Corporate Restructuring in East Asia

Introduction

Corporate restructuring was recognized as key to the affected countries' recovery process and long-term viability of their corporations in the aftermath of the 1997 Asian financial crisis. Governments of these countries have pursued various approaches to corporate restructuring, aided to different degrees by macroeconomic policies. In Indonesia, Korea, Malaysia, and Thailand, problem debts of large firms are being worked out voluntarily among creditors under government-sponsored processes or being liquidated and restructured under court supervision, while smaller firms' debts are mainly being dealt with on an out-of-court basis or through bankruptcy procedures. Financial sector restructuring and structural reforms, including reforms on bankruptcy and corporate governance, have been supporting the process of corporate restructuring. Meanwhile, Government-owned AMCs are helping to alleviate financial burdens of corporations and hold large amounts of nonperforming assets. The Philippines was less affected by the crisis, so the Government did not take specific measures on corporate restructuring. But there, there have been a number of reforms aimed at improving prudential regulation of the financial and corporate sectors.

However, progress in corporate restructuring has been modest. Banks have often had insufficient capacity to absorb losses without facing a serious threat of closure. In most of the countries, they operate with a full government guarantee on their liabilities, reducing any incentive to undertake deep restructuring. Banks also have limited technical capacity to restructure, while their long-standing links with corporations have complicated the restructuring processes in some countries. AMCs have helped in restoring banks' balance sheets, but they have not played a sufficiently constructive role in the financial and operational restructuring of corporations. Also, structural reforms, especially in areas of bankruptcy and corporate governance, have often lacked enough depth to force debtors to undertake the necessary financial and operational adjustments.

These have all left many corporations still burdened with high debts, and operating with low profitability, high leverage, and low liquidity. Thus, in light of a worsening global environment, corporate viability remains a major and critical policy concern in most crisis-affected Asian countries.

What Has Been Achieved?

Restructuring refers to several related processes: recognizing and allocating financial losses, restructuring financial claims of financial institutions and corporations, and operational restructuring. Recognition or resolution involves the allocation of existing losses and associated redistribution of wealth and control. Losses, i.e., the differences between market value of assets and nominal value of liabilities, can be allocated to shareholders—by dilution; to depositors and external creditors—by reduction of (the present value) of their claims; to employees—by cutting back on wages and suppliers; and to the government, that is, the public at large—through increasing taxes, cutting expenditures, or inflation. Financial restructuring for corporations can take many forms: reschedulings (extensions of maturities), lower interest rates, debt-for-equity swaps, debt forgiveness, indexing interest payments to earnings, etc. Operational restructuring includes improvements in efficiency and management, reductions in staff and wages, the sale of assets (for example, cutting subsidiaries), and enhanced marketing efforts with the aim of boosting profitability and cash flows.

When confronted with high levels of financial and corporate distress after the Asian crisis, most countries initially chose a decentralized approach. Banks and other creditors were expected to work out the problems of overindebted corporations on a case-by-case basis, while governments provided support to the banking system—through recapitalization, transfer of NPLs to AMCs, and other measures.

It was soon recognized, however, that a completely decentralized approach would not suffice, given the large scale of corporate sector distress and coordination problems among creditors. Thus, a larger role for government was both necessary and unavoidable. For most countries, with the exception of the Philippines, the model became large-scale corporate restructuring under a government-sponsored out-of-court process, the so-called London approach.

Outside the London approach (in various forms), there has been some purely market-based restructuring through court (bankruptcy proceedings) or voluntary actions, including mergers and acquisitions. Public AMCs have played an important role in separating NPLs from the banking system and thus restoring financial stability to crisis-affected countries. Such large holdings have led AMCs also to be a major player

in corporate restructuring. Further, much operational restructuring has been happening outside these fora, driven often by the lack of new financing, especially for small and medium enterprises (SMEs).

To complement these approaches, other reforms have aimed at strengthening the capital bases of weak banks, improving the financial system's structure, and bolstering corporate governance. Also, there have been changes to tax regimes regarding restructured debt and easier accounting and tax treatment of debt-for-equity swaps.

Government-sponsored voluntary workouts

Recognizing the scale of the restructuring challenges, all countries (with the exception of the Philippines) set up, through agreements among creditors, out-of-court processes for the screening and restructuring of large, distressed corporations. The out-of-court frameworks themselves have been built on the London approach for corporate reorganization first enunciated in the UK in the early 1990s. The London approach encourages creditors to follow certain principles—minimize their losses, avoid unnecessary liquidation of viable debtors, and ensure continued financial support to viable borrowers—in out-of-court restructuring agreements. Since the London rules were not designed for cases of system-wide corporate distress and allow for only informal sanctions from the Bank of England for noncompliance, the crisis-affected Asian countries have adopted more formalized approaches. These have involved accords under contract law through which creditors agree among themselves to follow certain processes and actions. The governments also enhanced the frameworks in several other ways, by adopting time-bound deadlines and sanctions for noncompliance, and creating formal arbitration mechanisms. These enhancements have also meant a larger role for government compared to the out-of-court processes in the UK and elsewhere.

