

**Property Rights, Collateral and
Creditor Rights in East Asia**

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**Douglas W. Arner, Charles D. Booth, Berry F.C. Hsu, Paul Lejot, Qiao
Liu & Frederik Pretorius**

**Asian Institute of International Financial Law
University of Hong Kong
www.aiifl.com**

Abbreviations

ADB	Asian Development Bank
AfDB	African Development Bank
AMC	Asset Management Company
CDRC	Corporate Debt Restructuring Committee
Danaharta	Pengurusan Danaharta Nasional Bhd
DBRA	Debtors' Rehabilitation and Bankruptcy Act
EBRD	European Bank for Reconstruction and Development
IADB	Inter-American Development Bank
IBRA	Indonesian Bank Restructuring Agency
IFC	International Finance Corporation
IMF	International Monetary Fund
INDRA	Indonesian Debt Restructuring Agency
INSOL	International Association of Restructuring, Insolvency & Bankruptcy Professionals
KAMCO	Korean Asset Management Company
LLSV	La Porta, López-de Silanes, Shleifer & Vishny
NPL	Non-performing loan
OECD	Organization for Economic Cooperation and Development
OHADA	Organisation for the Harmonization of Business Law in Africa
REIT	Real Estate Investment Trust
SAFE	State Administration of Foreign Exchange.
SEC	Securities and Exchange Commission
SOE	State-owned enterprise
SPV	Special purpose vehicle
TAMC	Thai Asset Management Company
UCC	Uniform Commercial Code
UNCITRAL	United Nations Commission on International Trade Law
UNIDROIT	L'Institut international pour l'unification du droit privé (International Institute for the Unification of Private Law)

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I. INTRODUCTION AND OVERVIEW

1. Several common preconditions must exist in order for a market-orientated financial system or national economy to develop and function effectively. Those relating to financial sector development rest on three principles: the first, institutional and legal; the second, largely legal; and the third, mainly related to policy:

- First, a market economy and a market-based financial system cannot exist if certain institutional and legal supports are not in place, namely, through the operation of a governance system that establishes property rights and provides for the consistent enforcement of contracts and dispute resolution. It is also important to provide for the development of human capital.
- On the basis of these institutional foundations, for a market-based financial system to function, a number of legal underpinnings must be available, including the availability of collateral (secured transactions), a system of law supporting both the establishment and exit of corporate bodies, and a supportive system of taxation. To maintain such effectiveness, national and sub-national governance should also provide more widely for the rule of law, which is taken to be transparent and non-discriminatory, in addition to establishing specific property rights, enforcing contracts and allowing for dispute resolution.
- Third, a financial sector functions most effectively in the context of appropriate macroeconomic policies. These policies, while largely outside legal and institutional concerns, operate best in the context of an appropriately designed and transparent institutional framework.

2. No sophisticated market economy or market-based financial system can exist without these prerequisites, regardless of indigenous or acquired national characteristics or the form manifested by that system. In this context, this study looks at the interrelationship within East Asia of economic development, governance, property rights, provisions for the deployment of collateral and the creation of secured financial transactions, and creditor rights and their relationship with insolvency.

3. The eight subject national jurisdictions appear in two groups, shown in Table 1:

- First, a core group of six to which attention is most closely directed, and which have undergone, or are intending to enact reforms in the subject areas.
- Second, two common law jurisdictions that are perceived as among the most sophisticated in the region in the issues examined, and which may represent benchmarks for reform elsewhere. It is not suggested that either jurisdiction represents an institutional or practical optimum.

Table 1: National Classifications

Study Core Jurisdictions	Reform Benchmarks
China	Hong Kong
Indonesia	Singapore
Korea	
Malaysia	
Philippines	
Thailand	

4. Law and practice in these areas is not advanced in most other jurisdictions within the region, but the issues addressed in this study have generally begun to receive attention from many policymakers and commercial interests.

5. The issues of policy and principle raised in this study have been debated in official and legal circles at intervals since the economic and social shocks associated with the 1997-98 Asian financial crisis. In no national case can the legal, regulatory or policy background be described as either complete or fully integrated, even in the two examples of benchmarks, or elsewhere in countries where specific reforms have been recently instigated or completed, for example in China or the Philippines.

6. Later sections include tables that give appraisals of:

- The legal framework for creditor rights, especially in relation to secured claims.
- The effectiveness of national insolvency systems.
- The mutual compatibility of systems for enforcement.

7. In Tables 2, 5, 7 and 8, a scale rising from 1 to 5 is used to indicate the quality or effectiveness of a number of specific factors, most of which are self-explanatory. These ratings have been developed largely on a qualitative basis and further research may be required to produce quantitatively robust results. Unless stated, these tables use terms such as ‘security’ and ‘interest’ in a generic sense without attachment to a particular legal system or jurisdiction. In each case, the appraisals given in the tables acknowledge not only pure aspects of law and regulation (which are often clear in jurisdictions that have seen recent legislation), but also qualifications to reflect enforcement issues, questions of integration with related law, and the stability of the regulatory setting. Commercial participants throughout the region have often found that while the law appears clear, it suffers from uncertain application.

8. It is now generally accepted that the form and practice of law influences economic behavior. In particular, institutional quality is often an important determinant of credit creation and flows of capital, both within the sectors of a national economy and in cross-border savings and investment. Factors such as a jurisdiction’s legal origins, the nature of the acquisition or founding of law, and details of its application and enforcement may be seen in features of governance, economic systems and structure, commercial culture, corporate behavior, and financing patterns, as well as affecting

broader variables such as changes in national output and personal income. The appraisals in this report and the research upon which they are based thus adopt the view of users, that is, principals and agents that become subject to law, and not those involved in its creation or administration.

9. At the same time, the efficiency and consistency of the law's operation will always form part of institutional costs, so that no assessment can ignore the organization and management of legal systems. This is especially valid in the context of creditor claims and corporate distress or recovery. In general, the main objective of the reform of laws governing security and creditor rights will be to influence behavior through changes in transaction costs.

II. GOVERNANCE, ECONOMIC AND LEGAL SYSTEMS

10. Issues of governance and appropriate political structure have been of interest since the development over ten thousand years ago of the first agriculture-oriented settlements based upon specialized human activity. This in turn allowed the development of writing systems appropriate and necessary to sustain the administrative and governance structures of such settlements. Building the 'perfect' society and creating the necessary governance systems to encourage its development has been a focus of many original thinkers, including Confucius, Plato, Aquinas, Locke and Marx. All political and economic systems function in close parallel, even though the connection may not always be acknowledged by political theorists. Certainly, the relationship between politics (or governance) and the economy has been a key interest of Adam Smith, as well as Marx, and more recently Keynes, Hayek and Milton Friedman. Although politics and economics developed as distinct disciplines in the twentieth century, by the end of the millennium the interaction between governance and economics was again being addressed, partly as a result of lessons learned in the process of a market-oriented transition undertaken by many centrally planned economies, and from the conspicuous failures of development models focused on economic policy to the neglect of issues of governance.

11. The role and development of financial intermediaries have become a focus of attention only recently in law, financial policy or economics, although each discipline is directly concerned with important issues forming both the problem and its several explanations. Similarly, the conditions that influence how the form of financial structure develops have begun to interest scholars in the developed and developing world, and those helping to create supportive policy. Since the late 1980s, financial intermediation has become recognized as vital to many aspects of economic development, and what determines the nature of financial intermediaries and financial system infrastructure is susceptible to both quantitative analysis and the qualitative tools of legal and economic theory.

12. Until the 1970s few economic or finance theorists gave attention to the nature of financial systems or how they may affect economic development. Similarly, the importance and influence of the characteristics of financial markets and intermediaries

has been accepted only since the late-1980s, with the growth of the law and finance and institutional economics schools.

13. By the beginning of the 1990s, two traditionally polar alternatives of central planning under state ownership and laissez-faire had merged into an apparent consensus as to the general superiority of a market economy, but one that would function under the framework of an appropriate and transparent regulatory system, with a benign but active role taken by the state. This would address the interests of society as a whole through the provision of public goods, systems to prevent or ameliorate market failure, and sanctions to penalize market abuse, whether arising from monopoly or the occurrence of asymmetric information available to privileged participants. Nonetheless, as Shleifer and others have recognized, many differences exist between extant economic and governance models around the world.¹ The question then arises as to what may represent the best choices among available options, and to what extent those choices lead to the disadvantage of certain individuals or interests.

14. For new institutional economists such as North and many writers in the law and economics school, governance systems must provide for two fundamental features to support a market economy, regardless of its ideological basis and consequent form. First, the system needs to provide for clear and usable property rights. Second, it must offer practical and fair contract enforcement. Both sets of literature agree that these conditions are essential in the context of imperfect markets where there exist accepted transaction costs. While there appears to be agreement as to the need to satisfy these basic points, the type of governance structure that best provides these two foundations for a market economy is less apparent, and may change in relation to the relative development of the host economy.

15. Many scholars have argued further that democratic models of governance are optimal in protecting property rights and the enforcement of contracts, albeit this was the result they sought most often to prove. However, Olson presented a convincing argument that a variety of governance structures can provide each of these necessary features.² Specifically, he maintains that an autocrat with a sufficiently long-term time horizon will have strong incentives to support both property rights and contract enforcement from economic self-interest, chiefly to maximize revenues from taxation. Likewise, he argues that any democracy, while also potentially providing for property rights and the enforcement of contracts, may nevertheless become subject to inefficient outcomes due to the presence of successful interest groups within the society. As a result, neither autocracy nor democracy is necessarily a superior political system from the standpoint of providing the most beneficial support for a market economy: what is necessary is a 'market-augmenting government'.³ There is contemporary anecdotal evidence that

¹ See Djankov, Glaeser, la Porta, López-de-Silanes & Shleifer (2003).

² M. Olson (2000).

³ C. Cadwell, Foreword, in Olson, above , p. x.

certainly supports Olson's theory.⁴ Further, recent empirical research has begun to test these ideas and also appears to be supportive.⁵

16. North sums up the interaction between the political system and property rights as follows:

Broadly speaking, political rules in place lead to economic rules, though the causality runs both ways. That is, property rights and hence individual contracts are specified and enforced by political decision-making, but the structure of economic interests will also influence the political structure. In equilibrium, a given structure of property rights (and their enforcement) will be consistent with a particular set of political rules (and their enforcement). Changes in one will induce changes in the other.⁶

17. The result is that a national governance structure is important in that it must provide for property rights and the enforcement of contracts, as well as human capital development. However, while some governance structures are clearly not conducive (for example, those run by short-term thinking autocrats who behave essentially as stationary bandits), there is at present no clearly preferable model. Both autocratic and democratic governance systems can support a market economy. Similarly, each can also provide for institutional choices that do not result in efficient, wealth-maximizing outcomes for any given economy.

18. Two further underlying issues are present throughout this study: those relating to the mechanisms that transmit influences on economic growth, and those involving the means by which finance affects economic development, including the relationship between legal systems and financial structure. Neoclassical economic theory, post-1940s growth theories and traditional finance theory all ignore or assume away the nature of financial systems.⁷ While finance and corporate finance theory examine commercial organizations in terms of contract or cost, a similar approach has been applied only recently to financial intermediaries, and rarely to examine financial systems.

⁴ Cf. China, Singapore.

