when the size of the debt restructuring problem is acute relative to the capacity of the private sector or special legal powers are needed to promote debt restructuring.[49] While government sponsorship may enhance the AMC's ability to resolve debt disputes quickly, it can be politically contentious and the use of special legal powers may distort the system of property rights.[50] In addition, government-run AMCs could be disadvantaged in that private information about the borrower may be lost (or difficult to transfer) when the assets are moved to the AMC.

54. Private AMCs, particularly where compensation structures are aligned to maximizing value in the recovered assets, tend to execute their functions more efficiently. However, where banks establish their own private AMCs, reliance on these vehicles should be assessed with caution by regulators given the risk that they be used by banks to cover up problems on their balance sheets. Notwithstanding some of the attractive features of private AMCs, funding for such operations can be constrained during, or following crises.

55. An innovative way of approaching asset management could be through hybrid public-private AMCs, leveraging both public and private resources and expertise. Examples are the recent initiatives to establish the Industrial Revitalization Corporation of Japan and the International Finance Corporation's Distressed Assets Recovery program, which raised funding and expertise for asset recovery efforts from both public and private sources.

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the private sector. See Daniela Klingebiel, *The Use of Asset Management Companies in the Resolution of Banking Crises: Cross-Country Experiences*, 2000.

[48] See further, Stefan Ingves, Steven A. Seelig, and Dong He, "Issues in the Establishment of Asset Management Companies," IMF Policy Discussion Paper No. 04/3, 2004.

[49] According government-sponsored AMCs with such special legal powers may be warranted in cases where the legal framework for the enforcement of creditors' rights is inherently weak or has been rendered dysfunctional by the effects of the systemic crisis.

[50] At a minimum, the granting of special legal powers should be temporary, fully transparent, and subject to proper oversight and mechanisms for judicial review.

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56. Thus far in the current crisis, reliance on AMCs has been limited.[51] However, some countries have established broader asset management programs,[52] including programs directed to removing distressed assets out of the balance sheets of banks,[53] while other programs have entailed guaranteeing high quality assets to support bank liquidity.[54]

V. Drawing Together Key Principles

57. The following principles merit emphasis in tailoring the design of a comprehensive corporate debt restructuring strategy to country circumstances:

Sequencing

58. **The sequencing and relative prioritization of policy measures relevant to a debt restructuring strategy will need to evolve over the course of a systemic crisis and its aftermath.** While it is important that a comprehensive debt restructuring strategy be envisioned at an earlier stage, concerted implementation of that strategy cannot be realistically sustained during the height of a crisis. However, given that changes to insolvency laws and the underlying institutional structure take time to effect, country authorities need to begin diagnosis of the debt problem and to anticipate the legal bottlenecks at an early stage. Furthermore, the onset of a crisis could present an opportunity for the authorities to galvanize relevant stakeholders into reform mode. Early and credible government commitment to engage in this process can reinforce positive expectations of market participants. Such expectations must, however, be managed since wide scale corporate debt restructurings in a wake of a crisis may take many—often difficult—years.

Crisis containment phase

59. **Rehabilitation of the financial sector is a first order priority.** Specifically, banking system dislocation must be contained and banks need sufficient capital to revive lending and to be in a position to restructure debt in the subsequent restructuring phase. In order to move

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[51] Ireland has recently established the National Asset Management Agency, a government-sponsored AMC primarily dedicated to property development loans; Germany established special purpose vehicles to take on illiquid structured assets and "bad bank" public entities to deal with risky assets and non-essential business operations; and Iceland has enacted legislation to enable establishment of a government-sponsored AMC to support restructuring of nationally significant firms.

[52] See IMF staff paper *Stocktaking of the G-20 Responses to the Global Banking Crisis*, March 13-14, 2009, available at www.imf.org/external/np/**g20**/pdf/031909b.pdf.

[53] For example, the public Private Investment Program in the United States.

[54] For example, the announced asset management programs in Australia, Canada, and Japan. In contrast, the UK Asset Protection Scheme is a guarantee scheme targeting losses on risky assets.

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the process forward, governments would likely need to step in to enforce timely recognition of losses and to recapitalize banks, where shareholder recapitalization is not feasible.

60. **A path towards macroeconomic stability is critical.** Debt restructuring can reinforce macro policies. But reasonably predictable asset prices, interest rates, and exchange rates are needed to enable debtors and creditors to make medium term judgments of viability required for restructuring on any sustainable scale. While insolvency law is needed—and reforms should be advanced where possible during the crisis containment phase—insolvency law is no substitute for macro policy responses.

61. **Where feasible, reform of the insolvency and other related laws should focus on provisions to support out of court restructuring.** In particular, enabling a court in an expedited manner to make an out-of-court agreement that is accepted by a qualified majority of creditors binding on dissenting creditors is key; as are provisions to support new financing by according it with a legal priority in payment.

