

# The restructuring revolution in the Asia-Pacific region

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The reform of corporate restructuring and debt restructuring practices in the Asian region following the 1997 economic crisis may well be described as a restructuring revolution. There has been a dramatic improvement in most jurisdictions in insolvency systems and credit risk management. In many cases the evidence of this is quite simple: countries which previously did not have insolvency systems, or which had systems that were outdated or rarely used, have developed modern, well-utilised insolvency systems that can in some respects be regarded as on the cutting edge of global developments. The improvement in risk management practices is evident from the fact that loose and outdated loan classification criteria have been revised so that a more accurate assessment of a country's level of non-performing loans can be made. In both cases, however, abuses endure, and rarely is there no room for criticism; but overall, the improvement is marked.

The period of significant change in the last eight years in Asia is perhaps best described as a restructuring revolution rather than an insolvency revolution, as most of the progress has centred on the development of corporate rescue regimes and informal workout practices. Following the economic crisis, many Asian countries began to reform their corporate insolvency, restructuring and debt recovery laws and procedures as part of a strategy to remedy legislative and institutional weaknesses and strengthen their financial and corporate sectors. In large part, the focus has also been on establishing limited-life, specialised bodies such as asset management companies and creating special legislative environments to facilitate investment in distressed assets and bulk sales of non-performing loans by financial institutions.

The level of understanding of insolvency and the way it should be handled has undoubtedly increased. However, the stigma associated with insolvency is still significant – there is not yet a culture of early admission of financial difficulties and an open, collective approach to deal with them.

## The implementation gap

The implementation gap between the design and implementation of laws remains in most developing economies. The focus of law reform has often been overly complex. Highly developed laws for asset management companies, cutting-edge rehabilitation laws and specialised laws to facilitate investment in non-performing loans and distressed assets have been enacted in countries where there remains no effective liquidation procedure, as well as limited and ineffective secured transactions laws and poor corporate governance. While there has been some effective development of systems, the same underlying problems often remain – fundamental elements of the systems have not been developed in many countries. The first steps have been taken, but there is still a need to focus on some of the fundamentals of an efficient insolvency and creditor rights system. For example, liquidation

procedures are perhaps the oldest and most successful form of insolvency procedure. In many developing economies, there has been an inadequate focus on the development of liquidation procedures as the backbone of the insolvency regime. In contrast, ineffective and slow rehabilitation procedures have also caused good businesses to collapse while waiting to complete the process.

In addition, the capacity of courts, government agencies and regulators to apply insolvency and restructuring laws is improving in many countries, and a new breed of consultants, bankers and executives has developed with a fuller understanding of the techniques and approaches to corporate insolvency and distress – inevitable consequences of corporate business activity in a market system.

In many of the developing economies in Asia, a continued lack of transparency and information frustrates risk management efforts by financial institutions. While some banks have developed ahead of others, the development of international credit risk management processes has often been inadequate. Of equal concern in some developing economies is the nature of some of the present lending activity, especially where there has been a significant and rapid credit expansion. Short institutional memories are already leading to reckless lending and poor risk management practices, similar in some respects – but also probably more diversified and complex – than those which characterised the pre-Asian crisis situation.

Credit information systems have developed with varying degrees of success. In some developing countries, these seem to focus on good information about loans made rather than bad information about defaults. Moreover, even in countries which have made significant progress in development, these systems barely scratch the surface in grappling with the complex group structures used by many borrowers in Asia, where family ownership and complex corporate structures are commonplace. Rarely is the information held on these systems of adequate detail to be substantively useful.

### **The fiction**

It is now *passé*, although still clearly true, to say that much of the restructuring that has occurred in Asia has been fictional rescheduling of debt without any realistic expectation that the debtor will be able to

comply in full with the revised timetable for repayment, and without any serious attempts at operational restructuring or other real restructuring techniques. Many restructuring plans do not truly focus on the viability of the business; rather, they are simply a rescheduling of debts with no real expectation that the debtor will be able to comply with the rescheduled debt reduction programme – in particular, the significant ‘balloon’ payment which is a common feature of many restructurings. Many formal rehabilitations do not enable the debtor’s business to continue in existence with a fresh start, free and clear of unsustainable debt. Creditors often use restructuring negotiations as a means to extract additional security, equity or fees when they are not truly committed to the long-term restructuring and do not expect that the debtor will be able to comply with the restructuring plan.

