BOND RESTRUCTURING AND INSOLVENCY SYSTEMS

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The benefits of bond markets

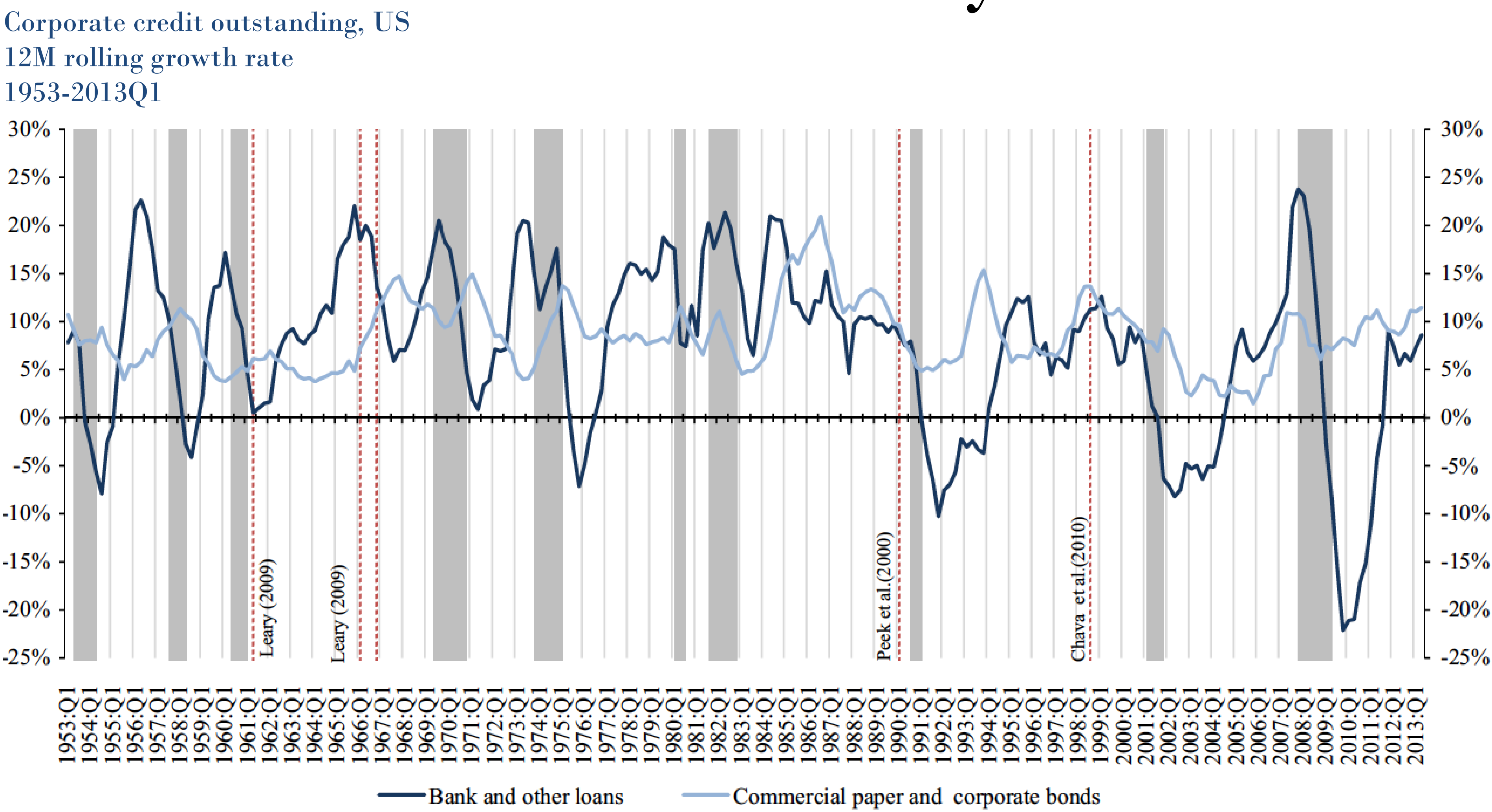
- Bonds available through cycle
  - Not reliant on bank capital
  - Arms-length (passive) investors: staffing needs become more stable
  - Longer maturities, bullet repayments => lend and forget
  - Investors respond to problems by selling (to activists), not withdrawing credit

