

Out-of-court debt restructuring is ineffective when a  
distressed firm is a large borrower from its main bank:  
Evidence from Japan during its “lost decade”

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Abstract

This study provides evidence that out-of-court debt restructuring lacks efficiency when a distressed firm is a borrower with borrowings from its main bank that are sufficiently large to affect the soundness of the bank if defaulted on. We focus on out-of-court debt restructurings that occurred from January 1993 to January 2004 in Japan. During this period, Japanese banks were hard-pressed to clear mountains of nonperforming loans from their books. Our analysis of sample firms shows that, after the launch of an initial out-of-court debt restructuring, distressed large borrowers again experienced financial distress relatively more frequently than the other distressed borrowers. In addition, main banks of the distressed borrowers suffer significantly negative impacts on their stock prices when their large borrowers request debt forgiveness, while they experience significantly positive ones when the other borrowers do. Thus, there is peculiar positive relationship between the probability of failure of a debt restructuring and the loss in the market value of a main bank. On the other hand, the probability of subsequent failure is lower when the ratio of nonperforming loans of a main bank is higher. Moreover, main banks with a high ratio of nonperforming loans have significantly positive impacts on their stock prices when they and their distressed borrowers reach agreements on restructuring plans, while main banks with a relatively low ratio do not experience any significant impact. This could suggest that policies for promoting the disposal of nonperforming loans would be helpful to avoid inefficiencies in out-of-court debt restructuring.

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