⁵ See Glaeser, la Porta, López-de-Silanes & Shleifer (2004). The authors argue that policies are more important than democratic institutions, specifically: (1) human capital is a more basic source of growth than democratic political institutions; (2) poor countries alleviate poverty through good policies, often pursued by dictators; and (3) democratic institutions are developed after economic 'take-off'.

⁶ North (1990), p. 48.

⁷ The growth school pattern probably began with Rostow (1953); Lucas (1988) is perhaps the most willful financial agnostic. Certain Marxian analysis asserts a causal relationship running from economic activity to financial structure to accord with the primacy of capitalist production. It is often unspecific in its treatment of both law and financial activity in this area, perhaps reflecting Marx's own disdain for 'merchant' or 'commercial' capital; an exception is McManus (1978), describing the origin of English consumer credit legislation.

19. At a general level, early modern studies of the determinants of economic growth identified a strong correlation between the ‘rule of law’ and per capita growth.⁸ These analyses were weak in terms of identifying with any practical precision the ways in which legal reform might be invoked to promote growth, given that the measures used to identify ‘rule of law’ variables were basic and included subjective components, such as commercial indexes of sovereign risk.

20. The law and finance school asserts that there exist significant causal links between the origins of law or the means by which a national system of law is acquired, and the nature of financial system development.⁹ Certain scholars further suggest a causal relationship that flows from financial development to economic performance, although most accept that such links are unlikely to be unicausal.¹⁰ Among the issues raised by the law and finance school are:

- The relationship of institutional development to general economic welfare.
- The relationship between legal origin and the effectiveness of legal systems.
- Whether legal origin or the form of its acquisition is a significant determinant of the effectiveness of a national legal system.
- Whether common law is inherently more effective than other systems in encouraging financial development or protecting property rights.¹¹

21. While the general premise of law and finance protagonists has become accepted, especially in suggesting more specific research agendas, it has been criticized for two main methodological reasons:

- First, in its choice and specification of explanatory variables,¹² which, for example (i) may be incomplete or not be unrelated to the objective questions that the analysis seeks to answer;¹³ (ii) may not signify close substitutes or take account of compensatory mechanisms in different countries or systems;¹⁴ or (iii) may reflect customary choice appropriate mainly to developed, homogenous markets.¹⁵

⁸ Notably Barro (1971, 1997 pp. 26-28).

⁹ Notably Beck, Demirgüç-Kunt and Levine (2002), Beck and Levine (2003), La Porta, López-de-Silanes, Shleifer and Vishny (1997, 1998), Mahoney (2001), Rousseau and Sylla (2001).

¹⁰ Glaeser, La Porta, López-de-Silanes & A. Shleifer (2004), King and Levine (1993), Levine (1997, 2004), Rajan and Zingales (2001).

¹¹ Given that the quality of creditor and shareholder protection measure such effectiveness. This is not synonymous with financial development, despite often being so taken, with the protection of claims used as a proxy for financial sophistication.

¹² Arestis and Demetriadis (1997), Berkowitz, Pistor and Richard (2003), Blum, Federmair, Fink and Haiss (2002), Kenny and Williams (2001), Thiel (2001), Wachtel (2003).

¹³ For example Rajan and Zingales (2003).

¹⁴ Roe (1994), Pistor and Wellons (1999), Pistor, Raisner and Gelfar (2000), Cools (2005).

¹⁵ Lamoreaux and Rosenthal (2004).

- Second, the usefulness of the law and finance school's conclusions, in terms of the scope they provide for legal or regulatory reform given that legal related explanatory variables have of necessity been general and unspecific.¹⁶

22. As examples, the scale of finance in an economy has often been used as an explanatory variable but it may not measure financial sophistication (contrary to the intentions of LLSV or Rousseau & Sylla); no distinction is made between types of claims against a debtor or firm; all debt is generally taken as secured. The chain of causation identified by the law and finance school (especially LLSV) runs from legal origin to enforcement, to financial development and finally to growth. This is unreliable if legality impacts growth but legal origin does not impact legality. A more fully informed identification of explanatory variables will assist with these problems. It may also overcome problems caused by the static nature of the law and finance school's analysis, for example, ignoring the contemporary convergence of civil and common law due to the impact of political regionalization and financial harmonization, expanding financial and trade treaty systems, and the roles of international self-regulatory bodies.

23. Theoretical interest in the structure and operation of financial systems was largely absent from legal and financial studies before the 1970s, and in economics was for long confined to political economy.¹⁷ That such indifference has vanished results largely from the influence of two lines of scholars. First, Goldsmith sought ways to test whether financial structure could be related to levels of economic development¹⁸. This work was to become a foundation of the law and finance school, with its strong econometric emphasis. Second, North¹⁹ and others synthesized hitherto separate concepts from law, finance and economics in what has become modern institutional economics, which stresses the nature and effect of core rights, duties and incentives. While the first is primarily concerned with whole markets or national economies and the latter is initially microeconomic in its emphasis, the two disciplines share certain interests, and meet in the analysis of the effects of legal systems and property rights, for example, on economic conditions and development.

24. The approach of the traditional financial development school was to examine the role of banking and bank credit creation. More recent law and finance analysis has taken account of environmental and cultural factors, and indeed all financial variables that are measurable. None has yet examined in detail the quality of law enforcement in a commercial context, for example, in the willingness of national courts to enforce foreign judgments and accept non-exclusive jurisdiction transaction provisions. Instead, where quality of law and regulation is included in analysis, its tendency to date has been on subjective index measures of the 'rule of law'. In addition, while law and finance scholars have sought to quantify the effect of national legal systems or their origins on financial

¹⁶ Cross (2002), Davis (2004), Davis and Trebilcock (2001), Roe (1996);

¹⁷ Due largely to Marx, Schumpeter and Weber and their acolytes, but in no instance with the dedication to detail of the modern law and finance school.

¹⁸ Goldsmith (1969).

¹⁹ North (1991).

development,²⁰ no systematic attempt has yet appeared in this context that together considers legal origin, its form of acquisition and the distinct nature of jurisdictions.²¹

25. The related work includes a very considerable body of empirical studies in the style established by Goldsmith and following the statistical methods begun by King & Levine and later, la Porta, López-de-Silanes, Shleifer & Vishny ('LLSV') in seeking evidence of causal relationships between financial market or institutional sophistication or structure (including legal origins and conditions), and economic development, commonly measured by growth in national output. While not unanimous, these studies generally suggest that finance often has a positive effect on growth, although (contrary to popular belief) there is no accepted theoretical school that asserts the contrary: that the primary causal flow is from economic growth to financial development.

26. This study contains summaries of qualitative appraisals of the effectiveness of current law and practice as to collateral and creditor rights in eight prominent East Asian jurisdictions. In particular, it examines discrete aspects of the creation and treatment of secured creditor interests, processes for insolvency, and the functional relationship between these related aspects of law.

27. The effects of globalization on both market practice and the harmonization of financial regulation, in each case among both the study core group and the regional reform benchmarks, mean that the private law governing international financial transactions differs less by virtue of the location of parties or the place of execution than by issues of judicial enforcement, including the willingness of courts to provide equitable and predictable judgments to domestic and foreign creditors.²² The quality of legal and practical provisions for insolvency is also central to the willingness of lenders and investors to provide funds for capital investment. By contrast, the nature of national legal frameworks for the taking and enforcement of collateral may be more subject to commercial custom and the nature of economic activity, although it remains heavily influenced by the prevailing form of law, and the roots of national law.

III. PROPERTY RIGHTS

28. Property rights were an important concern for Smith, Marx and Weber but received little attention from economists for a period of decades until the late 1970s and became intensively researched only in the last decade. Until comparatively recently the nature of finance, and thus the preconditions for its provision, were ignored or assumed away by generations of economists and finance specialists, and only 'maverick' opinion appears to have considered otherwise.

²⁰ For example, La Porta, López-de-Silanes, Shleifer and Vishny (1997) classify 49 national legal systems by their origins in English common law or French, German or 'Scandinavian' civil law; Berkowitz, Pistor and Richard (2003) divide the same sample among 10 original systems; Wood (1995) perceives 7 categories, not including states that lack a clear legal system or for which it may be 'emerging'.

²¹ Wood (1995, 2001) identified up to 307 distinct national and state jurisdictions. The number may change.

²² This appears in contemporary comparative analyses of commercial law, for example Wood (1997).

29. The importance of property rights began to receive significant contemporary attention after the disintegration of the Soviet bloc introduced the challenge of transforming centrally planned economies to market-based systems. Development specialist de Soto deserves considerable credit for increasing general awareness of the importance of property rights in this respect, especially in relation to the potential impact of endowing individuals with such rights.

30. In the classic description, property is seen as a ‘bundle of rights’. More specifically, ‘property’ includes some or all of a variety of different ‘rights’, including the rights to hold, use, modify, transfer or destroy a real or intangible asset. Questions of degree and time relate to all such varied rights, and the extent to which a property owner may exploit such rights may be constrained by the rights of others within a legal system, or as part of public policy. In addition, property can be real or personal, tangible or intangible. The more complex the system of property rights, the more effective is their potential use in the context of finance and capital raising.

31. According to North:

Property rights are the rights individuals appropriate over their own labor and the goods and services they possess. Appropriation is a function of legal rules, organizational forms, enforcement, and norms of behavior—that is, the institutional framework.²³

32. De Soto argues that capital is the engine of a market economy and that property rights provide the mechanism that allows it to be effectively deployed.²⁴ Further, relatively poor countries often fail to produce capital sufficient for adequate economic development because of failings in their property systems. First, such societies may have substantial masses of capital;²⁵ unfortunately, it represents ‘dead’ resources in that it is constituted by property that cannot be used or mobilized as capital. Second, capital itself is difficult to define or recognize. Third, governments around the world have neglected the importance of these two factors, an attitude that has begun only slowly to change.²⁶ Fourth, while the process taking place in a variety of emerging and transition economies of mobilizing property rights in ways that de Soto describes had earlier occurred in developed countries, it was often poorly understood or documented. Fifth, laws need to reflect existing national or sub-national circumstances in order to function effectively to allow assets to be transformed into capital.

²³ North (1990), p. 33.

²⁴ de Soto (2000).

²⁵ By his calculations, ‘[t]he total value of the real estate held but not legally owned by the poor of the Third World and former communist nations is at least [US]\$ 9.3 trillion’. *Id.*, p. 35 (citing table 2.1, p. 36).

²⁶ de Soto states this best:

The substantial increase of capital in the West over the past two centuries is the consequence of gradually improving property systems, which allowed economic agents to discover and realize the potential in their assets, and thus to be in a position to produce the non-inflationary money with which to finance and generate additional production.

Id., p. 65.

33. According to de Soto:

A well-integrated legal property system in essence does two things: first, it tremendously reduces the costs of knowing the economic qualities of assets by representing them in a way that our senses can pick up quickly; and second, it facilitates the capacity to agree on how to use assets to create further production and increase the division of labor.²⁷

34. De Soto concludes that formal property systems should produce six effects, and thus allow individuals citizens to generate usable capital:²⁸

- Making certain the economic potential of existing assets.
- Integrating dispersed information into a single system.
- Making people accountable.
- Increasing the fungibility of assets.
- Marshalling individuals into valuable social networks.
- Protecting the integrity of legitimate transactions.

35. Property rights and their identification and protection, including rights over intellectual property are therefore essential in a market economy.²⁹ Unfortunately, as de Soto suggests, property rights have evolved in developed economies over lengthy periods and it is often difficult to discern how they become established and function. As a result, it may not be simple to introduce successfully these experiences and systems to emerging, transition or developing economies.