These processes initially varied widely between countries, but they have converged more recently. There are three important ways in which frameworks can differ. First, have all (or most) financial institutions signed on to the accord under regular contract or commercial law? If so, agreements reached among the majority of creditors can be enforced on other creditors without going through formal judicial procedures. Second, is formal arbitration with specific deadlines part of the accord? Without such arbitration, an out-of-court system has to rely on the formal judicial process to resolve disputes—with associated costs and delays. Third, under the accord, are there penalties that can be imposed for failure to meet deadlines?

Not all countries immediately adopted these three features (Table 1). In Indonesia, for example, there was no formal arbitration in place by mid-1999. Malaysia's Corporate Debt Restructuring Committee (CDRC) is meant to provide a platform for workouts, but the committee does not have legal powers. The severity of penalties has also varied, with several countries initially not penalizing failure to meet deadlines and other breaches. Even enforcement of existing sanctions has been weak. Based on these criteria, the framework in Thailand was initially the most conducive to out-of-court restructuring, followed by those in Korea and Malaysia. Indonesia's framework has been the least conducive.

Table 1: **Features of Out-of-Court Corporate Restructuring Processes**

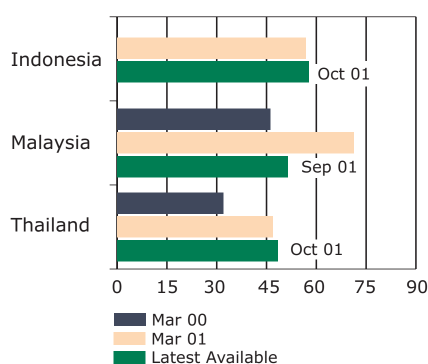
	Indonesia		Korea		Malaysia		Thailand	
Name of initiative or coordinating body	Jakarta Initiative Task Force (JITF)		Corporate Restructuring Coordination Committee (CRCC)		Corporate Debt Restructuring Committee (CDRC)		Corporate Debt Restructuring Advisory Committee (CDRAC)	
Basic approach	Forum for negotiations, followed by adoption of time-bound mediation procedures		Forum for negotiations, superseded in the fall of 2001 by a legal approach (Law on Corporate Restructuring)		Forum for negotiations		Forum for facilitation, superseded by contractual approach, i.e., Debtor-Creditor Agreements (DCAs)	
	mid-1999	**end-2000**	**mid-1999**	**end-2000**	**mid-1999**	**end-2000**	**mid-1999**	**end-2000**
All or most financial institutions signed on to accord	No	No	Yes	Yes	Yes	Yes	Yes	Yes
Accord provides for formal arbitration with deadlines	No	Yes	No	Yes	Yes	Yes	Yes	Yes
Accord imposes penalties for noncompliance	No	No	Yes	Yes	No	No	Yes	Yes
Resolution of intercreditor disputes	Nothing special		Possibility to have loan of opposing creditor purchased; also arbitration committee consisting of private experts		Nothing special, apart from suasion by central bank		Mediation in case only 50-70 percent of creditors approves workout. Any bank with large exposure can opt out	
Current default structure for failure to reach agreement	JITF may refer uncooperative debtors to government for possible bankruptcy petition		Foreclosure, liquidation through court receivership		Foreclosure, liquidation or referral to AMC with super-administrative powers		If less than 50 percent support the proposed workout, DCA obliges creditors to petition court for collection of debts	

Source: Mako (2001) and country sources for 2000; Claessens, Djankov, and Klingebiel (2001) for 1999.

The countries have improved their frameworks, however, over the past three years. Most have tried to put in place more meaningful sanctions and deadlines, although the effectiveness of these measures varies. As of mid-2001, all countries except for Indonesia had at least two of the three key features in place. Of the four crisis-affected countries,

Korea has now the most well defined setup, since it codified the framework in the fall of 2001—including all three features as well as others—in a law on corporate restructuring. Malaysia and Thailand have also established relatively strong frameworks, while Indonesia's framework remains weak, since not all financial institutions are obliged to sign on to the accord and there are still few effective sanctions for failure to meet deadlines. In practice, however, and regardless of the tightness of the framework, there remains slippage in implementation in all four countries.

Figure 1: **Government-Supervised Voluntary Workouts***



*Data refer to cases registered under JITF (Indonesia), CDRC (Malaysia), and CDRAC (Thailand).
Source: Web sites of JITF, Bank Negara Malaysia, CDRC, and Bank of Thailand.