Debt-for-equity swaps are being used as a mechanism for creditors to avoid having to write off their lost investment. There is justification for a debt-for-equity swap if there is perceived to be some possibility that the shares in the insolvent company will one day have value. However, in some restructurings this is not the case – the debt-for-equity swap can be simply a mechanism to hide the lost investment for a few years as there is no real expectation that the company will be able to comply with the restructuring plan.

The inability of some banks in the immediate post-crisis period to take ‘haircuts’ on debts due to the consequent effect on the bank’s balance sheet has skewed the structuring of many restructuring plans. Some central banks allowed financial institutions to amortise losses from restructurings over time in order to spread the effect of the write-down. This represents an acknowledged fiction, although it does provide a useful incentive to entice banks to move forward with restructurings that involve some write-down or other loss. Where asset management companies have been successfully used, they have commonly been accompanied by a concession granted to the transferring banks which allows them to amortise their losses on sale over many years, as an incentive to encourage the banks to sell their debts. The result is that the banks’ balance sheets do not accurately state their true position, as they carry assets which are not real and do not record losses which have already been suffered.

It is also *passé*, although again completely true, to say that official non-performing loan statistics issued by central banks often do not tell the full story of the level of non-performing loans in an

economy. Often these figures, by their nature, relate only to loans in the financial sector or loans issued by certain financial institutions. They rarely include loans transferred to asset management companies or other vehicles. This is not a failing of the statistics, as they report exactly what they are intended to: the level of non-performing loans in the financial sector assessed under applicable loan classification criteria. However, declines in the official non-performing loan figures are often interpreted and reported as representing the status or progress of restructuring in an economy. This is entirely misleading.

One of the biggest misconceptions and risk areas in the financial sectors of several Asian countries relates to restructurings of non-performing loans which have not been completed, but which have still been allowed to be reclassified as performing. In a number of corporate restructurings the deals made between the debtor and its creditors are subject to a number of conditions precedent, such as the granting of new security or re-registration of pooled security to secure the combined restructured advances of the creditors; but many of these conditions precedent have not been completely satisfied (eg, securities have not been properly perfected). Bankers have gone to their credit committees for approval to do restructuring deals on certain terms including the satisfaction of these conditions precedent, but in reality the conditions precedent have never been completed. In the event of default, banks will not be in the position that they and their credit committees think they will be in. This has occurred partly due to the administration of restructurings by banks. Often, once the deal is agreed and debt restructuring agreements signed, responsibility for finalising all remaining aspects of the deal is transferred to another department in the bank, such as the department which handles the security agent functions. The heat is off, as the loan has been reclassified, and there is little incentive or pressure to force the debtor to complete all terms of the restructuring deal. Central bank requirements, at their best, require that the debtor make payments under the restructuring plan for a few months before the loan can be reclassified; at their worst, they allow the loan to be reclassified on the smell of a restructuring, such as the agreement of a non-binding term sheet. Few actually ensure that the deal is fully completed. Central banks have allowed the banks to reclassify the loans as performing, and there has not been adequate investigation to ensure that all aspects of the proposed deal have been documented and perfected.

### The strategic defaulters

The ineffectiveness of the legal systems in a number of developing countries created instances of a culture of non-payment in the immediate post-crisis period. Borrowers believed they would never have to repay borrowed money. This period also saw the evolution of the so-called 'strategic debtor' – the debtor which is able to pay but chooses not to, since it cannot be compelled to in practice. Many of these debtors were able to achieve rescheduling agreements with their creditors.

It was feared that many of the restructurings based on such reschedulings entered into in the first few years after the crisis would fail and would need to be reworked. This is already occurring. Many plans contained forecasts based on unrealistic hopes of economic recovery, booms in certain markets, expansion of export markets, ability to secure new capital investment and other dreams that have not materialised. Interestingly, default under a plan has rarely had drastic consequences for the debtor; in fact, it has often resulted in the agreement of a reworked plan which is less onerous for the debtor.

However, these repeat restructurings are not remarkable. Rather, they are to be expected and are a natural consequence of an attempt to enter into a restructuring plan for a long period, say of 10 years or more. It is impossible to make accurate economic or financial forecasts over such a long period. In any 10-year plan, the parties must acknowledge that they will need to rework the plan at some point – possibly many times – as circumstances change. However, parties have preferred to enter into these long-term plans rather than a short-term plan for, say, the next two years which sets out clear requirements for those two years and provides for another round of negotiations at the end of the period to establish the provisions for the next short-term period.

