

RESTRUCTURING AND WORKOUTS¹

Debt restructuring has a crucial part to play in economic recovery by allowing the survival of viable businesses, while providing creditors the opportunity for maximum loan recovery. This speech examines how the workout process is progressing in Hong Kong and explains the role of the HKMA in workouts. It also proposes ways in which debt restructuring might be improved and suggests that a review of the HKAB Guidelines on Corporate Difficulties might be timely.

I am very grateful to Amcham for giving me the opportunity to speak to you today on the subject of restructuring and workouts. I am conscious of the fact that I am following in the footsteps of Chris Barlow of PriceWaterhouseCoopers who spoke to a different gathering of Amcham on the same subject only a month ago. To return to the subject so soon may seem like overkill, but I think that it is a reflection of the fact that there are few more important issues for Hong Kong and indeed the region as a whole at present. As the Governor of the Central Bank of Thailand has rightly said: "Debt restructuring is the key to an early economic recovery based on the survival of viable business operations, while providing creditors the opportunity for maximum loan recovery." In this speech, I intend to offer some thoughts on how the process is going in Hong Kong and how perhaps it might be improved, as well as explaining the role of the HKMA in workouts.

A workout can be defined simply as a private contractual arrangement to assist companies in financial difficulties. The number of companies in this position has risen to unprecedented levels as a result of the recession of the last 18 months. A drop in economic activity on the scale we have witnessed would be sufficient to put the finances of even well managed companies under some stress. But it was made worse by the shift from relationship banking during the 1990s which meant that too much indebtedness was incurred from too many banks. One of the features of the recent well-publicized financial difficulties of some Mainland-related companies has been the sheer number of

lending banks involved - for example, over 80 in the case of Guangdong Enterprises. That is a big company, but it has been not unusual to find even medium size companies in Hong Kong with dozens of bankers. In this situation, troubled companies find it difficult to maintain the loyalty and support of their banks. Those lenders that have no long-term relationship with the company in difficulties may try to protect themselves by pulling their lines at the first sign of trouble.

This is particularly so at a time when some foreign banks are reducing their commitment to Hong Kong because of problems back home or losses elsewhere in Asia. In 1998 domestic lending in Hong Kong fell by 5.5% after rising by a compound annual rate of 13% in the previous five years. The 1998 fall in domestic lending amounted to HK\$122 billion in absolute terms, of which over 60% was accounted for by the Japanese and Continental European banks combined. This withdrawal of credit drastically reduced the funding available to Hong Kong corporates and increased their financial difficulties. This in turn has fed through to increased bad debts for the banks.

Hopefully, the economy has now bottomed out and economic growth will resume this year as forecast by the Government. The stock and property markets certainly seem to be indicating an improvement in confidence and if sustained this will reverse the negative wealth effect of 1997/98 and encourage a revival in consumer spending that is necessary to take Hong Kong out of recession. However, in the initial stages of the recovery the

¹ This is the text of a speech delivered by David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, at the American Chamber of Commerce YPC/Financial Services Committees Luncheon Meeting on 29 April 1999.

financial position of many companies will remain under pressure, particularly as the upturn in the economy will increase their need for working capital.

In the meantime, an increasing number of companies are going into liquidation. The number of compulsory winding-up orders jumped to 763 in the financial year 1998/99. This is an all-time high that compares with the average of 480 in the previous five years. It is certain that without the alternative of workouts the number of liquidations would have been much higher. The role of the workout is to provide an alternative to insolvency and receivership which will allow commercially viable companies to survive as going concerns, thus preserving employment and productive capacity. 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. Bearing in mind the generally low recovery rate that unsecured creditors obtain from liquidations, workouts will usually be the better option. But the threat of liquidation must always be there as a last resort to provide an incentive for the debtor to face up to its problems and to agree to cooperate with the banks.

Workouts have a long history in Hong Kong but the principles that govern them were only recently codified in the form of the Guidelines on Corporate Difficulties issued by the Hong Kong Association of Banks in April 1998. These are generally known as the "HKAB Guidelines". The Guidelines are non-statutory, but they are supported by both HKAB and the HKMA and all banks are expected to use their best endeavours to comply. In my view, this represents one of the most important initiatives of HKAB in recent years, taken as it was at a time when the economy was in the early stages of recession and when the need for workouts would inevitably rise. The Guidelines are in turn based on the London Approach that was formulated by the Bank of England when the UK market was going through similar strains at the beginning of the 1990s. The underlying principles of the Guidelines are as follows:

- When it becomes public knowledge that a debtor company may be experiencing financial problems and the borrower has approached its banks, banks' initial attitude should be one of support. They should not withdraw facilities or hastily put the company into receivership, or issue writs demanding repayment.
- Further decisions should only be based on information that is reliable and shared fully with all the creditor banks (after obtaining the debtor's permission).
- The decision to offer the company financial assistance - or not - should be a collective one by creditor banks.

It will be seen that the process begins when the debtor takes the initiative to approach the banks and to call what is known as an "all banks" meeting. This is the first psychological barrier to be crossed, since companies are often reluctant to own up to their difficulties. The meeting with the banks 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 proposals to be presented by the company's financial advisers to restructure its debt, by for example extending its term, reducing the interest rate or even the principal amount and swapping debt for equity. If the shareholders are able and willing, it may also be possible for fresh capital or assets to be injected into the company to fill a hole in the balance sheet and to improve its income earning capacity.