Reflecting in part improvements to the out-of-court mechanisms, and the general increased experience with restructuring approaches, the number of corporations and amount of debt being restructured under the programs have steadily increased since inception. By October 2001, about 58 percent of debt referred to JITF in Indonesia had been resolved. In Malaysia, more than 75 percent of debt transferred to CDRC had been resolved as of mid-2001. But with CDRC's acceptance of 11 new cases in the third quarter, the percentage of debt resolved declined to 51 percent. In Thailand, only 48 percent of debt had been restructured as of October 2001—only 5 percentage points better than year-ago figures (Figure 1).

While restructuring has, thus, accelerated over the last year or so through out-of-court processes, most work in this regard over the last three years has been in the form of temporary financial relief. This has meant that some of the restructured debt has reverted back to nonperforming status, sometimes even within a few months after restructuring. In the case of Thailand, in the middle of 1999, for example, 13 percent of the restructured debt reverted to nonperforming status within just a few months.

Court-supervised restructuring and bankruptcy

Creditors in most crisis-affected countries, except Korea and Malaysia, regarded court-supervised restructuring as an unattractive option, because of initial weaknesses in the bankruptcy regimes.[1] As a result, restructuring via out-of-court processes was also impeded, because creditors lacked the means to force borrowers to come to the negotiation table in good faith, meaning there was little credible threat of using

[1]Each country has its own, particular set of laws and institutions relating to restructuring and liquidation, including different definitions and naming conventions. In Thailand, the restructuring process is known as "business organization," in Indonesia and the Philippines as "suspension of payments," in Malaysia as "schemes of arrangement," and in Korea as "composition" and "company reorganization." See also ADB (2001a; 2001b).

bankruptcy procedures to force restructuring or liquidation. Many of these weaknesses were rooted in the countries' respective legal systems, with many having a long history of pro-debtor bias and poor creditor rights. This pro-debtor bias was often aggravated by the limited efficacy of the judicial system.

Some of these deficiencies have since been corrected, as bankruptcy regimes have been improved (Table 2). For instance, Thailand introduced a reorganization procedure in its bankruptcy law in 1999. Indonesia revised its bankruptcy law in 1998 and set up special commercial courts to help in corporate restructuring. In Korea, bankruptcy and restructuring procedures were working relatively well before the crisis. Nevertheless, amendments were made to the corporate reorganization act, composition act, and bankruptcy law to improve the speed and efficiency of the system. The Malaysia bankruptcy system was also in good shape before the crisis and few changes were needed. Until recently, the Philippines had made little progress in bankruptcy reform, with its law dating back to 1909 (some amendments were made in 1976). The new securities code enacted in 2000, however, transferred some functions of the Securities and Exchange Commission in resolving corporate disputes—including suspension of payments—to the courts, with a view to strengthening the system of dealing with insolvency.

Table 2: **Bankruptcy Regimes—Creditor Rights (as of mid-2001)**

	Indonesia	Korea	Malaysia	Philippines	Thailand
Restrictions on reorganizations	1	1	1	0	1
No automatic stay on assets	1	1	1	0	1
Secured creditors first paid	0	1	1	0	0
Management does not stay on in reorganizations	1	1	1	0	1
Creditor rights score (sum)	3	4	4	0	3

1 denotes "yes" and indicates strong creditor rights.
0 denotes "no" and indicates weak creditor rights.
Source: ADB (2001a; 2001b).

Improved bankruptcy regimes and the establishment of specialized courts have led to an increase in the use of bankruptcy to resolve financial distress. From low bases, the number of cases filed using bankruptcy procedures increased sharply between mid-1999 and mid-2001—by about 30 times in Indonesia and about 60 times in Thailand. The largest increase, however, has come from the government-sponsored out-of-court programs deferring corporations to court-supervised restructuring. In Thailand, for example, about half of the court-supervised restructuring has come from this source. Some of the

increase in the number of cases is also accounted for by personal and small enterprise bankruptcies, which represent only a small fraction of overall NPLs. There may have been improvements to the formal regimes, but these have not eliminated many of the institutional problems facing the judicial systems of some countries. For instance, in Indonesia, bankruptcy judges are still in short supply, meaning creditors have little effective ability to clamp down on recalcitrant borrowers. As a consequence, the number of cases actually completed remains low as of mid-2001 (Table 3).

Table 3: **In-Court Restructuring (as of August 1999 and mid-2001)**

	Indonesia		Korea		Malaysia		Thailand	
	Aug 1999	Mid-2001	Aug 1999	Mid-2001	Aug 1999	Mid-2001	Aug 1999	Mid-2001
Number of registered cases	88	2,656	48	. . .	52	1,200	30	1,830
Number of cases started	78	2,348	27	. . .	34	. . .	22	135
Number of restructured cases	8	230	19	. . .	12	. . .	8	50
Restructured debt/total debt (percent)	4	. . .	8	. . .	. . .	. . .	7	. . .