### The disguised moratorium

Often in restructurings there is an initial period called a moratorium where things are frozen or stayed. Reschedulings may be viewed as an extension or adaptation of the moratorium. As one banker said, "We will do the rescheduling now and then do the restructuring next time they default." If the macro-objective since 1997 has been to achieve stability, at least in the short term, as well as satisfying stated requirements of the international agencies that assisted Asian countries

following the crisis, then restructuring has been a success. Grudgingly, it must be accepted that reschedulings may serve a useful purpose. The sad aspect is that many of them are drafted and agreed by stakeholders, knowingly or ignorantly, as fictions – that is, as though the parties expect the debtor to comply. If what is really intended is an extended moratorium, with additional security and fees being paid by the debtor during the moratorium period, then this is how the deal should be framed. The nonsense is when any restructuring, regardless of whether it is achievable or not, is allowed to permit the loans to be reclassified as performing. This, rather than the rescheduling itself, is what will haunt economic development in the years to come.

### **The plagued courts**

A number of countries have established specialised courts or court divisions to handle insolvency cases or have designated particular courts and judges to handle these cases. These measures, while often initially successful at speeding up the consideration of cases, have been plagued by constitutional and jurisdictional problems, the ease with which temporary restraining orders are issued, corruption of judges, inconsistent interpretations of the law, the build-up of caseloads, rotation of judges and delay tactics by crafty counsel and recalcitrant debtors.

### **The design battle**

In many developing Asian countries, the absence of strong, efficient and well-understood insolvency and creditor rights laws to underpin, incentivise and implement realistic restructuring efforts has limited much of the long-lasting utility of restructuring that has taken place.

Aside from the rush of legislative reforms in the immediate post-economic crisis period, insolvency law reform has been slow in a number of developing economies such as Thailand and the Philippines, and even slower in some of the more developed economies such as Hong Kong, China and Singapore. The design battle between pro-debtor and pro-creditor systems has been lost by all, with delay the only result and loss of value a side effect, as long-awaited and endlessly debated proposed laws have failed to make it onto the statute books.

The progress of legal and institutional reform has varied greatly across the region in the last year.

New insolvency laws were passed in 2004 in Indonesia and Vietnam, and progress has been made in finalising the eagerly awaited Enterprise Insolvency Law in the People's Republic of China. However, bankruptcy law reforms in Thailand and the Philippines have stagnated, as has the long-heralded proposed streamlined corporate rescue regime in Hong Kong, China known as 'provisional supervision'. Singapore's anticipated omnibus legislation has also progressed slowly.

As discussed above, there has also been little development of civil remedies and secured transaction regimes, and related court processes. In many countries, the enforcement of security can take many years, even decades. In a number of developing countries, secured transaction laws are outdated and do not permit a sufficiently broad spectrum of assets to be given as security. High registration, transfer and other fees and taxes also limit the utility of securities in some countries. The application of concepts of adequate protection for secured creditors in bankruptcy regimes has been limited. Rarely has a secured creditor been allowed to enforce its security in a rehabilitation case by showing that its security is not being adequately protected.

Nationalistic concerns have led to an excessive focus on developing individual systems without an acknowledgment of the benefit of having similar systems on a regional and global basis. The undeniable logic of this seems to be easily accepted in the context of risk management and the Basel Accord, but appears to be resisted at the micro-level of debtor and creditor relationships and insolvency systems. Cross-border insolvency systems have not been developed to date, despite the focus on them by institutions such as the United Nations Commission on International Trade Law, the World Bank and the Asian Development Bank. There have nonetheless been some movements in this direction, such as the adoption in Japan of a cross-border insolvency law and the conclusion of bilateral cross-border insolvency country treaties (eg, the Malaysia-Singapore treaty).

There is an inadequate focus on the long-term development of systems. Instead, the focus is on balancing short-term interests without understanding that, even if systems put in place in the short term do not work perfectly or cause harsh results, the long-term growth prospects of the economy will be enhanced by evolving efficient and effective systems. In the short term, even if there is not an efficient insolvency system, the government or the banking sector can set out

policies and consequences which force parties into informal workouts. Notably, there is movement towards developing unified standards in this respect to provide international benchmarks and recommendations for informal workout practices, and in particular for structured workout practices led by the World Bank and the Asian Development Bank. However, institutional development, capacity and regulation in the areas of insolvency and creditor rights have still not received sufficient focus in developing Asian economies.