62. **In extreme cases, government financing to facilitate voluntary standstills on payments could be a useful interim measure in the crisis containment phase, prior to wide scale debt restructuring.** Governments could provide limited financial support for working capital as an incentive for temporary standstills agreed between corporate debtors and their respective creditors that would preserve liquidity in the corporate sector while the ground work for debt restructuring is laid.

Restructuring phase

63. **While all country experiences of wide scale debt restructuring have been mixed, some government intervention moderated to complement case by case negotiations tends to be relatively more effective.** Such an intermediate approach should be tailored to the country circumstances, including macroeconomic conditions, composition of debt and legal/institutional framework. A different mix of tools may be needed with respect to SMEs, which may call for more across the board treatment—but caution should be exercised against throwing financing at non-viable SMEs in the face of reduced consumer demand.

64. **The debt restructuring strategy should respect inter-creditor equity and avoid targeting foreign creditors.** The longer term effects of disruption in financial relations resulting from a crisis could be exacerbated by debt restructuring strategies that overturn pre-determined rights (such as the priority ranking of secured creditors). Furthermore, the targeting foreign creditors in debt restructuring strategies would be short-sighted in view of the longer term access to international credit and investment needed to sustain post-crisis economic recovery.

65. **Government-sponsored out of court workout guidelines are conducive to maximize debt restructuring for viable firms.** To be optimal in the aftermath of a crisis,

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such guidelines will likely need to operate in a structured framework involving government enhancements, such as regulatory suasion on banks to sign on to the workout principles.

66. **AMCs may help to spur corporate debt restructuring.** However, the establishment and operation of AMCs present a number of design challenges, in terms of governance structure and pricing of assets. Consideration of AMCs is particularly warranted where the financial and technical capacity of banks are insufficient to address corporate debt restructuring reliably.

67. **Liquidation of non-viable firms cannot be avoided.** Firms exposed as non-viable should be eased out of the market place through speedy liquidation procedures and their assets recycled to more productive use in the economy. Government intervention directed to salvaging non-viable firms would present an undue drag on public finances and on the efficient recovery of the economy.

68. **Risks to public finances from government intervention in debt restructuring should be contained.** The scale of financial distress in the corporate (as well as banking and household) sectors and the unreliability of market-based solutions alone, imply that some government financial support for debt restructuring would be inevitable. However, fiscal space limitations cannot be overlooked. A well-designed intermediate approach would leverage private capacity to burden share between debtors and creditors, and conserve use of limited government financial resources.

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Annex A: Features of Out-of-Court Corporate Restructuring Processes

Feature	*Indonesia*	*Korea, Rep. of*	*Malaysia*	*Thailand*	*Czech Republic*	*Turkey*	*Mexico*	*Brazil*
Name of initiative or coordinating body	Jakarta Initiative Task Force (JITF)	Corporate Restructuring Coordination Committee (CRCC)	Corporate Debt Restructuring Committee (CDRC)	Corporate Debt Restructuring Advisory Committee (CDRAC)	None	Istanbul approach	Unidad Coordinadora del Acuerdo Bancario Empresarial (UCABE)	None
Basic approach	Forum for negotiations, followed by adoption of time-bound mediation procedures	Forum for negotiations	Forum for negotiations	Forum for facilitation, superseded by contractual approach (debtor-creditor agreements)	None	Forum for negotiations, superseded in the fall of 2001 by a legal approach (Law on Corporate Debt Restructuring)	Promotion of a voluntary debt workout program for the largest 40 corporations (only about 10 percent of all bank lending)	None
Onset of the crisis	Late 1997	Late 1997	Late 1997	Late 1997	1997	February 2001	Late 1994	January 1999
Resolution of inter-creditor disputes	No special procedure	Possibility to have loan of opposing creditor purchased; also arbitration committee consisting of private experts	Nothing special, apart from persuasion by central bank	Three-person panel to attribute differences, but any concerned creditor can opt out	No established framework for creditor coordination; efforts to reach settlements frequently undermined by minority and dissenting creditors	None	Possibility to form a *convention*; all creditors are treated equally and decisions bind all creditors	No possibility of consensual resolution among parties or establishment of creditor committees
Default structure for failure to reach agreement	JTIF may refer uncooperative debtor to government for possible bankruptcy petition	Foreclosure, liquidation through court receivership	Foreclosure, liquidation or referral to asset management company with super-administrative powers	If less than 50 percent support the proposed workout, debtor-credit agreement obliges creditors to petition court for collection of debts	Regular bankruptcy	Regular bankruptcy	Criminal bankruptcy procedures or "suspension of payments" to banks permitted by courts	Financial institutions not allowed to invoke insolvency relief pledge for secured debt; unsecured debt can be deferred or reduced (*concordat*)

Source: Stijn Claessens, 2005, "Policy Approaches to Corporate Restructuring around the World: What Worked, What Failed?" in *Corporate Restructuring: Lessons From Experience* (Washington: World Bank), p. 16.

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