Patrick Honohan: Reflections on corporate restructuring in Ireland

Address by Mr Patrick Honohan, Governor of the Central Bank of Ireland, to the Corporate Restructuring Summit, Dublin, 27 September 2012.

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It would be an understatement to say that corporate restructuring is a topical issue for Ireland these days, though it is worth remembering that a dynamic economy entails a continuous process of corporate restructuring and not just in bad times. In normal times firms adapt in part through internal reorganisations, including product and process innovation. But the individual firm does not always have what it takes to reinvent itself in response to major changes in technology and competition, and then its survival is subject to takeover, merger, or, in the case it is unable to pay its debts as they fall due, to various forms of asset or liability restructuring.

The need for corporate restructuring in Ireland today

Right now, though, an extraordinarily large number of firms in Ireland have been experiencing financial distress typically as a result of the deep domestic and (less deep but equally protracted) international downturn in demand, or because of their unwise property investments. An extended period of intensive corporate restructuring has begun. This is most conspicuous for the big property development companies, but there are many others.

Much of this restructuring has so far come through firm exit altogether. CSO surveys covering about half of the economy, and most of the non-agricultural business sector, throw some quantitative light on what's been happening (Table 1). The number of firms counted by the CSO in the census of Industrial Enterprises fell from about 5600 to under 4800 between 2008 and 2010, the worst period of the crisis and the latest for which data is available. Almost no subsector was spared. This proportionate decline, of over 14% in numbers of industrial firms, is not too far from the decline in aggregate employment in that sector (17%). The story is broadly similar in Construction and in Services, especially if one excludes the large number of very small firms in these sectors. Indeed, the number of construction firms employing more than 20 persons has almost halved, with their employment falling by almost two-thirds.

Broadly speaking, the relatively small change in the average employment per firm seen in the data suggests that the downturn has not favoured large firms over small, and also that the employment decline has been driven more by firm closure than by partial lay-offs.

Even after such a big shakeout, many of the remaining firms are in a weakened financial condition, and may need balance sheet as well as organisational restructuring in order to survive and prosper. Recent research[1] at the Central Bank has confirmed that stressed balance sheets are clear early warning signs of subsequent loan default. But the research also indicates that some well-run firms can ride these problems out, notably if they are being run by an experienced owner that has been with the firm through other ups and downs.

Many balance sheets are stressed because of unwise property investments made on the side of a viable non-property business. Restructuring these balance sheets without losing the true value of the resources, human, technological and physical, that are now engaged in each firm's core business, is a key challenge for corporate restructuring in Ireland today. Overall, this is a challenge that will absorb the efforts of banks, law firms, and – that most elusive of professions, well-represented here today – workout specialists.

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[1] Cf. Fergal McCann and Tara McIndoe-Calder. "Determinants of SME Loan Default: The Importance of Borrower-Level Heterogeneity," Central Bank of Ireland Research Technical Paper 6RT12, September 2012.

The modern economy is driven by firms: they generate the bulk of employment, and the output that supports the wages and salaries, as well as feeding directly and indirectly into the tax revenue needed to support the social and economic infrastructure that underpins all of economic activity. Healthy firms are a prerequisite for a growing economy that creates jobs. Too many of even the surviving Irish firms have not yet recovered from the crash and need restructuring.

Corporate failures in the last big downturn in Ireland

Restructuring of distressed companies is not a new phenomenon in Ireland or anywhere else. Reflecting on Ireland's experience with corporate financial distress over the years, many resonant names come to mind. Companies fail in good times as well as bad times, but it is the downturns that see the vast bulk of corporate restructuring business. The last big downturn in Ireland was in the 1980s. And I well remember some of the big names that got into trouble in those days and were either helped or not helped by the Government of the day.

Take Irish Shipping, for example, which got caught up in over-ambitious expansion and over-indebtedness as it built a large fleet of leased vessels well beyond that company's traditional goal, which aimed at controlling sufficient tonnage to avoid Ireland having to rely on foreign companies to deliver essential supplies in time of war. Though the deficiency of Irish Shipping – probably well under €0.5 billion in today's money – may seem dwarfed by the banking losses of recent years, it was too much for the Government to take on (even though it owned the firm) and Irish Shipping was liquidated.

Other high profile cases of the 1980s, such as Dublin Gas, Irish Steel, and the two big general insurance companies ICI and PMPA, saw public money poured in to protect what were seen as essential services.

