

HONG KONG APPROACH TO CORPORATE DIFFICULTIES¹

Following the guidelines issued jointly by the Hong Kong Association of Banks (HKAB) and the Hong Kong Monetary Authority (HKMA) to codify the principles governing corporate debt restructuring and workouts, this speech outlines the general process involved in a workout, the role of the HKMA, and its expectations of banks in facilitating a successful workout.

Introduction

The purpose of today's seminar is to hear more about the recently released joint HKAB / HKMA Guidelines on the Hong Kong Approach to Corporate Difficulties. The fact that they are issued jointly by HKAB and the HKMA, and that this is a joint HKAB / HKMA seminar indicates the importance placed on these Guidelines. Something that is endorsed by both the industry Association and the banking regulator is clearly intended to be taken seriously. Over the next few minutes I shall try to give you a better understanding of the Guidelines and of what is expected of each one of you in relation to them. Above all, I want to try and get across the importance of co-operation between you all on workouts and corporate restructurings and in particular the idea that this is both desirable for the banking sector as a whole and, importantly, in your own best interests.

Over the last two years every member of the Hong Kong banking sector has faced increased bad debts as the recession has severely weakened the ability of many borrowers to service or repay their debt. The number of Hong Kong companies going into liquidation has been at an all-time high. At the same time, many banks have been affected by the problems elsewhere in the region. And over the last twelve months another factor has been the financial difficulties of a number of Mainland-related companies.

This sharp growth in problem loans has heightened the importance of problem loan management, which can perhaps best be defined as the management of accounts so as to get lenders the best possible return in the circumstances. Usually the best way of achieving this best return

is not to rush to put a company into liquidation at the first sign of financial difficulty, but instead to co-operate with the company and with the other lenders to try to salvage the company and keep it going. Keeping commercially viable companies going is in itself desirable as it preserves employment and productive capacity. But the more immediate advantage from the lenders' point of view is that giving such companies the time to restructure their operations and financial position can ultimately improve their ability to service and repay their debt.

Bearing in mind the generally low recovery rate that unsecured creditors obtain from liquidations, workouts will usually be the better option as far as maximising the lenders' return is concerned. But it is important to note that workouts should not be seen as a soft option for the debtor or an act of charity on the part of the creditors. Banks will generally only be prepared to embark on a workout if the prospect of eventual recovery is greater than it would be in a liquidation. And the threat of liquidation must always be there to provide an incentive for the debtor to face up to its problems and to agree to co-operate with the banks.

Co-operation, and a recognition of shared interests, is integral to the workout process. Later this morning you will hear in much greater detail how the process works in practice, but let me just sketch out the bare bones.

The Process of a Workout

The first stage is recognition that a problem exists: that the company in question is experiencing financial difficulties that call into question its debt

¹ This is the text of a speech delivered by David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, at the Seminar on Hong Kong Approach to Corporate Difficulties on 29 November 1999.

servicing capacity and, ultimately, its ongoing viability. At this stage the company needs to take the initiative to approach the banks and to call what is known as an “all banks” meeting. This meeting offers the company the opportunity to explain the nature of its problems and to ask the banks to agree to a standstill on repayments of principal and possibly also of interest. The standstill provides an essential breathing space during which accountants appointed by the company can report on its financial problems and prospects for survival, and the company can try to reorganize its business and management. Assuming that the company looks as if it is salvageable, the banks will normally be prepared to continue the standstill to allow the company’s financial advisers to present proposals for restructuring its debt. Such proposals might include, for example, extending the term of the debt, reducing the interest rate or even the principal amount, or swapping debt for equity.

During the period of the standstill and while the restructuring plans are being formulated, it will be the responsibility of the lead bank appointed at the first all banks meeting to enforce the standstill, to negotiate with the company and its financial advisers and to share information with the other lending banks. The lead bank will be assisted in this process by a steering committee comprising a small number of the key banks. It is important to note that while the steering committee may recommend a restructuring plan to the bank group as a whole, it cannot commit them to it. This means that a workout can only go ahead if there is unanimous agreement among all the banks involved.