### The invisible shadow

Restructuring takes place in the shadow of liquidation procedures, secured creditor remedies and general creditor rights, with the relative efficacy of these laws and rights acting as a stimulant or suppressant, as the case may be, on out-of-court restructuring efforts. In Australia, for example, the liquidation procedures and antecedent transactions laws, which enable preferences to be cancelled and recovered, operate to make informal workouts almost extinct. Another factor that provides a key incentive to prompt recourse to formal rehabilitation procedures is legislation imposing personal liability on directors for insolvent trading; however, it is rare in Asia for such laws to operate effectively.

In some countries, the investigative and disciplinary aspects of the insolvency laws have been overlooked. Fraudsters can get away with their crimes and systems can be abused. Many laws are not enforced. There is no real focus on the importance of the interaction between insolvency laws and corporate laws – particularly the fact that insolvency laws create a dynamic that facilitates the proper functioning of corporate laws. The role of insolvency laws in preventing and punishing fraud and promoting good corporate governance has not received adequate focus in the development and, more importantly, the implementation of many new insolvency regimes across the region. The prevention of fraud and promotion of good corporate governance should be a primary focus in the formulation and enforcement of new insolvency laws. At the practical level, this often requires training and other capacity development and funding of official receivers, or other officials or private sector representatives who are appointed as liquidators of insolvent companies. At the opposite extreme, in countries such as Vietnam and the People's Republic of China there has almost been a criminalisation of bankruptcy, with a failure to

appreciate that some insolvencies are a natural consequence of entrepreneurial risk-taking market activity and involve no criminal wrongdoing.

However, insolvency is one stage in the life of a company (admittedly its death throes or, in the case of rehabilitation, hospitalisation) when a comprehensive review of the company's activities can be undertaken. It provides an opportunity to hold directors liable for insolvent trading and other breaches of fiduciary, statutory or other duties. Yet rarely has there been the resolve to seize this opportunity, and where aggrieved parties have been bold enough to pursue the wrongdoers, deficiencies in laws and practices have frustrated their attempts. In addition, few countries in the region have established funds or other mechanisms to facilitate performance of the liquidator's investigatory functions in administrations where the insolvent company has no assets at all. Assetless administrations are often the result of allowing fraudsters to strip their companies of all assets, leaving no resources to be used to investigate and uncover the fraud, let alone trace and recover assets.

In informal workouts – even major workouts covered on the business pages of international newspapers – creditors are too often offered deals as part of the workout which oblige creditors to release shareholders or former management and others from liability for some suspected fraud or improper conduct. This is often clearly stated upfront in the offer to creditors.

### The happy restructurings

Notwithstanding the above, there have been some instances of realistic financial restructuring and true operational restructuring. These have usually occurred where the debtor has cooperated in the process and expert independent advisers have been engaged. This success is reflected in share prices for listed companies following a so-called 'happy restructuring'. Clever debtors can use the restructuring process to make progress in areas that might otherwise be impossible due to sensitivities or internal political issues – they can blame the creditors or the advisers while pushing through changes they want.

There have been few instances of creditors resorting to aggressive actions against debtors seeking their liquidation or rehabilitation in cases where the debtor objects strongly to such action. Where aggressive approaches have been taken, systems have rarely facilitated action by the

creditors. Debtors have been able to use delay tactics or otherwise frustrate actions by creditors or their representatives. It has proved difficult to take control of businesses held by recalcitrant debtors; debtors have resisted, often successfully. Even if the resistance has ultimately proved unsuccessful, the debtor may have been able to achieve significant delay or at least sufficient time to arrange its affairs so as to hide fraud, distance assets and otherwise defeat creditors. In some cases, debtors have been able to bring action after action opposing the conduct of creditors or insolvency practitioners. These attacks have also extended to matters beyond those in dispute between the parties – in sporting terms, attacking the player rather than the ball. Few legal systems in developing countries in Asia permit the court to declare a party a vexatious litigant and restrain it from bringing any legal action that suits it.