36. However essential, the recognition of property rights is not a self-justifying goal, for the need is for such rights to be available for use other than in instantaneous transactions. This is one of the underlying subjects of the remaining sections.

IV. COLLATERAL AND SECURED TRANSACTIONS

Background and Framework of Analysis

37. Collateral exists to meet commercial customs, national practices and socio-economic constraints that differ between jurisdictions, even where the harmonization of financial market operations and regulation is well-advanced.

²⁷ Id., p. 63.

²⁸ Id., pp. 49-62.

²⁹ Klapper, Laeven & Rajan (2004), pp. 27-28.

38. Prior World Bank studies³⁰ have surveyed law, institutions and secured transactions, but the reasons for security to exist differ by nature and degree. This will affect whether the granting of collateral is efficient a choice for commercial or individual borrowers, or for creditors at large. Recent analysis of European transition economies suggests that the provision of collateral is important in inducing early-stage development.³¹

39. Schumpeter's 1939 description of the working of capitalism draws on his 1911 theoretical approach to interest and credit creation that came to be disputed by contemporary traditional classicists (Cannan), radicals (Keynes, Robinson) and for some remains controversial. It includes a generic description of the role of credit creation in banking not attempted by his contemporary critics. Schumpeter's approach includes a customary means by which a creditor bank may seek to overcome transaction obstacles and thus lessen the costs resulting from asymmetric information, which otherwise would often force the adoption of incomplete lending contracts. Modern structured finance techniques such as non-recourse project finance and securitization are intended to create substantially complete contracts. In each case, contractual structuring results in the debtor having no surplus value, so as to become theoretically constrained from engaging in activity outside the financed enterprise. By contrast, lending conducted under more general (incomplete) contracts involves 'uncertain' Knightian credit risks that cannot be quantified, since lenders will only ever be partially informed as to the scope of activities of companies to which they lend. Even though lenders may hope to mitigate the effects of incomplete contracts by incorporating covenants and assignments of actual or potential income into their agreements, the result will inevitably be subject to general practice and comparative strengths in negotiation. Even if a lender has full knowledge of a debtor enterprise, the volition of the debtor may lead to default, which may be rational in certain circumstances.³² Other mechanisms to encourage contract compliance (given that non-fraudulent debtors in advanced economies no longer face the threat of prison) include socioeconomic forces of the kind traditionally associated with certain distinct lending markets, for example, in the financing of the trade in diamonds or ship purchase.

40. By this view, the taking of collateral is thus not related to information discontinuities but represents a sanction to encourage contract compliance by the debtor. In terms of institutional analysis it will typically constitute a distortion, enabling credit substitution to become the means by which a bank lender avoids the moral hazard associated with asymmetric information.

41. At the same time, contrary to the findings of certain studies of domestic United States market practice, security is not a device to signal credit quality but the converse, except in cases where recourse to the principal debtor is non-existent or limited, as with conventional non-recourse project finance. Rather, it serves three main purposes for the principals involved or prospectively engaged in financial bargaining:

³⁰ World Bank (1989, 2002); Keinan (2001).

³¹ Haselmann, Pistor & Vig (2005)..

³² For example, in the case of home mortgage loans where the value of collateral falls below the amounts outstanding, given certain limits to creditor rights in bankruptcy.

Transformation:

- (a) - Change or substitution in credit risk for a potential financier.
- (b) - Change in capital asset use to make financing available.

Information:

- (c) - Signal credit risk strengths or borrower status.
- (d) - Signal risk or bargaining weaknesses.
- (e) - Facilitate credit substitution.

Incentives:

- (f) - Effect on costs and information for credit creation.
- (g) - Provide financiers with known credit risks.
- (h) - Encourage contractual compliance by collateral providers.

42. An adequate lending infrastructure enables banks to extend the time horizon of their loans and reduce regulatory capital costs by providing greater confidence with respect to the likelihood of repayment (credit risk). In this regard, two aspects of lending infrastructure are especially important for risk management: an effective system for taking security; and the development and enhancement of sources of information through accounting, auditing, credit rating practice and credit information systems. In addition, banks need systems to manage risks appropriately, these typically being imposed through capital and other prudential regulatory systems.

43. As the basic level of risk management, an effective system for the taking of security allows banks to obtain collateral to reduce credit risk and be confident that any such collateral may be realized where necessary to permit the repayment of loans. Providing a system of creation and registration of security therefore provides two advantages for lenders. First, it allows the limiting of monitoring costs by means of partial or complete credit risk substitution, providing that no failure to monitor collateral results in the creditor losing security protection. Second, it improves simplicity in lending decision-making, thereby increasing the probability that more such decisions will be made.

44. For property rights to be allowed to create capital, those rights must be applied to procure funding. The taking of security is the simplest form of risk management in banking: loans are made on the basis of the lender being provided with property of a proportionately equivalent or greater value. If the loan is not repaid, the lender retains the property and is protected against the credit risk of the borrower. In this simple case, the availability of collateral encourages lending. However, for this simple transaction to take place, the lender must know that it may retain rights to the property given contractual non-payment by the debtor. For this to be certain, the borrower must have valid initial title to the property, and the legal system must allow for effective transfer of ownership in the event of the security being enforced. Finally, the lender will need a means to appraise any supporting collateral. This may not always be simple and has been a problematic feature of developed economies, as well as emerging, transition and developing economies, usually in the context of loans secured by real property.

45. More advanced collateral-based lending involves sophisticated distinctions between property rights and the certainty of contractual enforcement, derived from the prevailing legal and institutional framework. For example, in the simple transaction of the preceding paragraph, a borrower provided physical, recognizable collateral to secure its indebtedness, as in the common South Asian example of loans secured by quantities of gold or silver. This is collateral deployed in its most simple form. For reasons presented in the preceding paragraphs, the use of collateral in secured transactions can become more complex only to the extent that it is supported by an adequate legal and institutional framework. If a borrower must deliver physical collateral to a lender then poorly capitalized enterprises will lack access to most secured lending.

46. With a legal system that supports more advanced practices, the borrower may be allowed to retain physical possession of any collateral that pre-dates the making of a new loan, so that it may keep day-to-day control of the use and enterprise value of its existing assets, whether land, buildings, plant or machinery. At a still more sophisticated legal level, a loan might be used to purchase real property or productive assets, secured by those newly-acquired assets, with the borrower retaining their full use in ways that may be expected to assist in the servicing of the loan. While the mechanics of such transactions are simple to describe, this type of purchase money security is not universally supported by security or bankruptcy law. Whether national law allows or limits such arrangements reflects an underlying view of the economic welfare associated with security and collateral. This is seen most clearly in the competing views of a commercial enterprise as being either revenue generating or as a custodian of assets, and may result in purchase money security treated in law as unfairly benefiting individual creditors at the expense of others. In each case, transaction complexity requires greater legal sophistication, and using moveable property as collateral typically requires a more complex legal framework than real property. Furthermore, while real or movable physical collateral is associated the largest share of secured lending in most emerging and developed economies, intangible property may also qualify as potential collateral, including intellectual property or trade receivables, for example. The rights of a secured creditor could thus extend to defined classes of assets such as inventory or receivables, to a company's entire asset base if its debts are secured by a floating charge as under English law, or to the right to receive revenue rather than actual receipt of that revenue, providing in each case that the legal system is sufficiently supportive.

47. Basic financial markets are greatly enhanced when the availability of collateral increases. As a minimum, functional markets require that real property used as security be left in the possession of the borrower. Developed financial markets typically operate with wide ranges of collateral assets, and sophisticated financial markets similarly require commensurate techniques for taking security, for example, in providing for securitization. Nonetheless, questions and anomalies exist even in advanced financial markets.

48. De Soto asserts that property must be allowed in use as collateral in order to encourage economic development, but fails to distinguish between the legal and institutional issues concerning property, which he addresses in a 'capitalization process', and in the use of property as collateral, except in relation to the recording or registration of property rights. In reality, capital is created or released only given both aspects of the

framework supporting the use of property and property rights as collateral for secured transactions. To extend de Soto's analysis, property rights must exist and property must also be usable in support of funding for a financial system to develop comprehensively beyond a basic level.³³

49. Despite the importance of collateral and secured transactions, this is an area of law involving highly varied legal systems and which is highly technical in developed jurisdictions. Perhaps as a result, secured transactions tend to receive analytical attention at relatively advanced levels and concern those emerging economies that are already well-progressed in systems supporting basic secured transactions. Once such transactions are supported by a legal and institutional system then there is considerable development value in enhancing legal and institutional support for more advanced secured transactions.

Real Property

50. Recent research supports the view that such systems of finance based upon property are highly relevant to financial and economic development.³⁴ Byamugisha's 1999 World Bank study develops a theoretical framework to guide the empirical analysis of the effects of property finance on an entire economy.³⁵ He argues that the conceptual framework encompassing real estate finance to financial development and economic growth has five main linking features: (1) land tenure security and investment incentives; (2) land title, collateral and credit; (3) land liquidity, deposit mobilization and investment; (4) land markets, transactions and efficiency; and (5) labor mobility and efficiency. All five linkages are required to be effective to facilitate real estate-based finance. Each is based upon the existence of appropriate legal infrastructure.

51. Given the significance of real estate finance as part of economic development, an ensuing question focuses on the development of markets in which the secondary financing of mortgage lending has an important role. For example, a 1997 World Bank study analyzed factors hindering the development of home loan markets in the transition economies of Central and Eastern Europe and proposed a strategy to expedite their development.³⁶ The analysis shows that banks in transition economies may be reluctant to make mortgage loans for house purchase because of the scale of risks they perceive in such lending, that is, the extent of credit, interest rate basis and liquidity risks. It suggests that a secondary mortgage market is likely to assist in solving these problems by allowing

³³ Note that in certain of the study core group, sophisticated financial transactions and state funding mechanisms exist alongside relatively primitive systems for mass consumer banking or credit creation.

³⁴ In addition to de Soto's suggestion that legal reform in developing economies can energize idle capital, see North & Thomas (1973), arguing that efficient economic organization is the key to growth; N. Rosenberg & L. Birdzell (1986) arguing that Western economic development hinged on factors promoting experimentation; Goldsmith (1995) providing empirical evidence that the growth of democratic freedoms and property rights in poor countries may lead to increased local prosperity; and Torstensson (1994) applying empirical analyses of property rights and economic growth to substantiate the findings of both Rosenberg and Birdzell, and North and Thomas.

³⁵ Byamugisha (1999).

³⁶ Jaffe & Renaud (1996).

banks to manage more easily their loan books to meet risk preferences, assuming that the initial (primary) provision of loans meets certain institutional standards.

52. A further World Bank study argues that successful land and real estate reforms must be ‘comprehensive in design, even if implementation is phased in over time.’³⁷ They contend that such reforms include three elements: (1) institutional reforms that better define property rights, reduce information asymmetries and improve contract performance (Property Rights, Information, Contracting and Enforcement); (2) capital market reforms making mortgage finance available at reasonable costs, especially for the poor (Finance and Risk Management); and (3) market reforms that reduce or eliminate distortions in the price of goods and services whose production is enabled by land and real estate assets (Market Regulation and Fiscal Policy). Their conclusions tie effective mortgage markets to the broader concept of using real estate finance to encourage all aspects of financial and economic development.

