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Executive Summary

Restructuring Corporate Debt in Israel

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About the Milken Institute Fellows Program

The Milken Institute Fellows Program accelerates Israel's economic growth through innovative, market-based solutions for long-term economic, social, and environmental challenges. Our goal is to accelerate Israel's transition from a Start-up Nation to a Global Nation with solutions that others can replicate.

Directed by the Milken Institute Israel Center, the Milken Institute Fellows Program awards annual fellowships to outstanding Israeli university graduate students. Through the Milken Institute Fellows program, we train some of Israel's best and brightest young professionals in creating pragmatic financing and economic policy solutions, and they deploy them as resources to government ministries, nonprofits and other key organizations. Our applied research and Financial Innovations Labs® are a launching pad for transformative change, using innovative financing mechanisms, programs and policies to bridge social, regional, economic and productivity gaps within Israel and between Israel and the world.

In addition, Fellows craft their own policy studies during their internship aimed at identifying barriers to job creation and capital formation in Israel. The Fellows' research, carried out under the guidance of an experienced academic and professional staff, support policy makers who shape economic reality in Israel. The program offers the ultimate training opportunity, combining real-life work experience with applied research.

Throughout the year, Fellows receive intensive training in economic and financial analysis, public policy processes, and research methods. They acquire tools for communication and presentation, policy analysis, leadership and project management. The fellows participate in a weekly research workshop where they meet senior economic and government professionals, business leaders, and top academic and financial practitioners from Israel and abroad. They also participate in an accredited MBA course. The course, which focuses on financial and economic innovations, is taught at the Hebrew University School of Business Administration by Prof. Glenn Yago (Senior Director/Senior Fellow at the Milken Institute).

Fellows Program alumni can be found in senior positions in the public and private sectors. Some serve in key positions in government ministries while others work at private-sector companies or go on to advanced graduates studies at leading universities in Israel, the United States and Great Britain. Within the program's framework, more than 80 research papers have been published, catalyzing reforms, reducing barriers, accelerating economic growth, and improving the quality of life for Israel's citizens.

The Milken Institute Fellows Program is a non-partisan, non- political organization. It is funded by the Milken Institute and other leading philanthropic organizations and individuals in the United States and Israel.

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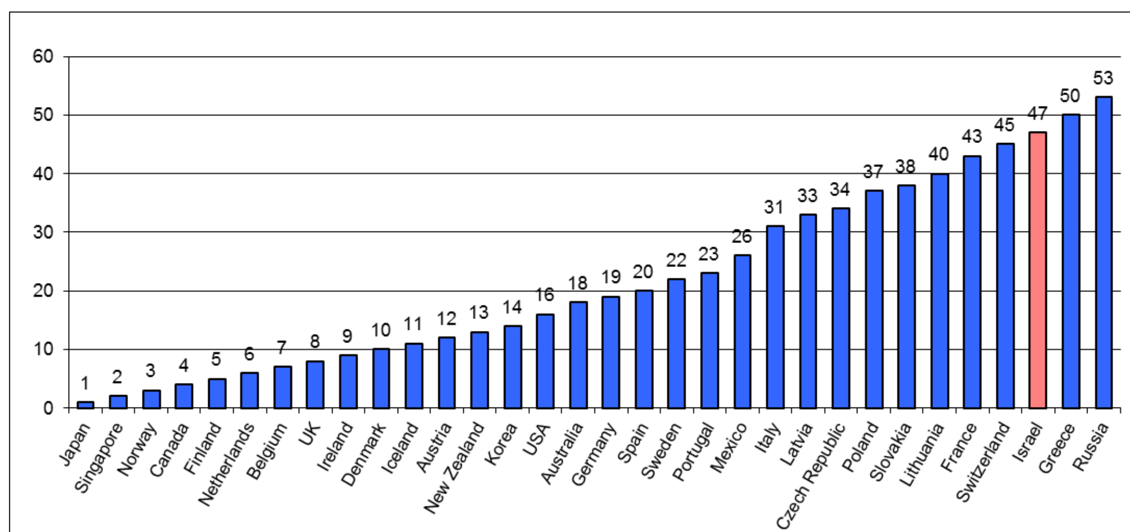
An effective and equitable process for facilitating debt-restructuring deals is a cornerstone of advanced capital markets and a robust economy. Such a process can be bolstered by ensuring that proper incentives are available to all parties in any given case. In Israel, the insolvency process is expensive, lengthy, and cumbersome. This paper will analyze the practice of workouts (the negotiation of debt-restructuring deals), assess the existing market failures, and suggest methods to fix these failures and reduce inefficiencies.

Israel is experiencing a wave of debt-restructurings after a decade of rapid growth in the corporate-bond market. According to the World Bank Index, Israel has one of the most ineffective processes for resolving insolvency, whether through liquidation or debt restructuring.

Figure 1: Resolving Insolvency index for selected countries



Source: World Bank, Doing Business Report 2013

This paper reviews debt restructuring and analyzes possible ex-post and ex-ante outcomes and risks–factors that might optimize the capital market and improve the performance of failing businesses, yet could also increase moral hazard and drive up the cost of raising capital.

Different approaches to workouts are examined, including the London approach and the global principles for multi-creditor workouts developed by the International Association of Restructuring, Insolvency and Bankruptcy Professionals (known as INSOL). There is a comparison of workout procedures in four countries, along with the Israel model.