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, normally consisting of about 4-6 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. Obviously this can delay the whole process - a point to which I will return later.

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, matched by support and forbearance by the banks and a willingness 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.

In the course of preparing this speech I have had the benefit of talking to a number of market participants about how effectively the workout process in Hong Kong and the HKAB Guidelines are working. It is fair to say that there are varying shades of opinion on this point, but there is general agreement that the Guidelines have made an important contribution in codifying what is expected of banks in Hong Kong. It is equally true that there may be room for improvement in the workout process. Let me highlight some of the main areas of concern about the current arrangements:

- First, the sheer number and diversity of banks involved in some workouts can make it extremely difficult to achieve the necessary consensus on restructuring proposals. This is compounded by the point I have already mentioned that a number of foreign banks are reducing their commitment to Hong Kong. This increases the possibility that some banks,

particularly those with a small exposure 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. Head offices sometimes encourage such an attitude. This indicates a lack of understanding of the spirit of cooperation that should underlie the HKAB Guidelines. Negotiation should not be by ultimatum.

- Second, the growing number of workouts is stretching resources. This is holding up progress in some workouts and is leading to concerns that more and more smaller companies could end up in liquidation because the banks lack the resources to deal with their problems. Banks may therefore need to strengthen their workout teams, though I admit that this is easier said than done.
- Third, there is a view that burden of handling workouts could be more evenly spread among the banks. The role of lead bank in Hong Kong is generally conducted by only two of the larger banks. While these banks have the skills and experience to do the job, even their resources are not inexhaustible. There may be a case to spread the role of lead bank more widely, or at least for banks to make a bigger contribution in steering committees. Steering committee members should strive to represent the interests of the bank group as a whole rather than their own interests. The representatives of banks on steering committees should also have the right level of knowledge and experience to understand the issues and to make a real contribution to driving the process along. They should also of course turn up to meetings in the first place.
- Fourth, banks need to be able to respond more quickly to restructuring proposals that are presented to them for approval. At present, it seems 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. While decisions are delayed, companies can bleed to death.

- Finally, and I realise that this is a contentious point, banks should 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.

All this results in a process which is often more protracted than it need be. The company suffers an escalation of legal and advisory costs and can hardly operate normally while its survival is being negotiated.

Let me turn to what the HKMA can do to assist in easing some of these difficulties. I should stress first of all that the HKMA is a strong supporter of the workout concept and of the HKAB 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. Some people have suggested that the HKMA should become involved earlier and play a more visible role in workouts. There is a risk however that this would detract from the role of the lead bank and the financial advisers and reduce the impact of the contribution that the HKMA can make - familiarity can breed contempt.

The HKMA has been involved in about 10 cases since the HKAB Guidelines were issued. Typically these will involve 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 realize 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 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 the case as we contemplate the task of restructuring the Mainland-related companies such as Guangdong Enterprises which are currently in financial difficulties. The scale of these problems and the unfamiliarity with the workout concept on the Mainland will pose particular challenges. The lending banks will need to exercise patience while the borrowers and their shareholders must face up to the need for transparency and openness with their creditors. This is going to be a long and arduous process which has only just begun, but the GITIC liquidation provides a clear example that the alternative is even more unpalatable.

I will close with some thoughts on how we might take forward the task of improving the workout process in Hong Kong to deal with the challenges ahead. One thing that will help is the proposal to introduce provisional supervision in Hong Kong. The aim of the proposal is to facilitate a company in working out a voluntary arrangement with creditors. It would do so by imposing a moratorium on legal proceedings against the company which could be extended for up to 6 months or even beyond with the consent of the creditors. During this time a provisional supervisor would take control of the company and formulate a restructuring proposal to be put to creditors which are bound by the moratorium. A statutory framework of this kind has its own drawbacks, but the general view seems to be that it would be particularly useful in giving a breathing space to smaller companies and freeing the lead banks from the effort of having to keep creditor banks in line in such cases.

The non-statutory form of workout will however still be required even if the proposed legislation on provisional supervision goes ahead. To make this work more effectively, it would appear to be timely to review the operation of the HKAB Guidelines a year after they were launched. It may be desirable to issue additional guidelines on various aspects of the workout process, for example on the role of the steering committee, the operation of a standstill or the provision of new money. There may also be scope for clarification of the role of the investigating accountants, in particular whether they should be appointed by the borrower, as at present, or by the banks.

Even if the Guidelines themselves remain as they are, and there is some merit in the flexibility which their current brevity provides, it may be appropriate to relaunch the Guidelines as part of an initiative to improve the familiarity of banks with the Hong Kong approach to workouts. This would stress among other things the need for a spirit of give and take, and a recognition on the part of the banks that "united we stand, divided we fall". One way of doing this would be for HKAB and the HKMA to host a joint seminar on the Guidelines to which the chief executives of all banks in Hong Kong would be invited. However, it is clear from what I have said earlier that the head offices of

foreign banks may also have to be brought more into the picture, in particular to try to ensure that decisions on workouts can be made in a more timely manner. One possibility would be for the HKMA to write to the head offices of all the foreign banks in Hong Kong to describe the thinking behind the HKAB Guidelines and to explain that we expect banks in Hong Kong to comply with them to the fullest extent possible.

I intend to write to HKAB to seek its views on these initiatives. The preparation of this speech has helped to concentrate my thoughts on the issues involved, and I would like to thank Amcham once again for giving me the opportunity to speak to you today. ☺