This is only a very short description of the mechanics of a workout and hardly does justice to what can be an enormously complicated exercise involving banks with widely different levels of security as well as non-bank creditors whose interests also need to be taken into account. But I hope that I have given you enough to illustrate the central principles of the process: a willingness by the debtor to recognize that there is a problem and to approach the banks to seek assistance; support and forbearance from the banks involved; and a willingness on both sides to work together to reach a solution by consensus. That solution

may not be the optimum one for every individual bank but the objective should be that each bank is at least better off than it would be in a liquidation and is treated fairly vis-a-vis others.

Workouts of this type have a long history in Hong Kong but the principles that govern them were only recently codified in the form of the HKAB Guidelines, now re-issued in the form of joint HKAB / HKMA Guidelines. The status of these Guidelines is that they are non-statutory, and compliance with them is therefore, in a sense, voluntary. However, they are supported by both HKAB and the HKMA and I would say that all banks are expected to use their best endeavours to comply with them.

The Role of the HKMA

Let me now say a little about what the HKMA can do to assist in the process. As I have said, the HKMA is a strong supporter of the workout concept and of the Guidelines. As set out in the Guidelines, we have indicated that we are prepared to help to resolve differences of views that would threaten a workout and to achieve an acceptable compromise. To this end, we are ready to listen to any involved party, irrespective of size or national affiliation.

In taking on this role, we are following the example of the Bank of England in offering to act as an “honest broker” or impartial mediator to help to bring negotiations to a satisfactory conclusion. I should emphasize however that we do not get involved in the detailed negotiations on the workout. That is the job of the lead bank, the steering committee and the company and its advisers. Similarly, it should be the task of these parties to make every effort to resolve disagreements before they are brought to the attention of the HKMA. In other words, the HKMA should only become involved as a last resort.

The HKMA has so far been involved in about a dozen cases since the Guidelines were first issued. Typically these have involved situations where a small minority of banks, sometimes only one, are refusing to sign a restructuring agreement or are threatening to take action, such as realising

security, which would cause the workout to collapse. Our practice in such cases is to listen to both sides and to understand their respective positions. Where a small number of banks are holding out against the majority view, we will ask them to explain their position and to weigh the costs of their behaviour against the potential benefits. Where the position of the minority banks seems to lack sound justification, we will usually try to persuade them to accept the majority view or at least make every effort to work towards a compromise. At the very least, we would request the banks to reach decisions on restructuring proposals within a reasonable period of time and to try to adhere to the deadlines which are set for these decisions.

The HKMA's role in the workout process is, I believe, consistent with the Monetary Authority's principal function under the Banking Ordinance, which is to "promote the general stability and effective working of the banking system". The banking system can only work effectively if there is an effective means of restructuring corporate debt. It is not, however, our practice to use our powers under the Banking Ordinance to force banks to take decision on workouts which are against their commercial judgment. Instead, we try to achieve our objectives through moral suasion.

Looking ahead, it is essential that the process of corporate debt restructuring in Hong Kong should operate as effectively and smoothly as possible. This is particularly important at this time, for, while the economy is certainly improving, it may be some time before the benefits feed through to all sectors. Consequently it is likely that many companies will remain under pressure for some time to come. There is also the continuing task of restructuring a number of Mainland-related companies such as Guangdong Enterprises which are currently in financial difficulties.

This revised version of the Guidelines has been expanded in a number of areas to take account of recent experience. There is now a lot more in the Guidelines about the role of the Steering Committee and of the lead bank. The role of financial advisors and investigating accountants is also covered in more detail, as is the question of the provision of new money. I

hope that you will take the time to review the Guidelines in detail so as to ensure that you are familiar with them next time you are involved in a workout.