#### **Corporate doctors without borders**

There have also been concerns for personal safety and threats of violence. These concerns are not illusory. On March 10 1999 Michael Wansley of Deloitte Touche Tohmatsu was assassinated while working on the restructuring of a group of sugar companies in Thailand – this should never be forgotten. Restructuring experts accept serious risks in performing their role, particularly in countries where business violence is not unusual. Expert advisers have proved easy targets for criticism and there has generally been a failure to appreciate the value that truly expert restructuring advice can add. There has been a focus on fees charged by financial and legal advisers. This is not remarkable in light of the fact that the consultancy fees borne by companies following the Asian crisis in restructuring their businesses were probably the highest ever fees paid by those companies for consultancy services; but this merely reflects the fact that never before had those companies required such significant levels of consultancy advice. It is often difficult to accept that thousands or millions of dollars in consultancy fees are justified by the contribution made by these experts. This attitude fails to acknowledge that, in many cases, intelligent restructuring advice and approaches can create savings or gains which far exceed the level of consultancy fees. In larger restructurings, parties can complain endlessly about the adviser's fees while failing to compare those fees to interest accruing on their loans. Rarely, even in the largest of restructurings, do consultancy fees exceed a

minor fraction of the accruing interest charges.

The reality is also that Asia lacked the required level of expert resources in the immediate post-crisis period to implement the restructuring that was needed. Consequently, foreign advisers provided much of the restructuring advice immediately following the crisis. This has triggered nationalistic and monopolistic sensitivities in the services sectors in some countries. There has been a degree of mistrust of foreign advisers, and some countries have adopted regulations or policies that prefer domestic advisers.

There is a reluctance to pay for true experts with integrity to handle and advise on non-performing loan resolution. Instead, practitioners with questionable ethics have prospered. Regulatory hurdles have not succeeded in eliminating crooked or corrupt players. There has often been a failure to appreciate the value added by experts with integrity and talent in turning around distressed corporate debt situations.

There has also been a failure to acknowledge the degree of knowledge transfer that can occur as a result of engaging international experts to work with local practitioners in handling the difficult challenge of resolving distressed situations. Often, advisers are also the only source of quality control in a restructuring. It is certainly essential to ensure that only qualified and reputable people are permitted to provide such advice. The reality in many restructurings is that the integrity of the advisers involved and their concern to protect their own corporate brand provide the dominant source of restraint against tendencies to illegal or questionable approaches in these restructurings.

The development of the use in Asia of expert corporate restructuring officers, which is common in other developed countries, is to be recommended

#### **Emergency measures**

Much of the reforms seen in Asia from 1998 to 2002 constituted crisis-related emergency reforms. There was a focus on short-term reforms aimed at providing immediate respite from the effects of the financial crisis. The crisis led to the establishment of many new institutions to assist in restructuring and recovery efforts. Some of these institutions have been highly effective, while others have been unable to deliver results. Each new institution offers the government of the day a political advantage, in the sense of allowing it to identify clear initiatives it has undertaken to address the prevailing economic problems. These emergency

reforms have included:

- the creation of asset management companies (eg, the People's Republic of China's four asset management companies, Taipei, China's private asset management companies and the asset reconstructions companies in India), national asset management companies (eg, Danaharta in Malaysia, the Indonesian Banking Restructuring Agency, the Korean Asset Management Company, the Thai Asset Management Company, the Industrial Revitalisation Corporation in Japan and the Debt and Asset Trading Company in Vietnam) or collective asset management companies (eg, the Taiwan Asset Management Company formed by a collective of financial institutions);
- the creation of rapid disposition agencies (eg, the Financial Sector Restructuring Authority in Thailand, which was responsible for disposing of the assets of 58 suspended finance companies);
- the creation of restructuring funds (eg, the Financial Restructuring Fund in Taipei, China);
- the establishment of independent facilitating bodies aimed at encouraging restructuring (eg, the Jakarta Initiative Taskforce (JTIF) in Indonesia);
- the creation of restructuring committees (eg, the Corporate Debt Restructuring Committee (CDRC) in Malaysia and the Corporate Debt Restructuring Advisory Committee (CDRAC) in Thailand, which have administered frameworks, binding and non-binding, for out-of-court informal debt restructurings); and
- the creation of special legislative environments and vehicles to promote investment in distressed debts and assets (eg, the mutual funds created by the Securities Exchange Commission in Thailand; numerous vehicles in the Republic of Korea, such as corporate restructuring vehicles, corporate restructuring companies and real estate investment trusts, and the special purpose asset vehicles in the Philippines).

