

Interview with Mahesh Uttamchandani for the Crisis Talk blog  
(<http://crisistalk.worldbank.org>)

April 2, 2009

*Editor's Note: Recently, I sat down to have a chat with Mahesh Uttamchandani, Senior Counsel for Insolvency & Creditors' Rights at the World Bank and head of the World Bank's Global Insolvency & Creditors' Rights Initiative. An expert on insolvency regimes, Mr. Uttamchandani kindly answered my questions about the role that effective insolvency regimes can play in helping emerging markets cope with the impact of the financial crisis.*

Q:

One of the issues that has been raised in the context of the crisis are the estimates for corporate debt in emerging markets – somewhere between \$1.25 and \$2 trillion is coming due in 2009. Do you see a wave of corporate bankruptcies in 2009? And if so, how prepared are emerging markets to deal with this?

A:

If you look first at the U.S. as an example, going from 2007 to 2008, you see a 2.5 times increase in the number of corporate bankruptcies, which is significant. But what is staggering – if you look at only non-financial firms – you see a 1,000 percent increase in the value of assets that have gone into bankruptcy. What we thought was a financial crisis is now a real-economy crisis, certainly in the United States. That's got to migrate, and it has certainly migrated to the developing world. So, the implication is you'll see rising unemployment and a significant drop in productivity as this hits the real sector.

In a lot of countries, particularly in Eastern Europe, the banks couldn't raise money in the local market sufficiently, so they went to the foreign market and raised foreign currency and passed this foreign exchange risk on to their borrowers. So now you have borrowers who have seen a significant drop in the value of their local currency, which raises their indebtedness overnight. So I think that's exactly what we're expecting.

Now, in terms of whether countries are prepared or not, we have been doing diagnostics on insolvency in the World Bank for close to ten years. Match that up with Doing Business, which also looks in a slightly different way at insolvency systems, and you see a pretty consistent message – insolvency processes go too slowly in most countries. And speed is a huge factor. The longer it takes, the less value stakeholders extract from it, and the fewer options you have in dealing with that insolvent business.

If it takes too long, your ability to potentially sell the business as a going concern depletes exponentially. And that's the method by which you're going to save jobs.

You're either going to reorganize the business or sell it as a going concern. But what happens in too many of the countries we work in is that the process just takes too long and there aren't the sophisticated legal tools to save a company. So you end up liquidating companies at a disproportionate rate. Assets get broken off and sold to the highest bidder, which in some cases may be the right choice. Some businesses should fail. The problem is that there is an absence of these legal tools to save a business that maybe is viable but just has a temporary liquidity problem.

Q:

As you mentioned, Eastern Europe has been one of the hardest hit in the current crisis because of large foreign exchange exposures. Would you say that this region is also one of the least prepared in terms of the laws it has on the books and in terms of its capacity to implement those laws?

A:

Well, I think the challenge in Eastern Europe is not so much the legislation. Eastern Europe more so than any other region or maybe on par with East Asia has the most significant number of new laws in this area passed during the 1990s and early 2000s. So you have a lot of modern legislation. What very few countries in Eastern Europe did is figure out how to make that legislation work. For example, one of the responses the World Bank is developing is to build the capacity in countries to regulate insolvency administrators. Now these are the people, accountants typically, sometimes lawyers, who really help implement the law because they run the business when it's going through a reorganization or they are the ones liquidating a business. They will be the ones advising the court whether a company should be saved or not.

Q:

What's the line of authority? Are these administrators state employees?

A:

That's one model. I don't think it's the preferable model. The more common model is either private practitioners – and you see them in parts of Eastern Europe – housed in PwC and Deloitte's, and what happens is the law provides a lot of authority to these people, even in Eastern Europe. They are the ones who have to report to the creditors, and say “we think it's a viable business, but you have to shut down this retail location, this division, but you have to renegotiate the debt. Or we think this thing can't be saved.”

But in a lot of countries, the people who practice this business are not professionals. There's no requirement that they have a finance background or an accounting background. They're not licensed in any way. So I think that's where you see a core problem in Eastern Europe. And that's one of the crisis responses we're developing in the World Bank. But I see that as a big problem. As you have an increasing number of cases,

you're going to strain the existing capacity of the handful of professionals who are good at doing this work.

Some countries have created a whole regulatory infrastructure to regulate these administrators. They're all private sector players, but they're regulated at the government level – there's a licensing exam, a discipline mechanism, a code of conduct. But you don't see it in most countries.