The Role of Banks

This leads me on to what steps banks can take - indeed the HKMA expects them to take - to improve the operation of the workout process. I have five suggestions.

First, the growing number of workouts is stretching resources. This has held up progress in some workouts and has led to concerns that more smaller companies could end up in liquidation because the banks lack the resources to deal with their problems. At the same time, there is a feeling that banks may not be maximising their recoveries because their loan management and recovery functions are not as efficient as they might be. Banks therefore need to strengthen their workout teams, and also, where appropriate, to create specialised debt recovery units. In June this year the HKMA wrote to all authorised institutions suggesting they review their debt recovery functions and consider, among other things, the setting-up of a unit capable of handling more complex restructurings. If your institution has not already acted on this, you should do so.

Secondly, for the process to work, banks need to send representatives to Steering Committees with the right level of knowledge and experience to understand the issues and to make a real contribution to driving the process along.

Thirdly, banks, particularly foreign branches, need to ensure that they are able to get a decision when one is required without holding up the whole process unduly. There is a risk that the decision-making process can get bogged down in internal bureaucracies within banks, particularly when proposals have to be sent to head office for approval. Clearly, it may be necessary to consult more widely on occasion, but this should be done as quickly as possible. To ensure that head offices are aware of the Guidelines, the HKMA has sent a copy to the head office or parent bank of every foreign bank in Hong Kong. The Hong Kong offices should follow up on this with their head

office or parent bank to ensure that they understand fully what is involved. The HKMA will expect foreign banks to act in accord with the Guidelines, including being able to respond promptly when a decision is required.

Fourthly, there is a possibility that some banks, particularly those with a small exposure, or those which are reducing their business in Hong Kong, may be tempted to take a hard line by threatening legal action or refusing to sign restructuring agreements in the hope of extracting better terms for themselves or being bought out by the other banks. This is something we have seen from time to time in particular cases. Head offices may sometimes encourage such an attitude. This indicates a lack of understanding of the spirit of cooperation that should underlie the Guidelines. Negotiation should not be by ultimatum and the HKMA will take a dim view of such tactics.

Fifthly - and finally - banks need to be realistic and pragmatic about what they can expect to get out of restructurings. While they should obviously be trying to extract the best possible deal from the company and its shareholders, this should not be at the expense of jeopardizing the company's future business viability. It may also be unrealistic to expect to make a full recovery.

The Way Forward

This leads me on to one final point. What we have been talking about this morning is how to manage the situation once a company has got into financial difficulties. I would suggest, however, that we should also be thinking about how better we can identify problems at an early stage, before they have become so serious as to necessitate a workout.

One important means of achieving this is for lenders to understand their borrowers and their business better. This implies improvements on both sides. As has been said many times before, banks need to focus less on collateral and more on the strength of the underlying business and on the cashflows it generates. For their part, borrowers need to be willing and able to provide lenders with such information, and to be open and honest in discussing their business and prospects.

Another means of improving banks' loan loss experience would, possibly, be to have a credit register in Hong Kong. Experience has shown that one of the main reasons for corporate collapses has been the accumulation of large amounts of debt from a number of banks which ultimately proved to be unsustainable. At the time such loans were granted, banks did not always have information about the borrowers' debt exposure and therefore had to rely on other less reliable information for their credit decisions. In hindsight, some of these decisions might have been different had more information been available at the time credits were approved. In a number of countries, this issue has been addressed in the form of a domestic credit register which provides information on the overall indebtedness of commercial enterprises to lending institutions.

The case for the introduction of such a register in Hong Kong is still to be made, but the benefits of such a system appear to warrant further consideration in the present environment in Hong Kong. Accordingly, the HKMA intends to undertake a more detailed study early next year to determine the costs and benefits of such a scheme and the form that it should take if it is considered desirable to set up such a scheme in Hong Kong.

This brings me to the end of my prepared remarks. Thank you for listening. I would be happy now to take a few questions from the floor. 🍻