53. Jaffee and Renaud suggest that secondary mortgage markets confer two main benefits: (1) allowing banks to shed risks associated with holding mortgages; and (2) creating standards for credit evaluation and collateral procedures that lead to greater efficiency in the primary markets for new mortgage lending. The authors suggest that governments adopt catalytic policies in developing secondary mortgage market systems and institutions. This role is based on similar experiences in developed countries, and has been adopted by several of the jurisdictions considered in this article.

International Standards for Movable

54. Wide disparities exist in the law relating to secured transactions in developed economies. This is often central to discussion and disagreement between common and civil law traditions.³⁸ Furthermore and largely as a result of those disparities, no internationally agreed standards or principles exist in the area of secured transactions.³⁹ Creating effective provisions for secured transactions demands a mastery of many aspects of an entire legal system (including laws of property, obligations, insolvency and civil procedure) and of administrative practices and procedures (for example, registration and enforcement). Nonetheless, research shows that the development of legal infrastructure underlies functioning collateral-based credit provision and that problems in such infrastructures hinder financial and economic development.⁴⁰

55. Recent BIS guidance⁴¹ describes the features of a generic collateral and credit law, which will include:

- Credit laws to govern creditor-debtor relationships in commercial transactions. These may be established by common law, contract law, civil codes or specific

³⁷ Galal & Razzaz (2001).

³⁸ For an excellent discussion, see Dahan (2000) and sources cited therein.

³⁹ See Goswami & Sharif, ‘Preface’, in de la Pena, Fleisig & Wellons (2000).

⁴⁰ See generally de la Pena, Fleisig & Wellons (2000).

⁴¹ BIS Committee on Payment and Settlement Systems (2006).

legislation, for example, in usury laws, banking statutes or creditor-debtor statutes.

- Pledging and collateral laws to (i) create and enforce rights in collateral security, preferably through legislation of specific or general application, rather than through contract or common law; and (ii) establish priority rankings among secured and unsecured claims in situations of default or insolvency, requiring legislation of a specific or general application.
- Example of such laws and regulations: US Uniform Commercial Code ('UCC'): Article 9; European Union Directive 2002/47/EC on financial collateral arrangements; 1997 OHADA Uniform Law on Security Rights; 1994 European Bank for Reconstruction and Development ('EBRD') Model Law on Secured Transactions; UNCITRAL Legislative Guide on Secured Transactions; Cape Town Convention on International Interests in Mobile Equipment; West African Economic and Monetary Union Regulation 15/2002/CM/UEMOA Regarding Payment Systems in the Member States.

56. In the work of multilateral agencies, the model law devised by the EBRD is one of the few international standards for secured transactions that has been applied successfully in practice, in conjunction with the Bank's set of core principles and glossary, all as part of an established process to approach collateral law reform projects.⁴² The Asian Development Bank ('ADB') has provided more recent assistance in creating modern secured transaction frameworks. The World Bank has addressed some of these issues in relation to insolvency.

57. More directly, the United Nations Commission on International Trade Law ('UNCITRAL') is developing a Legislative Guide on Secured Transactions, for completion later in 2006.⁴³ Other significant efforts at the international level have been undertaken by the International Institute for the Unification of Private Law ('UNIDROIT').⁴⁴ A number of regional efforts are under way in North America⁴⁵, Asia⁴⁶ and Europe. In addition, important harmonization efforts took place in the context of US UCC Article 9 and the Canadian Personal Property Security Acts, both of which often serve as models in East Asia and elsewhere.

Analysis: East Asia

58. A sound framework for secured lending can encourage the provision of credit and assist in the development of domestic financial markets. At the same time, any system that involves the widespread use of collateral assets to support corporate lending may risk fostering a monopolistic banking sector. The use of secured lending as a proxy for informed risk appraisal can become inefficient to the economy as a whole, both by

⁴² See Simpson & Menze (2000).

⁴³ See www.uncitral.org.

⁴⁴ See UNIDROIT (2001, 1988)

⁴⁵ See American Law Institute (1997).

⁴⁶ See de la Pena, Fleisig & Wellons (2000).

encouraging wasteful credit risk substitution and acting as a force oppressive to non-financial trade creditors. In East Asia, an over-reliance by lenders on the use of private and corporate real estate as collateral for corporate credit may have contributed to the scale and rapidity of the 1997-98 financial crisis, and provoked a severe subsequent credit squeeze affecting otherwise ‘healthy’ borrowers, even in national markets that were the least affected by the general loss in confidence. Collateral must be available as security to release the flow of capital but not such as unreasonably to protect the oppressive and inefficient.

59. The following questions must be considered in addressing such issues:

- The extent to which commercial secured is lending possible.
- The extent to which title finance is possible.
- Legal provisions for home mortgages.
- Provisions for the transfer of secured claims.
- Effects of related legal reforms, for example, civil jurisdictions’ enacting wholesale securitization legislation.
- The role of statutory priority vis-à-vis secured claims, for example, government or employee creditor claims.
- Simplicity of execution, perfection, notification, registration and enforcement.

60. Table 2 synthesizes a simple analysis of these issues in the economies addressed by this study, using a simple rising 1-5 scale. Scores such as 2/3 represent an intermediate appraisal between two given levels. As with Tables 5, 7 and 8, these ‘split’ scores are intended to reflect degrees of uncertainty as to commercial outcomes.

61. Granting and making security effective is regarded here as a form of property right, regardless of the legal form of the systems under review. Any appraisal will therefore question how the law links the granting of security to the rights of general creditors in both normal and distressed circumstances. The table thus shows how the system now supports, undermines or adds confusion to all aspects of secured transactions. No account is taken of informal systems, even if commercially entrenched.

Table 2: Legal Framework for Creditor Rights

	Enforcement of Unsecured Rights	Security Interest Legislation	Registration and Disclosure of Secured Rights	Enforcement of Secured Rights
China	2	2	2	2
Indonesia	1	2	1/2	1
Korea	3	1/2	1/2	2/3
Malaysia	5	4	4	5

Philippines	2	2/3	2/3	2
Thailand	2	1/2	2	2
Hong Kong	5	4	4	5
Singapore	5	4	4	5

62. Ideally, the law will allow the cost-effective, simple creation of security without affecting rights of conventional day-to-day collateral usage. It will be public and transparent, and function without discrimination and be enforceable in ways compatible with declared public policy, especially in relation to bankruptcy, receivership and corporate rearrangements.

63. The effectiveness of a national legal and administrative framework permitting the creation of collateral for secured transactions is revealed in several elements, not all of which are consistently present in the review countries. Among the issues that must be considered are the ease and cost of creating reliable security interests, systems for such interests to be disclosed, the costs and risks associated with the enforcement of charges, the relationship of security and collateral with bankruptcy and receivership practice, and the operation of creditor protection and stays to enforcement (Table 2).

64. Security interests traditionally differ under civil and common law, and the introduction of reform always needs to be sensitive to the existing contractual and legal setting. While the EBRD's model law governing all aspects of security over collateral was intended to be adopted by jurisdictions of all types, it is likely that the relatively well-developed legal systems in the core review group makes a single benchmark impractical. Such a device might have value in other Asian developing jurisdictions.⁴⁷ Elsewhere, recent legislative reforms appear to be effective in supporting transaction creation, but have yet to be tested in cases involving economic distress; this applies to Indonesia, Korea and Thailand, for example.

65. In a related area of law where new legislation has recently been adopted—securitization—such legislation remains untested in either Indonesia or the Philippines, but appears to be transactionally sound in Korea and Thailand.

Overview

66. At the onset of the 1997-98 financial crisis, Asia's legal provisions for secured credit transactions regimes were at least as outdated and inefficient as its insolvency laws. Yet less effort has since been made to reform those laws. Immediately after the crisis, most attention was directed to reforming corporate reorganization procedures and other features of insolvency law, even though insolvency laws cannot work efficiently when secured creditors find it difficult or impossible to enforce their rights in bankruptcy. Such delays were common in Asia prior to the onset of the financial crisis.⁴⁸ Similarly, credit creation will be adversely affected and economic growth is likely to be hampered when valid collateral must be held in possession by a secured creditor, or limits exist to the permissible categories of assets that may be used as collateral. As will be seen in the

⁴⁷ Although commercial and property laws began to be introduced in Vietnam after 1991, for example.

⁴⁸ See the ADB Office of the General Counsel (2000), pp. 75-76.

country-specific discussion below, these problems were also endemic prior to the crisis⁴⁹ but its impact finally drew attention to the need for coordinated legal reform and the creation of modern provisions for secured transactions. Thailand is an example of how this acceptance has been made, with legislation now under preparation.

Real property

67. In each jurisdiction within this study, the legal system provides for real property to be offered and taken as collateral. However, there is considerable divergence as how best to resolve a variety of issues, including the following: the ease and efficiency with which mortgages, charges or liens may be created; the requirements for registration; whether the mortgagor retains title to the collateral while the extension of credit that it purports to secure remains outstanding; and how secured creditors may enforce their collateral rights. Differences also exist in some cases in the treatment of collateral arising from varying statutory provisions for real property ownership by domestic and foreign interests.

68. Table 3 however does not address the actual issue of distribution of property rights, which is a focus of de Soto's work that merits attention in the context of the relationship between economic and governance systems and property rights.

Movables and Unsecured Property

69. The treatment of secured rights over movable property is still more varied throughout the study group. Although none of the jurisdictions within this study has adopted a US Article 9-style regime, the English origin systems of Hong Kong, Malaysia and Singapore work relatively well. However, Table 4 shows that delays and inefficiencies in the enforcement of secured rights are common in several jurisdictions. Similarly, limits to the movable assets that may be used as collateral is problematic or constraining in most jurisdictions. These include bars to taking security interests in chattel paper or accounts receivable, and more broadly a lack of provisions for charges over future property or the use of security to collateralize future loans.

⁴⁹ See Vassiliou (2003), p. 8

Table 3: Treatment of Real Property

Jurisdiction	Analysis
China	Land may not be mortgaged, but mortgages over land-use rights are permitted. Registration is necessary to protect secured creditor rights. The enforcement of a mortgage can require litigation in cases in which the mortgagee and mortgagor cannot reach agreement as to how the mortgagee claim may be satisfied. Transactions involving mortgages to be held by foreign entities are subject to prior approval and registration with the State Administration of Foreign Exchange ('SAFE').
Indonesia	Security interests may be taken in land but it often proves difficult for creditors to enforce a security interest. It is clear that the process is inefficient: enforcement can take many years. Auction fees and taxes are high and, in practice, recourse to the courts is almost always necessary. ⁵⁰ Official registers are maintained manually, which causes difficulties for potential lenders wishing to search for title or prior claims. ⁵¹
Korea	Most real estate rights must be registered. However, there are important exceptions from this rule (e.g., property acquired through inheritance or pursuant to a judgment auction).
Philippines	Real property may be mortgaged and both registration and notarization are statutory requirements necessary for creditor protection. Ownership is retained by the mortgagor while a charge is outstanding. Delays in foreclosure can occur because the secured party must use the courts in the absence of any contractual agreement for extra-judicial foreclosure. ⁵²
Thailand	Real property may be mortgaged and registration is necessary to protect the secured creditor's rights, but foreclosure cannot occur unless loan interest or charges have been outstanding for five years, contributing to an inefficient enforcement process that can be prolonged for up to decades and in some prominent cases subject to negotiation before the courts. ⁵³
Hong Kong Malaysia Singapore	All allow for a charge to be taken over land, which must be registered. ⁵⁴ Hong Kong and Singapore also provide for mortgages to be taken over land, but in Hong Kong (since 1984) the mortgage may be created only by a legal charge. The Malaysian courts will generally recognize a charge that is executed but not yet registered. All three jurisdictions allow for the appointment of a receiver to protect the creditor's interest and in all three jurisdictions there is a high level of predictability and efficiency as to the creditor's ability to enforce its rights.