An analysis of six large workout case studies negotiated in Israel leads to the conclusion that Israeli debt-restructurings fail to distinguish between economic distress and financial distress of otherwise healthy firms that suffer from poor capital structures. In the recent past, Israeli restructurings have avoided addressing the roots of the economic distress by failing to replace failed managers, improve corporate governance, reassess business models, lay off excess staff, and reduce excess assets.

The following financial-policy reforms are suggested:

A LOOK AT INCENTIVES AND BARRIERS

In order to strengthen the bargaining power of creditors, especially unsecured creditors, and to give them two viable options (debt restructuring or liquidation), it is essential to reform the resolving-insolvency process.

Limit the players involved. The workout process must be as certain, simple, and effective as possible. Currently, the process involves many players, precluding fast and effective workouts. This could be addressed by broadening the authority of the Administrator General, so he would be allowed to appoint members of an official bondholder committee with advice from the Israel Securities Authority–this would be similar to the authority of a U.S. trustee. Alternatively, it is worth considering another model that would limit positions in the bondholders committee to the largest bondholders only. An additional option would be to create one bondholder committee for both long and short bond series, so unsecured bondholders form one voting class.

Improve incentives for institutional investors and businesses. On the one hand, institutional creditors should be allowed to roll more than 50% of workout expenses over to the distressed business and institutional beneficiaries; and on the other hand, institutional creditors also should be allowed to include bonding and monitoring costs of a reorganization plan – rather than only workout costs – to the expenses that can be charged to beneficiaries.

Negative media coverage and the substantial expenses related to many workouts are perverse incentives that institutional organizations try to avoid, prompting them to sell distressed debt early on. Such sellouts may curb losses even before a workout has started. Selling and buying bonds are routine activities of investors, hence limiting discretion when selling distressed debt might do more harm than good. However, there are cases in which selling distressed debt does not stem from legitimate business discretion.

Incentives at the level of managers and controlling shareholders should also be improved to encourage them to start debt-restructuring within a proper timeframe, maximizing the chances of a successful reorganization. Positive incentives for controlling shareholders, such as an option to retain a certain amount of equity, and negative incentives, such as the inability to get immunity from prosecution or a personal liability for company debts, are playing an important role in inducing controlling shareholders to opt for timely debt restructuring. Similarly, rewards to management should be settled according to its cooperation during a workout and its contribution to the reorganization afterward.

The market for corporate control is another powerful tool for improving the restructuring mechanism. Such a market would substantially improve ex-ante and ex-post incentives for the controlling shareholders by jeopardizing their control in the event they do not meet stricter due-diligence standards and by requiring them to offer a better deal to creditors if there are other bidders to take over a distressed business. Similarly, activist investors have a positive impact on incentives of controlling shareholders. Institutional investors could play the role of activist investors given they are provided with proper tools and incentives to do so.

HOW TO STREAMLINE THE PROCESS

Explore business and operational reorganization. All debt restructurings in Israel have focused merely on the financial aspects of what each class of creditors would receive in the

restructuring. At times, the financial distress was caused by temporary factors, such as a liquidity problem, but in most cases, structural problems were the cause.

Establish a general framework for the workout process. The business and financial sectors, in cooperation with relevant regulators, could define a framework for workouts that would provide guidelines for negotiating debt-restructuring and assist participants in managing the process. The framework could be based on international standards and principles, such as the eight principles of INSOL that are used in Japan, Thailand, Hong Kong and other countries. It could include a time limitation for workouts, thereby concluding the debt-restructuring process more quickly and reducing expenses involved in managing the process.

Conduct a preliminary examination of debt-restructuring feasibility. Before starting the formal workout process, the creditors should examine the feasibility of a debt restructuring that would depend on the viability of a business as a "going concern"; they should also weigh debt restructuring versus liquidation. This examination should be based on credible information from a debtor company.

Identify and license economic experts on behalf of the court. This pool of insolvency professionals would be required to meet certain regulatory criteria and would charge fees according to standardized rates, similar to the well-established practice in most developed countries, such as Japan and France. The experts must hold distinct expertise in resolving insolvency, turning around companies, and the interface between law and economics. The practice of using experts in a given field according to standardized rates is common in proceedings of arbitration, mediation, and conciliation. For example, there are the Account General tariffs in the arbitration proceedings that involve the state of Israel. The tariffs can vary according to skills and experience.

Limit expenses. When a workout unfolds over a prolonged period, the management and controlling shareholder often continue to receive their usual remuneration. This arrangement does not help the distressed situation of the business. The economic expert overseeing the workout could recommend to the court steps to reduce operational expenses, such as limiting management compensation.

Enhance corporate governance and business structure. Debt restructuring is an opportunity to improve the somewhat wobbly corporate governance in the Israeli market. To resolve this problem, a "comply or explain" amendment could be adopted, similar to Amendment 16 of the Israeli Companies Law. The new corporate governance code should address new distribution rules, enhanced reporting to creditors, stricter rules to related-party transactions, and structural changes in management-reward schemes.

Seek regulatory opinion. This paper suggests that, in some cases, relevant regulators be asked to submit their opinions regarding a debt-restructuring agreement before final court approval, allowing the court to consider a wider range of possible projections. While debt restructuring rather than liquidation could benefit specific creditors, it also has the potential to damage all players in the aspect of moral hazard. Currently, the Administrator General is entitled to put forward an opinion in every insolvency case, generally in cooperation with the Israel Security Authority. However, other regulators, such as the Banks Supervisor in the Bank of Israel and the Capital Market Division in the Ministry of Finance, do not express their position, though they hold unique regulatory viewpoints that are likely to be relevant. Therefore, it is

reasonable to enlist their opinions in selected cases, especially in particularly large ones or those that could set important precedents.

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