Q:

There are some countries that have already hit crisis mode. How would you assess their response so far, and are there any lessons for other countries in Eastern Europe or any good practice models? What kinds of steps can other countries take to prepare?

A:

I think the model you need is a combination of a strong legislative framework that gives you all the sophisticated tools at the high end of the market, but then a good informal workout set up that allows debtors and creditors to negotiate out of the court in a less formal atmosphere. There are different models across Eastern Europe, and even though the region is at the forefront of this crisis, I don't think we've seen it tested in the corporate sector yet. The crisis is just getting there. You see some models in East Asia that came up in the last crisis. I think we're going to have a much clearer idea 8 or 10 months from now. And I think that's part of the challenge.

Q:

What about the idea of super-bankruptcy a la Stiglitz? Do you think there are any cases where this might make sense? What are the pros and cons of this approach?

A:

I think we have to distinguish between what we're trying to do both in the short-term in response to the crisis and on a longer-term basis. Once you've made that distinction, there are things that an ordinary corporate insolvency regime can respond to. It can provide a sustainable way to reorganize troubled companies. The problem is not just that a company has a debt payment due and can't make it and the company needs to amortize it out further. Sometimes there are basic operational problems with the business that don't mean the business needs to be liquidated but it can't operate in its current structure. And you saw that very much in the U.S. in the auto industry, you saw it in the airline industry. So there has to be some significant changes to the business.

And that's what a corporate insolvency regime can do. And it can do it in the current crisis on a wider scale by again providing avenues for out-of-court workouts, building the regulatory capacity in the country to handle an increasing number of cases, improving the courts. But then there are specific crisis issues, certainly in the financial sector, and in

some parts of the corporate sector, where you have industries that have systemic impact. And there you need a “crisis response” where a super-bankruptcy procedure might be useful. I’m less concerned about that solution – I tend more towards the view of the world that it may not be particularly helpful, but even then you still have to define what you’re using it for.

Again, you’re going to see it in this country. There may be something the government can do to facilitate an auto company going through a chapter 11 process by being a lender of last resort. So you have a crisis response blended with a traditional bankruptcy system, and that may be a one-off solution for a particular case. But at the same time you don’t want to put forward solutions that are going to create disincentives to actually reform the bankruptcy system. Otherwise, we’ll be here again in ten years. And that’s the concern I feel. If you come up with a response that says, look, we need to get these bad loans off the books of the bank, and we need to work them out very quickly in some abbreviated form. What’s going to happen when you fast-forward ten years and there’s still no comprehensive corporate insolvency regime. You’re just rescheduling debt and putting these problems into the future. That’s the big concern I see with some of these super-bankruptcy laws and a narrowly focused crisis response.

Q:

You spoke earlier a bit about the World Bank’s work on insolvency regimes. Could you go into a little more detail about what work has been done, what things we may be planning on doing, and where you think the emphasis should be?

A:

The World Bank has been working with the international community to set standards for insolvency regimes. This involved working with all the international institutions – experts, countries from around the world – to develop a set of 35 principles that tell you what an insolvency system should achieve, recognizing that different countries will achieve this in different ways. So it’s not a model law. It’s a set of overarching principles. The World Bank was then tasked to help countries assess or diagnose their insolvency systems. We’ve been conducting these diagnostics for 7 or 8 years. That has given us a body of knowledge that I think is going to be critical during the crisis because we have understood in very practical terms where the choke points are in insolvency regimes.

Now I think it’s important both in this crisis and beyond that we continue to do this, but we also have to turn our minds to implementing on-the-ground change in insolvency systems and providing that kind of assistance to countries. There is a joint initiative at the World Bank to offer three lines of technical assistance to countries. These will range from specific amendments to legislation to building the regulatory capacity for insolvency administrators to developing out-of-court workouts. And countries can access any one or all of these initiatives or request a more in depth diagnostic if they’re still at the stage where they need that kind of detailed picture. So I think there you have a menu of options for countries depending on where they are in the crisis, how they see the crisis

impacting them, whether they want a kind of rapid response/immediate assistance or they want a longer term approach. And I think that's really what the World Bank should be doing. The Bank has the comparative advantage of not having only developed the standard but also having the comparative view of what's been done in different countries, how it's worked in practical terms, what's failed, what hasn't failed, and I think that's where the Bank's real value added is.

Q:

One thing I haven't asked you about yet but that is probably at the base of all this is the banking system. Does there need to be a difference in insolvency regimes between the way the corporate sector and the financial sector are treated?