- Reduces financial system concentration

- Allows passive investing in fixed income
  - Mutual funds, pension funds

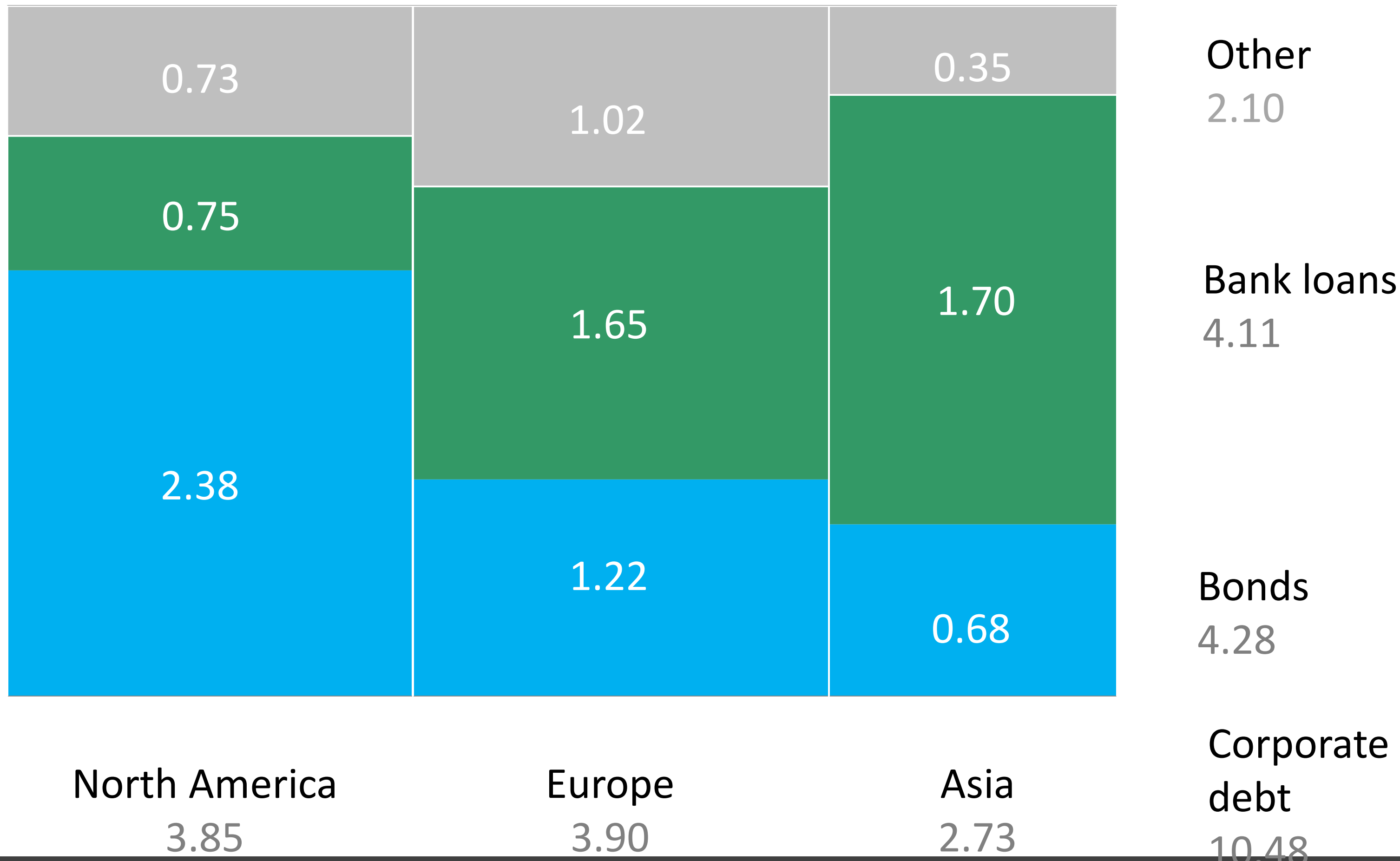
- Allows activist investing in fixed income markets