These measures enjoyed varying degrees of success. Some very successfully promoted the pace of restructuring, while less successfully promoted the quality of restructuring. The emergency measures may have also engendered some inappropriate practices, even moral hazards, including a culture of non-payment by debtors whose debts are shuffled around from banks to asset management companies to national asset

management companies without ever being resolved, together with a reckless approach to lending by state banks in particular, whose huge non-performing loan portfolios were transferred to asset management companies without any other real managerial or cultural change in the bank's operations, leaving the bank free to engage once again in the lending practices that initially created its huge non-performing loan portfolio.

Measures have been most successful where they have been sponsored by a strong regulator, often the central bank. In many cases, the influence of the regulator has not been directly applied, although it has been feared. The influence of Bank Negara was central to the success of restructuring in Malaysia. Even in countries such as Thailand, where the Bank of Thailand did not directly position itself as a regulator of restructuring, its influence via the CDRAC process conducted under its auspices was a material factor in the progress of restructuring. While the CDRAC did not involve itself directly in the positions taken by the parties in the restructuring, limiting itself to overseeing the timetable for restructuring established by the process, there was always a fear in the minds of creditors that unreasonable conduct could affect their general banking business in Thailand even though the power of the Bank of Thailand to impose fines for breach of the CDRAC process was rarely invoked. The CDRC in Malaysia, on the other hand, openly involved itself in the issues under debate between the parties involved in a restructuring and facilitated the resolution of disputes. It told parties when it thought they were being unreasonable – much of the ability to do so stemmed from the leadership of two individuals heading up the CDRC. A similar approach might not be accepted or be as successful in other jurisdictions due to cultural differences. In Indonesia, the JTIF was set up entirely independently of the central bank. It was not supported by a strong regulator. It had little in the way of 'sticks' to enforce reasonable conduct and only one real 'carrot' – certain tax incentives which applied to restructurings carried out under its auspices. Its success in progressing the pace of restructuring efforts was limited by these factors.

Many of the drivers for restructuring which existed in the period from 1998 to 2002 have now gone. Most of the specialised bodies mentioned above have a limited life, and some have already ceased operations. In all cases the focus was on providing a temporary opportunity or vehicle to promote recovery; none were intended to be long-

lasting reforms. The CDRC in Malaysia and the CDRAC in Thailand, and many of the asset management companies listed above which were established to promote the pace of restructuring, have ceased operations or downscaled. They no longer drive banks into restructurings. Tax incentives instituted to facilitate restructuring have expired. International Monetary Fund conditions have ended as loans as have been repaid.

Going forward, it is essential that the knowledge and experience built up within these organisations is not lost and that their absence does not become a cause of inactivity. Eight years after the financial crisis, it is clear that there is now a need to focus on the long-term development of efficient insolvency systems. This is not to say that these emergency reforms have had no utility. To the contrary, their influence on cultural development and practice in dealing with distressed assets is unquestionable.

However, banks in particular have short institutional memories. This is not true across the board, but is certainly a fairly safe generalisation. With notable exceptions, it would seem that the lessons of the crisis have not become part of the entrenched institutional knowledge of much of the banking sector. Few bankers will deny that a bank often makes the same mistakes every five to seven years. As the financial crisis fades into memory, an interesting change has emerged. At the beginning of the crisis, banks were commonly under-capitalised and scarce of funds. Following transfers of non-performing loans to asset management companies and other restructuring and capitalisation measures, the banks' position has now changed. With few good borrowers to lend to, banks have built up cash reserves, preferring to invest in bonds rather than lend. Consequently, they are now commonly holding excess liquidity. This has changed the dynamic in restructuring negotiations. Previously, under-capitalised banks were reluctant to accept write-offs because the effect on their own balance sheet and capitalisation would be too drastic. However, in this new period of over-liquidity, write-downs have become easier to accept.

That said, many banks still seem to be averse to accepting a write-down of debt. Commonly, this aversion stems from concerns on the part of the responsible account officer or bank committee or board that the decision to accept the write-off will crystallise a loss for which they may be held personally responsible; this is a particular concern in state banks and in institutions where

management is prone to change. One of the major dynamics affecting restructuring in Asia has been the fear of personal liability for commercial decisions. This has been a feature of the operation of state banks and agencies. It stems from the fear that the application of any level of discretion or commercial judgement could be questioned retrospectively where the result has caused damage or losses. This is particularly so where there are concerns that there will be a change of government or subsequent review of the conduct of the relevant agency. These concerns often cause activity to stagnate.