⁵⁰ Nurmansyah, Bakker, Rees & Adams (2006), p. 80.

⁵¹ Id.

⁵² Ongkiko, Laforteza, Franciso & Canilao (2006), p. 135, noting that mortgage contracts now usually provide for extra-judicial foreclosure to address this problem.

⁵³ See Vassiliou (2003), p. 8.

⁵⁴ Laws governing land registration differ between Peninsular and East Malaysia.

Table 4: Treatment of Movables

Jurisdiction	Analysis
China	Mortgages may be taken over existing tangible movable property, but not over future property. Secured creditors must register their claims to protect all such non-possessory rights. They may also protect themselves through possession in the form of a pledge. As with real property, foreign entities seeking security over movable property must comply with SAFE approval and registration procedures. The treatment of security interests in intangible assets such as bank accounts or receivables is less straightforward. Regulations have been issued allowing mortgages over such assets, but the effectiveness of these new forms of collateral is largely untested. Enforcement of unsecured claims can sometimes run into resistance at a local level; there have been reported instances in which banks and their clients have colluded to hide assets from the court.
Indonesia	Under the Fiduciary Security Law, a debtor may transfer title to goods to a creditor and retain possession of the goods in the absence of any default. Pledges are also permitted. A fiduciary assignment may be taken for security purposes over intangible property and receivables. ⁵⁵ As with real property, enforcement over movable property requires recourse to the courts and both auction fees and taxes are punitive. ⁵⁶ In essence, secured creditors foreclosing on collateral are forced to resort to substantially the same court proceedings as unsecured creditors. ⁵⁷
Korea	Rights in personal property may only be protected by possession. Korean law does not recognize purchase money security interests or floating liens.
Philippines	Chattel mortgages and pledge are permitted over movable property. Chattel mortgages must be recorded. Philippine law does not recognize chattel mortgages over future property; but the courts have created exceptions for interests in inventories of raw materials, goods in process, and finished goods. Chattel mortgages may not secure future obligations.
Thailand	Only certain forms of movable property may be mortgaged, including large ships and boats, floating houses, beasts of burden, and classes of machinery. Creditors holding rights of retention are also recognized as secured creditors. Other types of property may be pledged. Enforcement of secured rights requires either a court judgment or a public auction. Enforcement is slow and costly. Fixed and floating charges are not permitted at present, but would be allowed under draft secured transactions law. The enforcement of unsecured debts in Thailand can extend for many years.
Hong Kong Malaysia Singapore	The laws in all three jurisdictions provide for a variety of security over movable property (both tangible and intangible), including charges, liens and pledges. Retention of title is also permitted. Security may be taken over future property. Fixed charges may be taken over tangible assets and floating charges over classes of variable assets such as inventory or book debts. Less clear is whether secured creditors may take fixed charges over book debts. These English-origin systems require the registration of many types of charges, including charges over book debts and floating charges over the general undertaking of a company, but statutory rules are less clear and comprehensive than US UCC Article 9. Usual practice in these three jurisdictions is for a debenture to provide a secured financial creditor with contractual remedies upon default allowing appointment of a receiver or special manager. All three jurisdictions have efficient debt collection procedures for unsecured creditors.

⁵⁵ Nurmansyah, Bakker, Rees & Adams (2006), p. 80.

⁵⁶ Id.

⁵⁷ Id.

Securitization

70. Securitized transactions require a permissive framework of existing or dedicated law, acceptance of certain accounting principles, acceptable regulatory assent, and a non-discriminatory taxation background. They also require accepted commercial precepts that are not matters of legal policy, for example, a lack of contractual restrictions to the transfer of financial claims. Such restrictions are common in all review markets, except generally in Hong Kong and Singapore.

71. The details of generic transactions will vary among jurisdictions, but are assumed to entail the irrevocable transfer of assets to an insubstantive special purpose vehicle ('SPV') to which the asset seller has no ties of ownership or control. Funding for the asset purchase is provided by the sale of public or private securities to third party investors. The transaction must withstand any legal claim in bankruptcy against the asset seller; its economics must withstand taxes and duties on transfer; and in most cases securities issued by the SPV must provide for the dependable subordination of claims.

72. In general, the elements of law typically associated with securitized transactions in advanced markets are present in the three common law review jurisdictions, especially those affecting existing or future claims originated by financial intermediaries. However, certain future claims that cannot be specified in ways expected by current law may be seen as hazardous source material by investors or third party monoline insurers, for example, credit card receivables.

73. A summary of the provisions for securitized transactions and their effectiveness is given in Table 5. Its assessments of the effectiveness of enabling legal provisions (column 1), the enforcement of foreclosure or repossession of source assets (column 4), and ongoing threats to the integrity of transfer of assets to a SPV (column 5) are in each case based on transactional evidence, and appraisals of governing laws. However, it must be noted that in most jurisdictions transactional integrity has yet to be fully tested through a complete credit cycle. This would apply even in common law jurisdictions such as Hong Kong and Singapore, for example in relation to new rules permitting the creation of real estate investment trusts ('REITs'), although in each case the probability is small that a completed transaction will be successfully challenged.

74. While aspects of law may now be clear in some cases, it may be little used as in Thailand (or wholly unused, as in the Philippines) in private contracts, and is thus untested. Further, no significant number of completed securitized transactions has yet to undergo periods of economic stress, or be attacked by creditors of the originator. In contrast, Korean reforms since 1998 seem to be demonstrably successful.

75. Malaysian common law is supportive of securitization. Rules setting out general parameters for securitization were first published only in 2001 but sales of whole or partial interests in pools of home mortgages began in the mid-1980s. Shariah-compliant transactions have been few to date and involve intricate structuring at all stages, but are now considered to be generally feasible, at least as single deals.

Table 5: Provisions for Securitization

	Sale, assignment or other conveyance of assets by originators to securitization vehicles				Creation, maintenance and operation of SPV		Other
	Legal framework for creating, transferring and perfecting ownership interests	Restrictions on types or terms of financial assets that can be transferred	Taxation and gain recognition issues	Default and foreclosure and/or repossession at level of individual assets	Legal and regulatory impediments (e.g. bankruptcy remoteness)	Taxation or licensing requirements	Restrictions on securitization vehicles to issue multiple tranches with varying characteristics
China	1/2	1	1	1	1	1	1
Indonesia	2/3	2	2	2	2	2	2
Korea	5	4	3/4	4	5	5	5
Malaysia	5	4	4	3/4	4	4	5
Philippines	2/3	2/3	1/2	2/3	2/3	2/3	2/3
Thailand	3/4	3	3/4	3/4	2/3	4/5	2/3
Hong Kong	5	5	4	5	5	5	5
Singapore	5	5	5	4	5	5	5

76. Four of the five civil law review jurisdictions have since 1998 introduced, or plan to introduce, enabling laws that, to different extents, permit the creation of securitized transactions recognizable by international standards. The most notable provisions are shown in Table 6. In particular, these allow for the creation of SPVs, which would otherwise generally not be permitted.

77. Indonesia permits certain transactions under authority granted to the principal securities regulator, Bapepam. Several Indonesian securitized transactions were completed before 1997 but post-crisis deals are virtually non-existent, since counterparties may have been more willing to enter deals in a time of moderate confidence than thereafter. There has been some doubt since 2000 that regulatory decrees on which new transactions depend may subsist during its lifetime. Last, certain jurisdictions are affected by related issues of law, tax or market rules, rather than pure securitisation provisions: this further reflects uncertainty, and applies to the Philippines, for example.

V. CREDITOR RIGHTS AND INSOLVENCY

Background and Framework of Analysis

Insolvency

78. At the formative stage of economic development, the risk and incidence of defaults by debtors often prevents the efficient deployment of funds for investment. A proper framework of law to provide both for company incorporation and the orderly resolution of proceedings for recovery and bankruptcy is thus a crucial foundation of development.

Table 6: Status of Enabling Legislation for Securitization

Jurisdiction	Years of enactment
China	Major bank sector securitization legislation expected 2006-07 Trial deals permitted by banking and securities regulators 2005-06
Indonesia	Pre-1997 securitization decrees 2002-03 securities regulator guidelines
Korea	1998 asset-backed securities law 1999 mortgage backed securities law 2003 Korea Housing Finance Corporation law
Philippines	2003 special purpose vehicle act 2004 securitization act (largely untested)
Thailand	1997 securitization decree 2003 asset-backed securitization act 2004 special purpose vehicle act

79. A functioning legal framework for insolvency management is crucial to the operation of any modern market-based economy. No corporate sector can function effectively as a whole without mechanisms to recognize and govern the exit of insolvent participants. Further, the financial sector will refrain from credit creation for many companies and individuals if lenders are uncertain that their status as secured creditors will prevail upon the liquidation of their debtors or that a reliable means will be available for the enforcement of security. The general objectives of a system of corporate insolvency have been simply described as the reduction of uncertainty, promotion of efficiency, and fair and equitable treatment for all participants.⁵⁸ A functioning insolvency regime can thus help reduce or simplify the risks associated with lending and the potential cost of debt service and if this is the case will thereby increase credit availability and the making of investments generally.⁵⁹

80. Furthermore, functioning insolvency procedures are thus central to the legal and institutional environment for sound finance in any market-based economy, regardless of whether public policy requires the law to favour debtors or creditors. A well-administered insolvency system may be seen as valuable in promoting market discipline. Effective insolvency laws provide the means for the identification of non-competitive participants and in some cases for their controlled exit. It provides, in other words, an effective penalty for the least competitive. While this view stresses the retroactive character of insolvency law, it also has a considerable preventive element in that it creates incentives for the uncompetitive to improve performance so as to avoid the sanction of administration by a third party on its creditor's behalf.

81. A number of international organizations and associations have been involved with the development of standards for modern insolvency law and related systems. Many of these activities have focused on the development of standards for cross-border insolvency cases in particular, such as the UNCITRAL Model Law on Cross-Border Insolvency and the EU Insolvency Regulation of 2000.⁶⁰ More recently, a working group chaired by the legal

⁵⁸ See the report of the G-10 (2002).

⁵⁹ IMF Legal Department (1999). Note that this argument is silent as to the quality of investments so financed.

⁶⁰ Council Regulation (EC) No. 1346/2000 of 29 May 2000 on Insolvency Proceedings, OJ L 160, 30/06/2000.

department of the IMF presented a document containing detailed principles for the development of workable, modern insolvency legislation.⁶¹

82. While there is no internationally agreed key standard in the area of insolvency, the World Bank is coordinating efforts to develop such a benchmark and is working with UNCITRAL to develop a framework for implementation.