The 1990s saw the even larger failures of the meat concern Goodman International and of the aircraft leasing company GPA. The latter was a huge global operation, owning hundreds of aircraft and exploiting a taxation arbitrage as well as know-how about the demand and supply conditions in the aviation industry. But it became overstretched and over-indebted and was unable to raise the equity capital which would have allowed it to ride out a cyclical downturn: it was dismembered and mainly sold to a US company.

Some of these large failures reflected insufficiently controlled over-expansion; others a process of senescence leaving the company prone to bankruptcy as soon as the next economic downturn came along. In each case, it generally fell to the bankers to pull the plug. It is usually they who have to refuse further accommodation, to stop the drain of unrecoverable resources.

Interestingly, in several of the large historic cases mentioned, Irish banks did not find themselves as heavily exposed as one might have expected. Perhaps the Irish banks had a closer view and a better understanding of the potential risks back then, or perhaps there were other reasons, but other creditors, including banks abroad, seem to have absorbed or been exposed to the largest losses in several of these failures. Perhaps that experience was one of the ingredients contributing to embolden the Irish banks to feel invulnerable to downturns. Perhaps one day we will fully understand just how fundamental decision-making in the banks (during the property bubble) ended up so insulated from adequate attention to basic risk-controls – and indeed in the end from common sense!

Optimal restructuring

When restructuring works well, the assets of the failing firm, along with the human capital embodied in its employees, will find a good alternative use. Receivers and liquidators will certainly have worked to get a good price for the physical assets. Aircraft and ships owned by GPA and Irish Shipping may have been laid-up for a while, but most found employment

later. Employees did not always fare as well. The collapses often happened during periods of weak global activity associated with levels of unemployment at home and abroad that make it hard for displaced workers to get a job. The plight of the misfortunate former Irish Shipping workers has rightly been highlighted.

There are inherent conflicts of interest between different stakeholders in a restructuring though, and not all work-outs do contribute to overall economic efficiency. Indeed, sometimes key protagonists may be aiming to build a monopoly or attempting aggressive risk-shifting. That's why public policy, for example, competition policy, or mergers and monopolies policy, may need to be activated.

In the past, Governments have sometimes got involved more directly. For example, when Irish Steel looked like closing, the prospect of so many workers being displaced into the depressed labour market conditions of the mid-1980s, perhaps to remain on the dole for years, weighed with the Government of the time in its decision to provide funds to keep that firm going for some years more by subsidising its activities.

But a greater awareness of the opportunity costs of Government rescues of companies has reduced their frequency over the years. Propping up a doomed company is not always good even for those who seem to benefit. Few now bemoan the demise of the Irish car assembly business. Indeed, a decade after that business collapsed following the Anglo Irish free trade agreement, manufacturers of car parts for export employed more people than the assembly industry did in re-assembling CKD (completely knocked down) car kits.

Making sure it's done well – avoiding delay and dealing with owners

Faced with cleaning up the post-crisis mess, procrastination is an ever-present cancer. Hoping something will turn up is a natural reaction when the alternative is facing up to the inevitable and taking steps that crystallize losses and directly affect the stakeholders of firms including the employees and trade creditors. But the hidden consequences of procrastination impose costs elsewhere in the economy – costs that destroy even more jobs elsewhere. That was the experience of Japan in the 1990s, and Ireland can't afford to suffer a similar protracted delay. An unhealthy firm balance sheet means that access is denied to new funding that can enable expansion, upgrading or innovative investment that could generate output and employment growth. Indeed, especially in the current crisis which is driven by balance sheet problems more than operating account problems, delaying the financial restructuring is likely to threaten jobs in the distressed company itself, as well as imposing indirect costs on those dependent on other companies.

Owners will resist restructuring, especially when it means that they stand to lose control over some or all of the business. They have of course a large financial, and not seldom emotional, interest in retaining their position and may also think that only they have the expertise to make the most of the assets of the company. In some instances, creditors will agree with this proposition. In his book,[2] Professor Cahill suggests that the lending banks (most of them foreign) may have found it a "bitter pill" to retain the CEO of Goodman International in executive control and with a sizeable equity stake in the restructured company. Other high-profile cases saw the more conventional presumption that the old shareholders and top management will go. That has been the basic modus operandi of the Government in the current banking crisis as far as the banks are concerned. In the case of NAMA, dealing as they are with a huge number of property-owners and developers, the modus operandi to date appears to reflect a kind of extended triage of their borrowers, with some being kept on, and others eventually not.