The US credit cycle



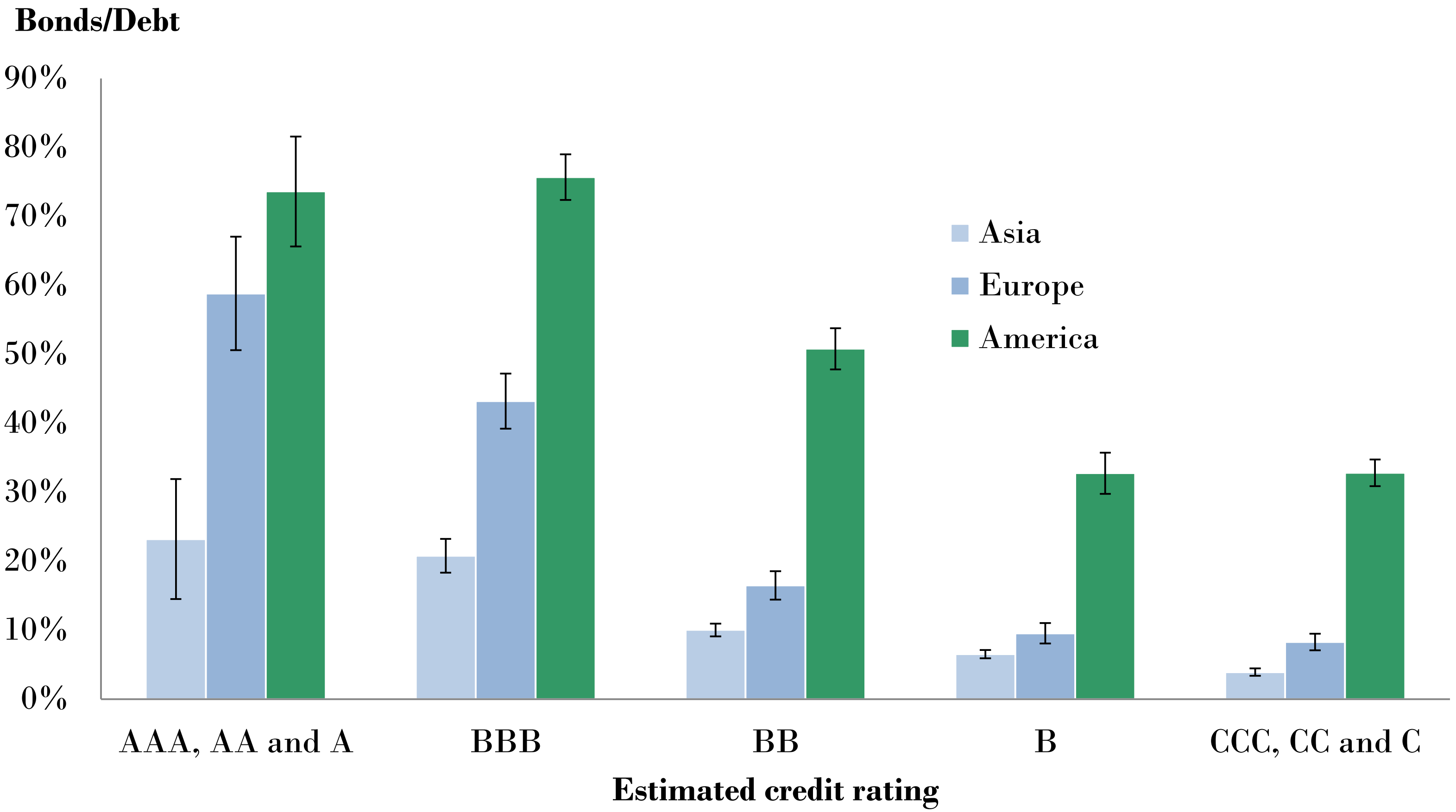
Source: *Becker and Ivashina (2014 JME)*