As banks have been recapitalised, they do not feel the same pressure to deal with non-performing loans. Banks have become flush with cash and are now reducing their non-performing loan ratios by increasing total lending rather than decreasing non-performing loans. Crisis countries have endured, and have not collapsed or suffered unbearable poverty or downturns in standards of living by not dealing with their non-performing loan problems. Governments have realised that you can have GDP rates of five to 10 per cent while still carrying 10 to 50 per cent non-performing loans. Investors have returned, forgetting – at least at the institutional level – earlier bad experiences and looking to the East to make their bonuses, as the United States and other economies simmer. The overall result is that the pace of restructuring has slowed. Of greater concern, perhaps, is that it seems that some non-performing loans may never be resolved, but will just sit quietly in the corner hoping not to be noticed as the party in Asia starts up again.

### **The funding gap**

There has often been an inability to accept the role of foreign investment in bridging the funding gap for the workout and resolution of non-performing loans, and in the funding of the activities of asset management companies and asset reconstruction companies. The secondary debt markets and disposals of non-performing loans fill the funding void due to the absence of effective insolvency systems. There has also often been an inability to accept the true purpose of asset management companies and asset reconstruction companies and the role of distressed debt investors, and a lack of political will to provide the necessary incentives to allow them to operate effectively. The non-performing loans disposal and restructuring programmes through asset management companies and other vehicles have been slow in a

number of developing countries, and have often lacked adequate transparency. The delay in drawing new investment in non-performing loans and distressed businesses has led to assets being left idle or poorly managed, and economic value being lost. The focus in some countries on the structure of private asset management companies and asset reconstruction companies seems to assume they will be around for the long term, when in reality these vehicles should be a short-term emergency solution in which sponsors are allowed to make fantastic profits so they are enticed to inject capital into such risky distressed assets.

The asset management company, special purpose vehicle and securitisation structures have also been used as way of circumventing foreign ownership restrictions, and have enabled foreign investors to control assets they would otherwise be prevented from accessing.

The asset management company structure enables banks to transfer their non-performing loans – accumulated over many years and probably including a number of connected, directed or simply imprudent loans – to an asset management company. These ugly loans are simply transferred off the bank's books in exchange, commonly, for bonds or some other debt instrument which the bank can book as an asset in its balance sheet. The bank is now free of any non-performing loans. After a while, the formerly balance-sheet-negative bank now has rich cash reserves, with little idea what to do with them. After investing in treasury bonds for a while and realising that they are a poor substitute for lending, and with lending officers wondering where their bonus will come from, the bank again looks to lend. However, the quality of potential borrowers has not changed. Undeterred, the bank, having been able to rid itself easily of non-performing loans in the past, embarks on a wave of reckless lending. New lending is sometimes an indication of a rash institution. It is notable that in many restructurings, new money required for working capital comes from the institutions that were previously, prior to their transfer to asset management companies, the highest holders of non-performing loans.

### The disposal culture

There has been a focus on bulk disposal rather than restructuring of distressed debt, and numerous debt warehouses have been created which are yet to deal with the real issues. Little restructuring of the businesses owing these non-performing loans has

occurred; although some attempts have been made, progress has generally been slow. The philosophy has been to deal with the banks' balance-sheet issues first and leave the restructuring of the corporate sector until after the financial sector restructuring is complete. The focus on disposal of non-performing loans has limited the development of specialised divisions within banks with expertise in handling non-performing loans. Some banks have been able to develop expertise and have applied the lessons learnt to credit risk analysis at the front end of their business: lending. However, this has been limited. Many banks which transferred their non-performing loans to an asset management company or sold them to investors have been unable to develop a culture of managing distressed accounts. From a long-term perspective, this is perhaps the most troubling legacy, or missed opportunity, of the emergency steps taken to deal with the crisis.

### Enter the hedge funds

By far the most dramatic development in Asia in the restructuring arena in recent times at the practical level has been the increasing role of specialised distressed debt hedge funds. The funds have changed the dynamics in many informal restructurings of late. They can inject new monies into distressed businesses and often engage in substantial debt purchasing which can remove many of the inter-creditor issues in a restructuring. They are also focused on medium-term turnarounds of companies, rather than short-term profits from taking hold-out positions. Their approach differs significantly from the approach of many of the funds seen in restructurings in the immediate post-crisis period. In the early years, 'vulture' funds did well by taking hold-out positions in a restructuring whereby they acquired a debt position and held it, while at the same time refusing to agree to reasonable restructuring proposals, in the hope that they would be bought out by other creditors at a significant profit just so the restructuring could be achieved. Many of the present-day specialist distressed debt hedge funds have a completely different approach, which is often based on turnaround management of distressed investments. Their approach is far healthier and should be encouraged.