A:

I think it's an unqualified yes. Insolvency regimes typically are divided into three categories: the financial sector, corporate sector, and household sector. And I think that they all share the common notion of insolvency, but they're three completely distinct animals, and we should not conflate them.

The financial sector insolvencies need a very strong regulatory hand. There is a whole concern about systemic problems, about public confidence that is much less of a concern in the corporate sector. Of course, if a major industry goes into bankruptcy, you will have some systemic impact and you will have some public confidence issues, but it's day and night from a large bank. So I think we need to keep them very separate.

Q:

Do you have any other thoughts on the crisis that you'd like to share?

A:

Currently, there is a disproportionate weight toward liquidation. And we know that from the diagnostics we've done under the ROSC [Reports on the Observance of Standards and Codes] program. And Doing Business tells us these processes take too long, which means we're going to end up in liquidation. What I see as a problem as this crisis spreads is a wholesale destruction of industry in a lot of lower and middle income countries where there just isn't the legal regime to respond and try to save companies and maybe there isn't the public sector ability to respond. That will result in significant job loss. One of my concerns is that we see what is a commercial problem translate into a much more significant personal problem. I think the household sector is going to be deeply affected if you look at the wave of credit card defaults that are probably coming over the next few months. I see this as a problem that will potentially spread to all regions and manifest itself perhaps in different ways. But at the lower and middle end it's an issue of too much liquidation. Because there's going to be a concern among creditors to get their hands on

as much money as possible in the fastest time, and liquidation will seem like the easiest approach – relatively low risk, but I think low return.

Another concern we need to think about is that one of the big success stories of the last 10 or 15 years has been the growth of the private sector in emerging markets. But this growth has come at a time of excess liquidity, or at least very low cost liquidity, and many of these industries have never been through an economic downturn. A lot of the players – whether in the public or private sector – haven't turned their mind to what happens in a downturn.

A classic example that I always think of is, if you go back 15 or 20 years and you look at the airline industry in a lot of countries, you would have seen one domestic carrier, probably state owned, flying local routes. Fast forward, and in a lot of emerging countries you see a booming domestic airline industry, two, three, four or sometimes more domestic airlines, and people haven't figured out what we will do when those planes have to stop flying. Twenty years ago the government would have intervened in its own business. Here, now, in many emerging markets there's such dependence on domestic air travel, and we just haven't figured out what we will do. What's the mechanism? Because the law can't respond to it. And if the law can't put a protective shell, for example, around the debtor in an appropriate case where the debtor can be saved, then creditors will move in and they will take their assets, and it will grind to a halt. I think we've taken the private sector for granted in many cases in these countries. I think there needs to be a response on the legal and regulatory side that provides a set of tools to troubled countries.

Q:

One final question on bailouts of systemically important industries. If governments start bailing out large industries in an ad hoc way, they may start to put their own finances at risk. What measures can be taken to help limit the burdens that governments take on so that they don't put themselves into a difficult situation?

A:

I'm a big believer that that kind of intervention done improperly not only creates the kind of situation you describe but also creates a serious moral hazard. I think it's inappropriate for the equity holders to be saved even if there's a recognition that the enterprise needs to be saved. So I think government needs to get creative, and where you are operating in an environment where you have the right legal tools, what governments can do is step in where the private sector has been unable to provide the necessary refinancing capital. So rather than simply saving the business as it currently stands and saving the shareholders, what I think government can do is say, look, we recognize that in a chapter 11 bankruptcy process you would typically be able to go out there and get superpriority financing, what is known as debtor-in-possession financing, which is a low-risk and high-return type of finance.

In this economy, that liquidity may be gone. That's where maybe the government can step in and provide a loan that is low-risk, high-return, first-repaid, with less risk to the taxpayer, but yet there's a legitimate need that market can't or is unwilling to respond to. And at the same time you've then achieved the legal restructuring you need to maybe renegotiate labor contracts or shut down unprofitable divisions and those things can all happen under the stability of a bankruptcy process, where a lot of the politics is just extracted from the process. And this is done on a commercial basis under a judge's supervision. That again makes the argument for having the legal tools which gives the government options – it's not faced with simply the option of throwing money at the problem, it can do things in a much more structured way.

We have to make sure we're not creating a disincentive to actually create the proper legal framework. It's got to be more sustainable. I think that's probably the big danger for countries as we go forward. There's been a lot of focus in a lot of countries on access to finance as something that you need long-term on a sustainable basis. In the same way that you need that entrance, you also need the exit to be managed responsibly.