Corporate debt around (most of) the world, 2010



Source: *Becker Josephson (2016, Review of Financial Studies)*

The difference in debt mix is strongest for high risk firms



Source: *Becker Josephson (2016, Review of Financial Studies)*

The Becker Josephson hypothesis

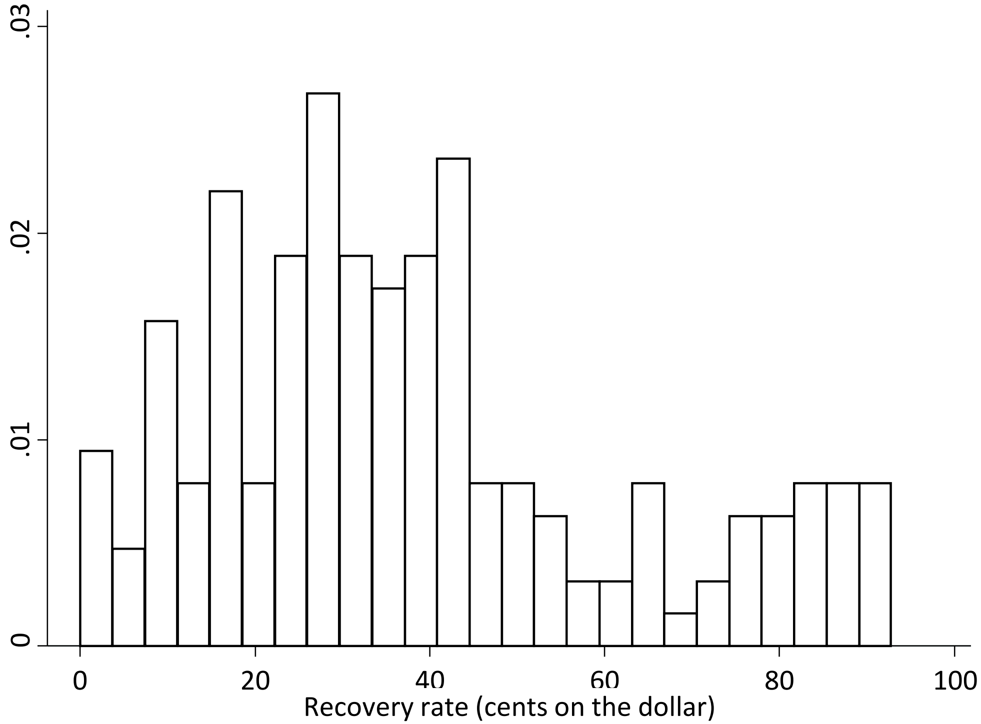
- Bond holders at a disadvantage (vis-à-vis banks) in out of court ('OOC') restructurings
  - Small stakes
  - Less information, experience

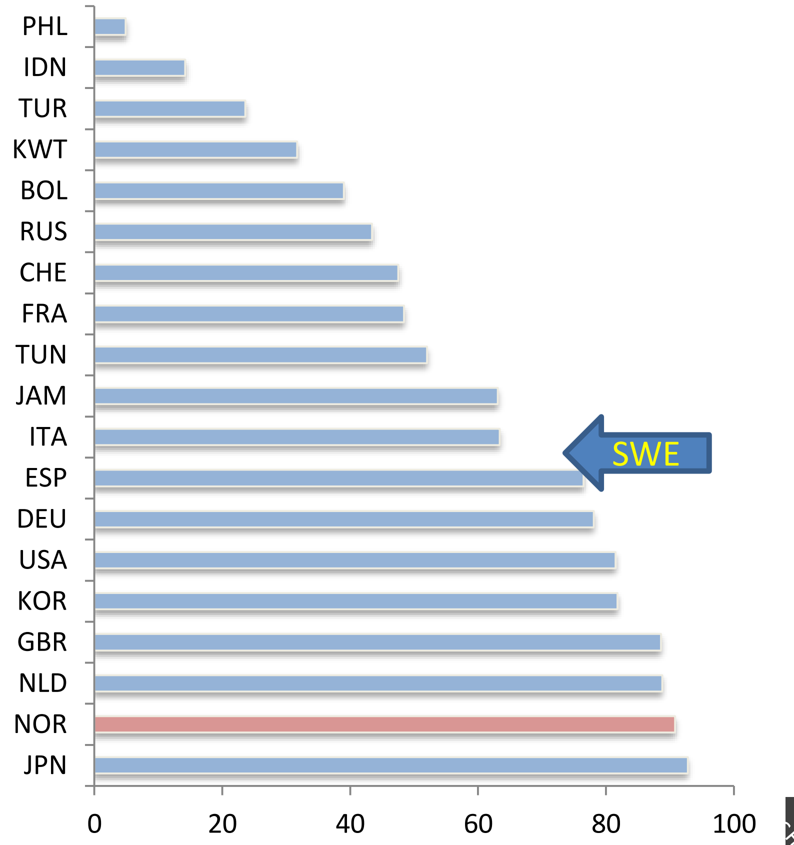
- In-court procedures are often good at protecting dispersed & otherwise weak claimants