83. The World Bank issued a first set of Principles and Guidelines for Effective Insolvency and Creditor Rights Systems in April 2001⁶² and a revised set is under development that takes into account feedback from insolvency assessments conducted under the ROSC initiative.⁶³ The Bank is also preparing a technical paper containing detailed implementation guidelines to complement the principles. Finally, UNCITRAL released its Legislative Guide on Insolvency Law in 2005, a combination of model provisions, recommendations and explanatory notes that builds upon the work of other international organizations including the World Bank, IMF and ADB.⁶⁴

84. According to the World Bank, effective corporate insolvency principles:⁶⁵

- Integrate with broader national legal and commercial systems.
- Maximize the value of a firm's assets by providing an option to reorganize.
- Strike a careful balance between liquidation and reorganization.
- Provide for equitable treatment of similarly situated creditors, including foreign and domestic creditors.
- Provide for timely, efficient and impartial resolution of insolvencies.
- Prevent the premature dismemberment of a debtor's assets by individual creditors seeking quick judgments.
- Provide a transparent procedure that contains incentives for gathering and dispensing information.
- Reorganize existing creditor rights and respect the priority of claims with a predictable and established process.
- Establish a framework for cross-border insolvencies, with recognition of foreign proceedings.

⁶¹ IMF Legal Department (1999).

⁶² World Bank (Apr. 2001). The Principles ('ICRPs') were prepared in collaboration with the AfDB, ADB, EBRD, IADB, IFC, IMF, OECD, UNCITRAL, INSOL International and International Bar Association.

⁶³ The World Bank's latest draft dates from 2005, see http://www.worldbank.org/ifa/rosc_icr.html (visited 30 April 2006).

⁶⁴ United Nations, New York, 2005. Adopted by consensus at the 792nd meeting of UNCITRAL, 25 June 2004.

⁶⁵ World Bank (Apr. 2001), ICRP 6, p. 24. According to which, these elements were identified by the G-22. Id., p. 24 n. 10, citing G-22 (1998), pp. 16, 44-45.

85. In supporting these objectives, the thirty-five World Bank insolvency principles cover five main areas: (1) legal framework for creditor rights (principles 1-5)⁶⁶; (2) legal framework for corporate insolvency (principles 6-16); (3) corporate rehabilitation (principles 17-24); (4) informal workouts and restructuring (principles 25-26); and (5) institutional and regulatory frameworks for implementation of the insolvency system (principles 27-35).

86. The most recent version of the UNCITRAL Guide⁶⁷ is divided into two parts: part I deals with the design of the key objectives and structure of an insolvency law, while part II includes core insolvency law provisions. Unfortunately, until the revised World Bank principles and the final UNCITRAL Guide are integrated, approved and released, it is impossible to identify an international consensus in this area.

Interaction between creditor rights and insolvency

87. Debtor-creditor laws include systems for collecting debts and insolvency systems for terminating the collection of unpaid debts. Collection systems include:

- Secured transactions, using movable property as collateral.
- Mortgages, using fixed property as collateral.
- Unsecured lending, a system that uses no property as collateral.

88. One simple view of the interaction between secured lending and insolvency laws sees secured lending and insolvency address distinct problems, each with separate solutions. A secured lending system asks how are lenders repaid, whereas by contrast, insolvency systems ask what is the appropriate treatment for defaulting borrowers.

89. At the same time, there are important points of intersection between secured transactions and insolvency, and the two systems must be integrated. Neither system can substitute for the other.

90. Any reform of debtor-creditor laws must embrace both secured lending and insolvency law, as well as closely related aspects of other areas of law. It may be that the need for such drafting integration is more widely realized in East Asia as governments contemplate reform than would have been the case prior to the shared experience of the 1997-98 financial crisis.

91. Secured transactions have often been seen as important in assisting general welfare by helping create or encourage certain benefits for society as a whole. Regardless of the nature of preferred insolvency laws, East Asian national economies are likely to gain by enhancing their respective laws on secured lending. This relies on the premise that general access to credit and certain of the terms on which it becomes available will improve in the borrower's favour as the quality of collateral-taking improves.⁶⁸ Effective secured transactions systems that allow for

⁶⁶ This section, while at first glance appearing to address collateral and secured transactions, only addresses these in the context of insolvency.

⁶⁷ UNCITRAL (2003).

⁶⁸ This is not universally accepted, see for example Schwartz (1981, 1984) who questions the transaction cost results of secured lending.

movable property to be used as collateral may allow distressed firms to gain access to credit and so avoid the final resort of insolvency. In such conditions it also becomes less essential for creditors to initiate the insolvency process to be repaid.

92. All security interests must be properly publicized. An effective method of publication puts both existing and potential creditors on notice that a debtor company has available less unencumbered assets in which future lenders might obtain interests. It also provides notice as to the order of priority for the distribution of assets if a company becomes insolvent. Filing or registration systems are comparatively effective due to inefficiencies associated with possession as a form of security, with a filing system often more efficient and accessible.

93. The efficient enforcement of security interests is central to an effective secured transactions system. It is also important in promoting both informal and judicially supervised workouts. An efficient system will minimize the need for judicial assistance wherever possible and expedite the enforcement process.

94. In the interaction between secured transactions and insolvency, the essential need is for insolvency law to respect the pre-existing priority rights of secured creditors. If insolvency law poses unreasonable threats to secured lending, banks may raise their lending charges or restrict access to credit. Furthermore:

- Where before insolvency or in contemplation of insolvency a company charges or mortgages assets to a creditor in exchange for it providing identifiable value to the company, then as a general rule such charges or mortgages should not be voided by subsequent insolvency proceedings.
- Secured creditors should be permitted to convert an unsecured debt into a secured debt providing such transactions are completed substantially before the commencement of any insolvency proceedings.
- Fraudulent or commercially unfair transactions that have a security component may be avoided.
- Post-petition grants of security should be permitted.
- As a general rule, pre-petition interests should continue in post-petition proceeds.
- As a general rule, priorities in insolvency should be abolished.

95. Overall, East Asian economies would benefit from enacting insolvency laws that respect the pre-existing rights of secured creditors. However, in deciding to what extent exceptions to the rule should be permitted and how best to balance the needs of secured transactions and insolvency, governments in East Asia must first decide which approach they believe most appropriate.

Analysis: East Asia

96. Recent evidence suggests that effective legal systems for insolvency are positively associated with national income growth, domestic credit creation, and with recorded levels of inward foreign direct investment. Where legal reforms are overdue, the result is often manifested in obstacles to inward capital and direct investment.

97. The appraisals given in Table 7 acknowledge extra-legal regulatory guidance for collaborative multi-creditor practice, for example, in Hong Kong, Indonesia, Malaysia and Thailand. In these jurisdictions, regulators have attempted to instill informal out-of-court corporate workout practices similar to the well-established ‘London Rules’ or ‘London Approach’ promoted in the 1970s by the Bank of England as an alternative to formal court-based corporate insolvency proceedings.⁶⁹ After the onset of the Asian financial crisis, such out-of-court workout procedures were utilized more frequently than court-based formal reorganizations.⁷⁰ Most jurisdictions also set up public administrative agencies to assist with the restructuring of domestic financial intermediaries and the disposal of non-performing loans (‘NPLs’).

98. In both Hong Kong and Singapore, systems and practice are well-established and generally sophisticated but legislative reform has tended to lag both market practice and the willingness of the courts to intervene creatively in cases of corporate distress.

Table 7: Development of Effective Insolvency Systems

	Legal framework for corporate insolvency	Corporate insolvency implementation	Judicial decision-making and enforcement	Effective insolvency practitioners
China	1	1	1	1/2
Indonesia	2/3	1	1	1/2
Korea	4	3/4	3	3/4
Malaysia	4	4	4	4
Philippines	2/3	2/3	2	2/3
Thailand	3	2/3	2/3	2/3
Hong Kong	4	5	5	5
Singapore	4/5	5	5	5

Insolvency

Pre-1997 Overview

99. At the opening of the Asian financial crisis, only Singapore among the jurisdictions in this study had an insolvency regime adequate to deal with a high number of corporate failures. All other jurisdictions were hampered by antiquated laws and procedures, many of which dated from colonial times, and none maintained effective formal corporate rescue procedures. The Hong Kong and Malaysian corporate insolvency procedures were modeled on mid-20th century English law; Thai law dating from 1940 was influenced by English personal bankruptcy laws,

⁶⁹ The London Rules were incorporated into U.K. legislation in 2001.

⁷⁰ ADB (2000).

while Indonesian law was mainly Dutch in origin and dated from the late 19th century. Korea's insolvency regime drew on Japanese law, in turn derived from German, Austrian, and US principles and statutes. China's insolvency laws were more recent, with bankruptcy provisions for state-owned enterprises ('SOEs') enacted in 1986, but these were to prove no more adequate for their purpose. All these regimes used liquidation-based procedures, with the exception of those in Singapore. For the most part, these insolvency laws were underused for liquidation and seldom used for corporate reorganization.

100. The insolvency laws in Hong Kong, Malaysia and Singapore share a basic structure of detailed liquidation (winding-up) procedures and an abbreviated scheme of arrangement procedure for use in corporate rescues. The liquidation procedure in these laws is the most efficient in the region, although in need of modernization, but the scheme of arrangement procedure is cumbersome and expensive. Hong Kong and Malaysia procedures do not provide for an automatic stay in the absence of a winding-up order; Singapore operates a stay only on unsecured creditors. In no jurisdiction are there mechanisms to force uncooperative secured creditors to the bargaining table. The result is that prior to the onset of the Asian financial crisis, the procedure was rarely used, although it was used more frequently than in Hong Kong or Malaysia. Singapore also introduced judicial management procedures in 1987. Judicial management may be commenced either by a debtor company or its creditors, and the procedure provides for an automatic stay while the judicial manager takes over the running of the company and becomes responsible for proposing a plan of reorganization for creditor approval.⁷¹

101. Korea's insolvency regime has been more complicated. Until recently, the law had three parts, comprising laws concerning bankruptcy, composition and reorganization, all dating from 1962. Rather than develop its own insolvency solutions, Korea translated and enacted Japanese laws, so that the Bankruptcy Act was based on the Japanese Bankruptcy Act 1922, itself derived from German law. The Composition Act was based on a Japanese composition law taken from Austrian law; the Reorganization Act copied the Japanese Reorganization Act 1952, derived in turn from the US Bankruptcy Act 1898. The composition law was triggered by a debtor's filing and only provided for temporary relief until creditors voted on a composition plan. The more complicated reorganization process was better suited for larger, public companies.

102. The Philippines legal system is primarily a civil law system but has long-standing common law aspects (now found in some modern European jurisdictions) in that its supreme court decisions are binding as precedents. The pre-1997 Philippines insolvency law dated from 1909 and included a rarely used liquidation procedure and a corporate rescue suspension of payments process taken from Spanish law that was available only to solvent companies experiencing temporary cash flow problems. Any proposal for debt rearrangement required the full payment of debts, and so was rarely used. A rehabilitation procedure was introduced as an alternative to the inflexible suspension of payment process under a 1976 presidential decree, amended in 1981. Unusually, the amendment gave jurisdiction for the rehabilitation and suspension of payments procedures to the Securities and Exchange Commission ('SEC') rather than the judiciary. The rehabilitation procedure provided few rules and contained curiosities, such as not requiring that creditors approve any rehabilitation plan and at times treating secured and unsecured creditors alike.

⁷¹ Lee (2003) discusses Singaporean corporate insolvency law.

103. Indonesian and Thai insolvency law also provided for both liquidation and suspension of payments procedures but were also rarely used. Indonesian debtors are able to present a plan of composition even within the liquidation process. Suspension of payments provides the debtor with a longer period of time in which to finalize a repayment plan. Under Thai bankruptcy law, composition is possible either pre-petition or post-petition. An unusual aspect of the Thai Bankruptcy Act 1940 is that its presumptions of insolvency appear to have been influenced by the acts of bankruptcy in 19th century English law.