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[2] In refreshing my memory on these cases, I have found Edward Cahill's *Corporate Financial Crisis in Ireland* (Dublin: Gill and Macmillan, 1997) of great assistance.

Asset management companies or in-house operation of the banks?

Some may find irony in the fact the banks are among the main actors in driving restructuring. After all, they themselves have experienced some of the most far-reaching balance sheet restructuring, with their shareholders wiped-out and subordinated debt-holders also nursing losses, and central bank lending filling the hole left by other departing creditors. That job losses in the banking sector have not to date been as bad as the economy on average reflects the Government's decision to step in and keep the operations of the banks going because of the services they provided.

(Incurring by far the biggest ever costs seen in corporate restructuring, the Government also tried to avoid a wider financial instability as well as the loss of credit standing that would have accompanied losses hitting depositors and other creditors, but that story, which began exactly four years ago today, has been the main theme on many other occasions and so I will not dwell on it here).

Anyway, despite all of this, the banks have also had to change gear and become heavily involved in loan recovery and the associated task of balance sheet restructuring of many of their distressed corporate (and individual) customers.

But can one improve on having the banks as the engineers of restructuring? This question was widely discussed around the turn of the millennium, as researchers and practitioners tried to draw lessons applicable to the East Asia crisis (which hit half a dozen rapidly growing countries in 1997–8 and left a debris of corporate insolvencies), and from the earlier experience of banking crises in Japan, Scandinavia and the United States, as well as some other developing countries cases. The broad conclusion from this debate[3] was that centralised asset management companies, as in Sweden and with the US Resolution Trust Corporation, can work well where what needs to be restructured is mainly a class of property companies. This is because the main assets of the companies are relatively easily transferred and do not depend on a specialised production chain, patents, firm-specific know how and so on. To overstate somewhat, the value of real estate may, especially in a downturn, be pretty much independent of who manages it. In a rising market, the Swedes managed to do well in realizing their property portfolio over time. The international literature also warns, however, that large state-owned AMCs can become vulnerable to improper political pressure, especially where large and prominent firms have become bankrupt. Fortunately there is no evidence of such pressure occurring in respect of NAMA in the current Irish crisis, and indeed the legislation setting up NAMA has built in protections against such pressures.

On the other hand, non-property related distress may (according to the international research) best be managed by the banks themselves. Specific company know-how can help in devising the best solutions for maximising the value of the firm's assets – provided that the restructuring process can be insulated from the denial and over-optimism that may have contributed to poor loan underwriting in the first place. The banks in turn need to be provided with sufficient capital to allow them to fearlessly accept and crystallise the unavoidable loan-losses, sufficient liquidity to be able to provide further financing to set the restructured firm back onto a healthy growth path, and eventually move it out of the limbo of financial distress. As against all of this, it has to be acknowledged that few bank staff startout with the skill-set needed to implement corporate restructuring: it is a very different business to loan underwriting. And a bank which diverts many of its most effective staff into such activities may not be so effective in fostering new lending relationships.

[3] Cf., for example, Marinela E. Dado and Daniela Klingebiel, "Decentralized Creditor-Led Corporate Restructuring: Cross-Country Experience." World Bank Policy Research Working Paper 2901, October 2002.

Ireland's institutional arrangements for dealing with the situation to date do seem to mirror this international consensus about the most appropriate institutional arrangements: NAMA for the big property loans, the banks for the remaining bad loans, and massive recapitalisation of, and extensive liquidity provision to, the banks. The differences are ones of scale rather than design. In particular, the losses destabilised the finances of the State, limiting its ability to react.

There have been suggestions that further blocks of banking assets could be moved off the balance sheet of the main banks. Certainly the banks have large blocks of hard-to-value and hard-to-sell assets on their balance sheets which are a drag on the investability of the banks because of the tail-risk of further losses that they embody and because they contribute to the over-scaling of the banks.

In practical terms, though, the management of numerous SME assets is a task for a large and decentralised operation. The operational risk of transferring this task to another agency would be very considerable. Even if ultimate ownership of the loan assets might possibly be shifted at some point in order to improve the balance sheets of the banks and hence their standing in wholesale markets, I foresee that they would in practice continue to manage most of the restructurings.