These distressed debt specialist funds feature in almost all major restructurings in Asia at present. They come to the restructuring table with significant funds which they are eager and able to

deploy in a turnaround or event-driven restructuring circumstance. Banks can commonly be removed from a restructuring early on in the process, as they will sell their positions to these funds. The growth of credit default insurance has also had a similar effect on the transfer of risk and therefore the agenda of the parties involved in restructuring negotiations. The faces and approaches of those around the restructuring table today look very different from those that participated in steering committees in the first few years after the economic crisis.

### **The future**

As simplistic as it is to say, it is accepted that eventually there will emerge countries with good systems which will benefit from cheaper credit, and countries with bad systems that will suffer and whose long-term economic development will be significantly hampered in the global economy. Against this, however, is the undeniable fact that, at present, many countries in the region with poor insolvency systems and poor credit risk management systems enjoy low credit costs and relatively high economic growth rates – this dampens the movement towards improved systems. Despite this, governments and industry must have enough vision to continue the movement forward. Many are striving to create efficient and effective insolvency systems and credit risk management systems.

Governmental interference in restructuring activity has been unpredictable, and consequently ongoing fears for investors and bankers have been priced into the cost of credit. Countries with clear and predictable policies have benefited from maximising the value from non-performing loans quickly and refocusing their economies for growth; although countries which have not done so seem to have also prospered. Government interference in the turmoil of a distressed company or at times of crisis is not necessarily a bad thing, and indeed may at times be the only hope to resolve problems.

The predictability of systems is sometimes more important than the particular result in one case. Similarly, if the rules can change in the middle of the game because one player keeps breaking them, why should players have regard for them the next time they play? The restructuring game in Asia remains one where the players are still learning the rules; the rules keep changing; the players keep changing; some prefer to cheat; some pretend to play just for the benefit of the crowd; and only

occasionally do you get to see a really well-played match with a fair result.

Longstanding non-performing loans (which are often hidden), fictionally rescheduled non-performing loans and new non-performing loans are veiled by recent economic growth. As almost a direct affront to the proponents of the need to deal with non-performing loans efficiently as a key ingredient for economic growth, countries which to date have probably made fewer realistic attempts to deal with some of the longstanding non-performing loan overhangs have seen the highest level of gross national product growth. In a number of Asian economies, growth has been outstanding of late, despite the baggage of non-performing loans. However, hidden, veiled or simply unresolved non-performing loans leave economies vulnerable to economic downturns or shocks.

Recovery in Asia has come too quickly, with economies rebounding without some of the underlying problems being realistically resolved. In many cases the corporate sectors, and the finance sectors which fund them, have simply marched on, ignoring pre-existing problems. It is almost as though, while the new economy has been born, the old economy has been left languishing without ever really being nursed back to health or allowed to pass away. Vietnam affords a wonderful example of this phenomenon, where the new free-enterprise economy is striding forward despite many problems in the state-owned sector and no significant improvement in existing non-performing loans

No new or innovative approaches to restructuring or insolvency legislation have developed in Asia following the financial crisis. Most of the approaches have followed insolvency regimes in other countries or restructuring techniques adopted elsewhere (eg, the Resolution Trust Corporation created in the United States following the savings and loan crisis, and the London Approach on out-of-court multi-creditor workouts). As yet, no innovative approach to restructuring has been developed that addresses the cultural issues in many Asian countries and produces a truly efficient system. What has become clear is that there is no uniformly accepted regional solution. Each country has a different background, different problems and a different stage of cultural evolution in dealing with insolvency matters, and therefore requires a different solution; although all require the fundamental backbone of an efficient and effective insolvency and creditor rights system. It is also clear that an insolvency law is just one

piece of the puzzle. Effective systems, rather than just laws, must be established which create the right dynamics at a particular time in a country to resolve the non-performing loans problem in a realistic way. It must be remembered that the efficient reallocation of resources is one of the main objectives of an insolvency system. The real challenge in many of these countries is to create an

insolvency system that actually works in the prevailing environment, not just one which should work if everything else is fixed. The approach must be dynamic and flexible at all times, particularly in the short term, but should always strive for the development of a sustainable, effective and efficient system, which reflects global best practices striving to uniformity, over the long term.