104. China was spared the severest economic problems related to the Asian financial crisis, and is the only jurisdiction in the study group whose bankruptcy laws in 1997 had been recently promulgated. Nevertheless, at the time of the financial crisis China was affected by domestic problems resulting from the poor financial condition of its SOEs and state-owned banks. The current insolvency framework in China is an overlapping patchwork that includes the 42-provision 1986 Bankruptcy Law for SOEs; the eight provisions in Chapter XIX of the PRC Civil Procedure Law; judicial interpretations of these short laws, notably the 2002 interpretation by the Supreme People's Court; and most importantly, several policy decrees issued by central government. These decrees are crucial in understanding the government's approach to insolvency issues. Although the number of insolvencies in China has been increasing, it is generally considered to be far lower than justified by the condition of most SOEs and banks. The current laws clearly are inadequate and a new bankruptcy law, under discussion for more than a decade, may be enacted later in 2006.⁷²

105. The profound impact of the 1997 crisis led to an immediate call to reform or replace archaic liquidation regimes and supplement them with modern corporate rescue procedures, including both formal court-based regimes and out-of-court and administrative procedures. Since the crisis, two waves of reform have crossed the region. The first included insolvency reforms in Indonesia, Korea, Malaysia, the Philippines, and Thailand. The second includes the new bankruptcy law enacted in Vietnam in 2000 and ongoing law reform efforts in China, Hong Kong and Singapore, although it should be noted that the reform process in both China and Hong Kong began prior to mid-1997.

Post-Financial Crisis Legal Reforms

106. Thailand was badly affected by the 1997-98 crisis. A new chapter on business reorganization was added to the Bankruptcy Act in 1998 to facilitate corporate rescues. One reforms provided for the appointment of a bankruptcy planner to manage the affair of the debtor company and prepare a plan of reorganization. The new procedure is intended for large corporate debtors owing at least Bt10 million (US\$265,000) to its creditors and further provisions would be appropriate to create an efficient procedure for smaller debtors. Further amendments were made to the bankruptcy law in 2000.

107. An important part of the Thai reforms was the establishment of a bankruptcy court in 1999 with exclusive jurisdiction for bankruptcy cases pursuant to the Act for the Establishment of and Procedure for Bankruptcy Court. The act was amended in 2004. Perceptions of the introduction of the bankruptcy courts has varied over the years. Initial views were positive, but

⁷² See Booth (2005).

concerns have increased as to the overall efficacy of these changes. There have been claims of inconsistency among individual courts; a fear that much of the expertise gained through the formation of the courts is lost when judges are rotated into other courts; an increasing backlog of cases has been observed; and there are perceptions that corruption and fraud may be affecting the courts' work.⁷³ At present, these concerns appear have eased somewhat and there is a re-emerging sense that the judicial reforms were for the best.

108. Indonesia was still more badly impacted by the 1997 crisis. In 1998, the Bankruptcy Ordinance was amended by a Government Regulation in Lieu of Law. Indonesia established a Commercial Court after the crisis to hear bankruptcy cases, but the court 'has been plagued by concerns of corruption and inconsistent application of the Bankruptcy Act.'⁷⁴ Many abuses have been publicized (with a case involving insurer Manulife the most well-known, having been the subject of much international media coverage) and '[t]he Indonesian Corruption Watch of reports of corruption in the legal system is staggering.'⁷⁵ However, the IMF and the ADB together funded a group of local lawyers and judges known as 'Team 7' to address such problems and evaluate the Commercial Court's decisions.⁷⁶ Further amendments to Indonesian law were enacted in 2004.

109. Korea has made the most significant changes to the formal insolvency laws of the all jurisdictions in this study. Korea's corporate sector, especially its closely-controlled *chaebol*, were traditionally highly-leveraged, which proved an immediate burden in the light of a post-crisis withdrawal of available credit. Korea agreed to enact substantial changes in law at the instigation of the IMF and the World Bank, in the form of amendments to its tripartite insolvency legislation covering liquidation, composition and reorganization. US bankruptcy law influenced many of these changes. Among the notable reforms were the inclusion of creditors' committees in composition proceedings and management committees in reorganizations, while the time limit for reorganizations was halved from 20 to 10 years. Many changes were intended to expedite reorganization procedures. Further amendments were made in 2000 and 2001, the latter including formalizing an out-of-court Workout Accord in the reorganization legislation to enable creditors to file proceedings to bind foreign creditors. A recent major change to insolvency law was a Debtors' Rehabilitation and Bankruptcy Act ('DRBA'), which came into effect on 1 April 2006. This new legislation consolidates the three different insolvency acts for the first time. The act further expedites corporate rescue processes. It expands the reorganization system and abolishes the Composition Act. The task for Korea may now be to ensure that its new legal framework is properly implemented, for which further judicial and practitioner training is likely to be necessary.

110. Amendments to Philippines law were made in July 2000. Among the most significant changes was that jurisdiction for rehabilitation and suspension of payment cases was transferred to the courts. The Interim Rules of Procedure for Corporate Rehabilitation were promulgated in December 2000 and were far more detailed than the procedures under the prior Presidential Decree. Suspension of payment cases and rehabilitation have become more common since the financial crisis, however, delays remain a problem under the new regime and obtaining post-

⁷³ Vassiliou (2003), p. 7.

⁷⁴ Id., p. 6.

⁷⁵ Id., pp. 6-7.

⁷⁶ Id., p. 35.

petition financing has often proven difficult. Other reforms are currently under discussion, notably a Corporate Recovery and Liquidation Act and a Corporate Recovery Act, intended to improve further the corporate rehabilitation and liquidation regimes. It is hoped that the Corporate Recovery Act will include provisions for fast-track rehabilitations, but the congressional passage of these bills has been slow. The goal for the Philippines is also to increase the institutional capacity of the judiciary and the insolvency practitioners. The reasons for transferring the jurisdiction of insolvency cases from the SEC to the courts are understandable, but make the Philippines the sole jurisdiction in the study core where the administrative and judicial enforcement capacity decreased after the financial crisis. Another goal for the Philippines will be better to protect the rights of secured creditors.

111. China is the only country in the study core now in its second wave of major law reform. China is on the verge of enacting a new bankruptcy law that will unify the current patchwork of laws and judicial interpretations, and so radically improve both liquidation and corporate rescue processes. At the heart of these reforms is the introduction of an office of the professional administrator, to replace the current inefficient liquidation team. The new reorganization procedures will allow for reorganizations led either by the administrator or a debtor-in-possession. Experienced Hong Kong insolvency practitioners may be permitted to serve as administrators under the new law. A substantive issue delaying implementation has been a conflict between the interests of secured creditors and workers in cases where company funds are insufficient to meet wages in full. The most important issue that will need to be addressed post-enactment is what the scope of the new law will be: up to 2,000 designated SOEs will not be made subject to the new law, but will instead remain subject to other administrative regulations. It may be preferable instead for SOEs to become subject to the new law rather than bankruptcy policy decrees, allowing the insolvency of almost all SOEs to be addressed uniformly and transparently. It is also imperative that China raise its resources for handling insolvency cases, and consider establishing three or four ‘trial’ benches of bankruptcy judges in specified provinces to handle cases under the new law. Furthermore, thousands of insolvency practitioners will have to be educated about the new law, whether or not their counterparts in Hong Kong are permitted to administer in domestic mainland cases.

112. Hong Kong insolvency law reform pre-dated the 1997 financial crisis. In 1996 the Hong Kong Law Reform Commission set out the broad framework for a new regime by which upon commencement of the process, a qualified specialist called a ‘provisional supervisor’ would take control of the running of the company and be responsible for drafting a proposal for a voluntary arrangement to be voted on by creditors. The first draft bill was gazetted in 2000. The bill offered many advantages over current law, but its primary flaw has been a proposal that employees’ salaries be paid in full, or sufficient funds placed in trust for the purpose.⁷⁷ Fortunately, the judiciary has become receptive to the use of provisional liquidation as a mechanism to facilitate corporate rescue. The enactment of the provisional supervision regime in the near future is becoming increasingly unlikely.

113. Singapore’s insolvency regime is the most comprehensive of any jurisdiction in the study group. For the last five years or more, schemes of arrangements have proven more popular than judicial management cases. Among the reasons for this change are that a stay on unsecured

⁷⁷ See Smart & Booth (2001); Booth (2005).

creditors' actions in the scheme of arrangement procedure gives a company sufficient time to proceed to propose such a scheme; the debtor can remain in possession; and less stigma and adverse publicity arises in relation to a scheme of arrangement than to most judicial management cases. As with Hong Kong and Malaysian law, one of the weaknesses of the Singaporean model is a bifurcation in the corporate insolvency procedures in company law and the personal insolvency procedures in bankruptcy law. Singapore is considering the enactment of unified legislation to address this problem, but this will not take place in the short term.

Post-Financial Crisis Out-of-Court Reforms

114. Although legal insolvency reforms received much attention due to the needs created by the Asian financial crisis, the time taken to enact and implement new legislation is often inevitably protracted. As formal reforms were being considered, other efforts began to save or recover companies whose businesses could create value for creditors and other stakeholders. These efforts led to two types of reforms, promulgation of out-of-court workout procedures based on the London Approach (including the Bangkok Approach, Corporate Debt Restructuring Committee ('CDRC') in Malaysia, the Hong Kong Approach, the Jakarta Initiative, and the Workout Accord in Korea), and where national banking sectors were severely affected by delinquent loans, the establishment of administrative asset management agencies to assist with restructuring and the disposal of NPLs (including the Indonesian Bank Restructuring Agency 'IBRA', Pengurusan Danaharta Nasional Bhd 'Danaharta' in Malaysia, and the Thai Asset Management Company 'TAMC'). For the most part, these entities were created as part of emergency measures and are now in the process of being wound down.

115. Hong Kong established the Hong Kong Approach to Corporate Difficulties, which is modeled on the London Approach and has the backing of the Hong Kong Association of Banks and the Hong Kong Monetary Authority.

116. The government of Korea established an out-of-court workout process in June 1998, in the form of a Workout Accord among financial intermediaries. Two problems with the process were that it excluded foreign creditors and provided no priority for post-commencement financing. In 2001 the Workout Accord procedure was promulgated as part of the reorganization law to address these two problems and formally expired on 31 December 2005. The Korean Asset Management Company ('KAMCO') also assisted with resolving the banking sector's considerable NPL problem. Unlike similar asset management companies ('AMCs') in the region, KAMCO was not a temporary entity established to deal with the 1997 crisis, but rather had been formed in 1962.

117. Indonesia established several out-of-court mechanisms, including the Jakarta Initiative for financial creditors, a more structured version of the London Approach made subject to the Jakarta Initiative Taskforce; the Indonesian Debt Restructuring Agency ('INDRA'); and IBRA to deal with NPLs and other impaired assets of Indonesian financial intermediaries. IBRA was a massive entity and became the largest landowner in Indonesia before being dissolved in 2004.⁷⁸ Its overall results were seen as less effective than those of other state-sponsored AMCs, such as KAMCO or Danaharta.

⁷⁸ Vassilou (2003), p. 35.

118. Malaysia established CDRC to assist with informal out-of-court rescues and an asset management entity (Danaharta) to assist with problems encountered by the financial sector. Danaharta had strong powers of enforcement and its results are favorably viewed as playing an important role in addressing post-crisis problems in Malaysia.