One of the recommendations of the literature is that the private sector should be involved as much as practical in the restructuring process. Private sector restructuring specialists can have the high-powered incentives to find quick and profitable solutions. Of course the process is costly. Private-equity firms will buy distressed assets only at a discount to what they think they can achieve when restructured and resold. Their time horizon is relatively short and their return thresholds high. Where it is a question of cleaning up a privately-owned bank, these costs simply imply a transfer within the private sector. But if the private shareholders have already been wiped-out, it is the State that will bear the costs. Its decision on these matters must therefore balance the prospect of a more effective restructuring by private firms against the costs that this will impose. Private sector solutions have not been neglected in the Irish case. To date there has been by considerable deleveraging of the banks to the private sector: asset sales totalling €32 billion in the past three years – most of them abroad.

Finding grand solutions that improve the situation is thus not easy. But that is not a reason for delay. On the contrary, every month that passes for an un-restructured distressed corporate is an energy-sapping lost opportunity for recovery. Urged by the Central Bank as regulator, the banks have been building their internal capacities through hiring, training and education, to deal with the situation. There is now an improved understanding of how best to deal with the numerous cases of distressed SME borrowers. This includes such matters as collecting adequate borrower information: adopting a realistic approach to post-restructuring viability calculations; ensuring time-bound execution in accordance with concrete implementation guidelines; quantified tracking of the progress in processing cases and, procedures for quality assurance. Yet the banks know they have not made sufficient progress in turning that understanding into a robust mechanism at scale for delivering an adequate stream of realistic and viable restructurings.

It's often not just a question of financial (balance sheet) restructuring, but also the need for operational restructuring, which is something which generally goes well beyond the skill-set of the traditional lender. Often there is a personal guarantee involved, so the owners will not be fully off the hook: the new personal insolvency legislation should provide a backstop for that element. Thousands of cases need to be dealt with decisively in such a manner. This is truly a daunting organisational challenge for the banks, but one to which, encouraged and pressed by the Central Bank, they are now stepping up. But, as I am sure they will themselves acknowledge, there is much work to be done and progress to date has been painfully slow.

Given the large number of firms still under pressure, implementation of an effective and speedy but surgical approach to corporate restructuring could have a big impact. By reinvigorating the Irish business sector, it would ultimately help boost economy-wide employment. Requiring unusual and scarce skills and judgment, this is a task which urgently deserves heightened attention.

Table 1: *Firm exit and employment decline in selected Irish economic sectors*

(a) All firms

	2008	2010	Change	% Change
Industry[4]				
No. of firms	5589	4782	-807	-14.4
Employment (000)	*216.2*	*195.5*	*-36.7*	*-17.0*
Avg empl per firm	*38.7*	*37.5*		
Building & Construction[5]				
No. of firms	47518	32293	-15225	-32.0
Employment (000)	*151.9*	*94.6*	*-57.3*	*-37.7*
Avg empl per firm	*3.2*	*2.9*		
Services[6]				
No. of firms	122046	124758	+2712	+2.2
Employment (000)	*995.8*	*891.2*	*-104.6*	*-10.5*
Avg empl per firm	*8.2*	*7.1*		

Note: the table shows the change in the number of enterprises recorded in three CSO enterprise surveys. This population covers about two-thirds of total employment in the economy.

(b) Firms with 20 or more employees

	2008	2010	Change	% Change
Industry				
No. of firms	1644	1379	-265	-16.1
Employment (000)	*188.1*	*160.5*	*-27.6*	*-14.6*
Avg empl per firm	*114.4*	*116.4*		
Building & Construction				
No. of firms	1204	620	-584	-48.5
Employment (000)	*97.1*	*34.6*	*-62.5*	*-64.4*
Avg empl per firm	*80.7*	*55.8*		
Services				
No. of firms	7569	6196	-1373	-18.1
Employment (000)	*605.4*	*517.0*	*-88.4*	*-14.6*
Avg empl per firm	*80.0*	*83.4*		

[4] Industry sectors 05 to 39.

[5] Sectors 41 to 43

[6] The Annual Services Inquiry covers retail, wholesale, transport and storage, accommodation and food, information and communication, real estate, professional, technical administrative and other selected servcies sectors