- In many countries, in-court procedures are so bad that restructuring must be done out of court
  - Consequently, these markets see limited bond issuance
  - Bonds appear expensive - relative to loans – in eyes of CFOs (need to compensate for future losses)
  - For safest firms (IG), the difference is limited, and bond market develops

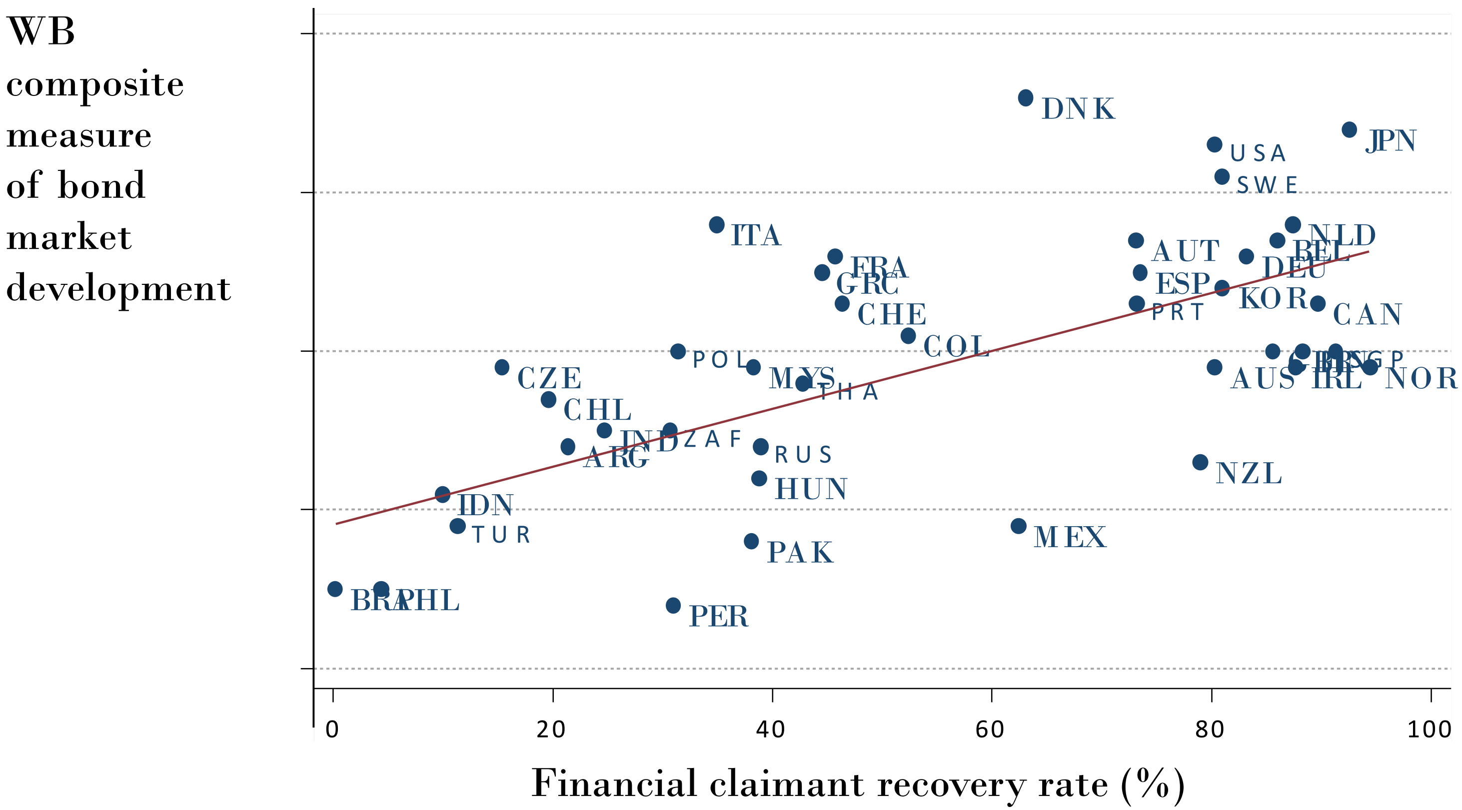
Insolvency resolution is very different

The World Bank measure of bankruptcy efficiency





The empirical link between bankruptcy and HY bond market



Selected reform examples	
Brazil (2004)	• Stronger role for creditors • Limitations to the size of labor claims • Reduced priority for tax claims • Going concern sales free and clear of tax and labor liens and liabilities introduced
Italy (2004-2007)	• Prompted by Parmalat • Firms allowed to reach a deal with creditors outside of bankruptcy • Minimum requirements for a reorganization (instead of a liquidation) reduced • Creditors' committee gained influence • Removed limits to operations in bankruptcy • Reduced case backlog
Poland (2004-7 & 2010, 2012)	• Procedural and operational reforms • Changed documentation requirements • Increased qualifications and pay limits for administrators • Eliminated procedural steps • Introduced a reorganization procedure • Secured creditors have also received stronger rights
Peru (2001-5)	• Security interests were vastly simplified • Out-of-court resolution facilitated • Amending and adjusting a reorganization plan became more difficult • Implementation of the reforms were problematic • Reduction of bankruptcy efficiency around 2007

	(1)	(2)	(3)	(4)	(5)	(6)
Dependent var.	Bond share					
Sample	All	Years with change in recovery	All	Years with change in recovery	All	Years with change in recovery
Dep. var. mean	0.216	0.204	0.216	0.204	0.216	0.204
Bankruptcy recovery	**0.306***	**0.363***	**0.381****	**0.436****	**0.539****	**0.569*****
	0.170	0.196	0.170	0.195	0.183	0.194
Recovery x Credit rating			**-0.057****	**-0.056****	**-0.017*****	**-0.017*****
			0.025	0.028	0.003	0.004
GDP per capita					**-0.302***	**-0.255**
					0.163	0.211
GDP growth					**0.069***	**0.010****
					0.037	0.005
Population					**0.402**	**0.131**
					0.276	0.307
Rating x GDP per capita					**0.005****	**0.007*****
					0.002	0.002
Rating x GDP growth					**-0.037****	**-0.033****
					0.016	0.017
Rating x Population					**-0.047**	**-0.068**
					0.041	0.047