119. In 1998, Bank of Thailand established an informal out-of-court restructuring procedure for financial creditors to be headed by the Corporate Debt Restructuring Advisory Committee, known as the Bangkok Approach and which is modeled on the London Approach. TAMC was created pursuant to emergency legislation in June 2001 to assist in the disposal of Thai financial sector NPLs.

120. China established four AMCs to address the accumulation level of NPLs at each of China's four largest state-owned commercial banks: China Xinda Asset Management Company ('Cinda') for Construction Bank of China and China Development Bank (the first Chinese AMC created in April 1999); China Huarong Asset Management Corporation for Industrial and Commercial Bank of China, Dongfang Asset Management Company ('Oriental') for Bank of China; and China Great Wall Asset Management Company for Agricultural Bank of China. Other regional AMCs were also established, including the important Guangdong Guangye Asset Management Company.

Interaction Between Creditor Rights and Insolvency

121. A theme of this study is that effective insolvency regimes go hand-in-hand with effective secured transaction regimes, but this parallel development of secured transaction laws is absent in the majority of jurisdictions considered in the study. It is within insolvency cases that the effect of secured transactions and the rights of secured creditors are tested. The overall implementation of the insolvency regimes would benefit from the upgrading or implementation of effective secured transactions systems throughout the region.

122. The English company law system adapted in Hong Kong, Malaysia and Singapore put secured creditors in a relatively strong position in insolvency matters. Secured creditors act outside the liquidation and are not subject to a general stay against creditors. Unless they give consent, they also act outside the scheme-of-arrangement process. It is only in judicial management cases in Singapore that secured creditors are made subject to the stay. The Hong Kong provisional supervision proposals would subject secured creditors to a stay, but there would be an exception for major secured creditors, defined to include 'any holder of a charge over the whole or substantially the whole of the company's property'. There is a high level of predictability as to the rights of secured creditors in these three jurisdictions.

Table 8: Compatibility of Creditor Rights and Insolvency Systems

	Principal source of current law	Form of legal transplant	Compatibility of systems relating to creditor rights and those permitting secured transactions
China	Mixed (Emerging; German civil; Socialist)	Adoption	NA

Indonesia	Dutch civil	Imposition	1/2
Korea	Mixed (German civil; English)	Mixed	3/4
Malaysia	English common	Imposition	3/4
Philippines	Mixed (Spanish civil; US common)	Imposition	1/2
Thailand	French civil	Adoption	1/2
Hong Kong	English common	Imposition	4/5
Singapore	English common	Imposition	4/5

123. In China, the rights of a secured creditor currently depend on whether a bankruptcy case is entered pursuant to government policy decrees or the bankruptcy laws. Although secured creditors are subject to a stay in both liquidations and reorganizations, they have priority in payment to the extent of their collateral and there is a traditional priority scheme in bankruptcies with employee claims given priority only after those of secured creditors; in policy bankruptcies, the secured creditors can lose their priority in land-use rights (and other secured assets) to employees to assist with their resettlement and other rights. However, the latest draft of the Chinese bankruptcy law provides that where there assets are insufficient to pay the claims of employees in full in any bankruptcy begun under the new law, then employee entitlements shall have priority over secured creditors' rights. This provision has proven contentious and has led to the delay in the enactment of the new law. It appears that a compromise is in the offing.

124. In summary, China, Indonesia and the Philippines adopt the US approach in which secured creditors are subject to a stay in both liquidations and reorganizations. In contrast, in Korea, Singapore and Thailand, secured creditors are subject to a moratorium in reorganizations, but not in liquidations or compositions. Last, secured creditors of companies in Hong Kong and Malaysia may act unilaterally outside both bankruptcy and reorganization. It has been noted that in those jurisdictions in which secured creditors are subject to the automatic stay, the courts have rarely applied principles regarding adequate protection when secured creditors seek to be exempted from the stay.⁷⁹

125. In the Philippines, secured creditors have less say as to the preparation of and agreement to a reorganization plan than elsewhere. In some instances, secured creditors have been required to share *pari passu* with unsecured creditors.

126. Areas of law relating to the interaction between secured creditors and insolvency that need to be improved in most jurisdictions in this study are:

- Concepts of adequate protection for secured creditors seeking exemption from the automatic stay.
- Not allowing open-ended employees' priority in claims over properly established secured interests.

⁷⁹ *Id.*, p. 8.

Summary

127. In an immediate post-crisis study of the insolvency law reforms in the Asian and Pacific Region, the ADB found that although the level of insolvency cases in Indonesia, Korea, Malaysia, the Philippines and Thailand had risen from pre-crisis levels, they remained low. Indonesia, the Philippines and Thailand were identified as having 'extraordinarily low' numbers of liquidations, and Indonesia and Thailand were identified as the two countries in which the use of the new formal reorganization laws was surprisingly low. Liquidations were most numerous in Korea and Malaysia (with Malaysia having more) and Korea by far had the greatest number of reorganizations, but even these levels were lower than would have been expected given economic conditions immediately after the crisis. The study also found that out-of-court processes were used with much greater frequency than the formal insolvency laws (except in Korea), yet their overall use was also 'surprisingly low'.⁸⁰ Data for the study were obtained from observations up to mid-1999 but subsequent anecdotal observations also support these findings. It remains difficult to obtain accurate insolvency case data from most jurisdictions in Asia and harder still to locate accurate data on out-of-court workouts.

128. However, case data may not be the sole benchmark of success. One benefit of enacting formal corporate rescue laws is that by setting out voting minimums and requirements for passing any reorganization plan, the law provides a framework for extra-judicial negotiations and thus plays an important role in addressing problems of the type caused by intransigent holdout creditors before the financial crisis. At present, if holdout creditors use such tactics, the debtor or creditors (as the case may be) may threaten to commence formal insolvency proceedings in which the holdout creditor can be outvoted.

129. The ADB study data demonstrate that the promulgation of new insolvency laws is only one step in achieving an effective insolvency system. Although the laws are modern in design and were enacted to facilitate corporate rescue, their practical impact will take time to discern. The benefits from out-of-court rescue processes have usually been more immediate.

130. Of the jurisdictions in this study, implementation of an effective corporate insolvency regime is best achieved in Singapore and Hong Kong, which are also the two jurisdictions that have made the least changes to their laws since the 1997-98 crisis. Hong Kong is unusual in that it while it lacks an effective formal corporate rescue law, it scores highly due largely to the quality of its judiciary and insolvency practitioners and their creativity in crafting out-of-court corporate rescues and through the adaptation of the provisional liquidation procedure. The main goals for both Hong Kong and Malaysia remain the need to enact modern corporate rescue systems and to update aspects of liquidation procedures. The latter is also relevant for Singapore, as for most countries in this study. China is another jurisdiction needing to enact a modern insolvency law and is widely expected soon to do so.

131. The goal following the enactment of formal insolvency laws is resource building in judicial competence and the development of effective insolvency practitioners. Specialized courts or benches are valuable but experiences in Indonesia and Thailand demonstrate that the creation of such courts is not a panacea. It is important for the judiciary to strive for consistency

⁸⁰ADB Office of the General Counsel (2000).

and eliminate corruption and the trading of influence. Professional and judicial training are crucial in this process. Another important feature of strengthening the implementation of the law is the development of a government agency to regulate insolvency processes. The Official Receiver's Office in Hong Kong and the Official Assignee's offices in Malaysia and Singapore all perform this function effectively. It is also important for practitioners to interact regularly as well as with the staff of the regulator's office to discuss contemporary insolvency developments. Hong Kong currently offers the best example of this interaction, which contributes to the overall effectiveness of sector. Lawyers and accountants meet regularly for training sessions run by the Insolvency Interest Group, housed in the Hong Kong Institute of Certified Professional Accountants. The latter runs insolvency training courses including an advanced diploma course that is recognized by the Official Receiver's Office. This arrangement could serve as a model for the region.

132. The activities of the World Bank and UNCITRAL show that there is no single set of provisions for an effective insolvency regime. Nonetheless, three issues have commonly caused difficulties in the implementation of new insolvency laws in the region:

- Priority or preference provisions that are overly generous to employees can lead to an unconstructive response by secured creditors and ultimately adversely affect bank lending and secured transactions.
- Requiring the managers of a company in liquidation or insolvency immediately to be replaced by an outside administrator can be a serious disincentive for many company officers and directors, especially those of smaller family-controlled companies that are seeking relief from creditors.
- Commencement criteria should be as clear as possible, for example, avoiding balance sheet insolvency tests.

VI. CONTRACT ENFORCEMENT AND DISPUTE RESOLUTION

133. Looking forward, it is clear that the most critically neglected emphasis throughout the region is in enforcement and implementation, with the partial exceptions of Hong Kong and Singapore. According to Haselman, Pistor and Vig:

The major function attributed to law is that it empowers creditors to enforce their contracts. Effective legal institutions reduce the risk of lending and therefore result in greater lending volume in an economy as a share of GDP. Implicit in this view of how law affects economic outcome is that all actors in the economy benefit from better law.⁸¹

134. This suggests that it is less the law that matters but its enforcement. Both theory and experience support this position.

135. Ronald Coase was first to observe and describe the importance of delineation and enforcement of contracts, in analyses unusually based upon non-statistical observations of

⁸¹ Haselmann, Pistor & Vig (2005).

prevailing industrial practice.⁸² In an environment of imperfect markets with real transaction costs, parties will seek efficient results through contracting. Unfortunately, transaction costs extend to costs of enforcement and if enforcement does not exist, then contracting cannot produce solutions to imperfections nor lead to stable long-term outcomes. Rather, contracting will tend towards instantaneous transactions.

136. The enforcement of contracts requires a governance system capable of producing, applying and policing results. Part II of this study showed that a range of governance systems may be capable of producing this function, and history has provided many disparate examples.

137. Enforcement of contracts is not equivalent to the existence of the rule of law; rather, it is one component of a system that can be described by that term. The rule of law is not a precondition for a market economy, despite generally being considered important to economic development and highly significant in financial market development. Rather, only a governance system that enforces contracts and resolves disputes in a credible and predictable manner is a necessity to a basic market economy and to allow financial markets to develop beyond facilitating single instantaneous transactions. This is important to institutional concerns such as the enforcement of financial contracts, efficient insolvency and collateral systems, and dispute resolution procedures. In this context, mechanisms for contract enforcement and resolving disputes may be more important than specific laws.

138. The foregoing Tables 2, 5, 7 and 8 show that most jurisdictions covered by this study have developed generally acceptable laws relating to creditor rights and insolvency but have not yet reformed their collateral and secured transaction regimes. At the same time, where such insolvency and/or collateral laws have been enacted, few jurisdictions have been effective in implementing and enforcing those laws. This is the concern to which legislative and administrative attention needs to be devoted and which clearly demonstrates the linkage between effective governance, economic and legal systems and property, collateral and creditor rights in East Asia.

139. Certain other issues of general concern are:

- The need to broaden the availability of real property ownership and mechanisms to support its use; especially in enforcement matters and dispute resolution.
- The need to broaden and simplify secured transactions, providing particularly for security interests in intangible property.
- The requirement for effective registration systems extending across a range of assets, including real property, security and intangibles, to simplify the use and availability of collateral and its enforcement, thereby encouraging a reduction in reducing transactions costs.
- The ineffectiveness of most judicial systems for enforcement and dispute resolution means that appropriate mechanisms for creditor and debtor self-assistance deserve to be

⁸² Coase (1960, 1937).

allowed and supported, providing they are transparently fair and just manner. This would include encouraging greater use of commercial arbitration.

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