Firm controls:	Credit Rating, ROA, Dividend Indicator, Cash/Assets, Market capitalization, Book-to-market, Volatility, Book assets, Volume					
Country, industry, year F.E.	Yes	Yes	Yes	Yes	Yes	Yes
Country F.E. x Rating	No	No	Yes	Yes	Yes	Yes
N	93,050	76,075	93,050	76,075	93,029	76,068
R-squared	0.265	0.266	0.265	0.264	0.266	0.267
Clusters	269	221	269	221	263	220

- Insolvency reform is associated with gains in bond market development
- Especially large gains in HY
- Suggests that EU reform initiative on insolvency law is helpful for capital markets

Insolvency rules drives commercial developments; ex: investors

Kreditkvalitet	Investment Grade	High Yield	Distressed (spread >10 %
Antal positioner för en typisk investerare	100+ obligationer	20–100 obligationer	5–50 obligation aktier m.m.
Investeringsprinciper för en typisk investerare	Exponering mot branscher, löptider. Diversifiering	Analys av individuella obligationer	Aktiv involvering med individuella utgivare
	Makroexponeri låg kostnadsb		Kreditanalys, stöd till rekonstruktion

na över amerikansk

nas överavkastning efter

PIMCO

Investment Grade Corporate Bond Fund

GUGGENHEIM

"The fund seeks to gain exposure similar to the high yield bond market by investing in credit default swaps, high yield securities, futures"

OAKTREE

We favor large, fundamentally sound companies that are over-leveraged and we often assume a leadership role in the financial restructuring process

Lessons for European insolvency

- Ch. 11 remains gold standard
  - Only system that can restructure large complex capital structures on top of a viable business
  - Ex. American Airlines, KMART, GM, etc.

- Some key features of full-blown Ch. 11
  - Without bankruptcy tools, not easy to fix operations
  - Must produce stable capital structures after restructuring: cram-downs, debt-for-equity swaps etc.
  - Valuation: to distribute value fairly, must value. Takes time, relies on asset markets
  - Avoid hold-up by equity without economic value: cramdown
  - All this requires very competent courts: specialized courts required

How does Norway's system fit into this analysis?

May Norway offer a way to realize most of the benefits of restructuring in Europe?

- NB. no specialized courts and twenty five legal systems
  - Liquidizing bankruptcies

- Option 1: let UK run system (like Delaware and SDNY)

- Option 2: facilitate private contracting solutions out of court, like Norway
  - More feasible
  - Generate most of the benefits for credit markets