. . . = not available.
In-court restructuring in Indonesia refers to IBRA cases only.
Source: Claessens, Djankov, and Klingebiel (2001); and country sources for updates.

Restructuring by asset management companies and state-owned banks

Governments themselves have become large claimants on the corporate sectors, and as such they have become a major direct party to the restructuring. Four affected countries (the Philippines is the exception) now have a publicly-owned AMC, which together held a total of some $135 billion in assets as of the third quarter of 2001, or about 59 percent of all NPLs in these countries (Table 4). The AMCs' mandates allow for asset disposition to the private sector through various means, minimizing the direct role of government in the restructuring of individual corporations.

In practice, however, asset disposition has been slow for various reasons, including difficulty in valuing assets, thin markets for selling assets, the fear of selling them too cheaply, and social and political pressures. Claims on large, difficult-to-restructure corporations have often remained with AMCs. More recently, the rate of dispositions has accelerated in Malaysia, where Danaharta had disposed of 83 percent of NPLs by September 2001, and in Korea, where KAMCO had a 53 percent disposition rate by August 2001. But IBRA has barely disposed of any of its large nonperforming asset holdings, achieving less than 6 percent as of September 2001. Total holdings by AMCs thus remain a large percentage of all NPLs.

Table 4: **Holdings of NPLs and Powers of AMCs**

	Indonesia	Korea	Malaysia	Thailand
Name of AMC	Indonesian Bank Restructuring Agency (IBRA)	Korea Asset Management Corporation (KAMCO)	Danaharta	Thai Asset Management Corporation (TAMC)
NPL holdings: In $ billion* In local currency	(Sep 01) $32.0 Rp310.9 trillion	(Aug 01) $77.8 W99.5 trillion	(Sep 01) $12.7 RM48.1 billion	(Oct 01) $12.9 B577.3 billion
NPLs purchased as a percent of total NPLs	(Jul 01) 85.2	(Jun 01) 71.6	(Jun 01) 39.4	(Oct 01) 40.9
NPLs disposed as a percent of NPLs purchased	(Sep 01) 5.6	(Aug 01) 52.6	(Sep 01) 83.3	Minimal yet
Special powers	Power to seize debtor assets	None	Appointment of special administrators for business restructuring. Foreclose on collateral.	TAMC-administered business restructuring largely bypasses court processes. Foreclose on collateral.
Asset disposition and management	Debt and business restructuring; outsourcing of medium-sized loans; auctions of smaller loans; foreclosure.	Auction; public sale; equity partnership; and securitization.	Private auction; tenders; securitization; special administration (business restructuring).	Debt and business restructuring; outsourcing; foreclosure.

*Converted using exchange rates as of dates indicated.
Source: Various sections of this web site and IMF, *Thailand Recent Economic Developments*, 20 August 2001.

With their continued large holdings, AMCs, sometimes with other government agencies, are often the most important creditor, among many others. Further, some AMCs have special powers. In Malaysia, for example, Danaharta is allowed to foreclose more easily on collateral; in Indonesia, IBRA can seize debtor assets; and in Thailand, the TAMC-administered restructuring largely bypasses the court process. Therefore, AMCs have the ability to set the pace and intensity of restructuring in the out-of-court programs, introducing additional financial as well as social and political dimensions.

In several complex restructuring cases, AMCs have been able to play a lead role. These include such companies as Daewoo and Huyndai in Korea, Renong and UME in Malaysia, and ATP in Thailand. In these cases, AMCs, together with other (government) agencies, such as the Korean Development Bank and the Malaysian Employee Provident Fund, have taken the lead in providing financial relief and initiating debt restructuring.

However, concerns remain as to whether AMCs are sufficiently aiding corporate restructuring, even in these large cases. Experiences in other countries suggest that AMCs can often delay, rather than speed up,

restructuring (Box 7) and that the ingredients for fast disposition of assets using AMCs are more likely to be met in advanced and developed countries than in emerging markets. Indeed, the nature of the claims—mostly in the corporate sector—and the conditions in some crisis-affected Asian countries (limited skills, often weak institutional frameworks, and political constraints) have led some to suggest that AMCs could best focus on fast disposition of assets and should attempt only a limited role in corporate restructuring.

Box 7: **Cross-Country Experiences with AMCs**

A review of seven centralized approaches to using AMCs shows that most AMCs did not achieve their stated objectives when it came to corporate restructuring. The review distinguishes corporate restructuring AMCs from bank rehabilitation AMCs. In two out of three cases, corporate restructuring AMCs did not achieve their narrow goals of expediting restructuring. Only the Swedish AMC successfully managed its portfolio, acting in some instances as lead agent in the restructuring process. Rapid asset disposition vehicles fared somewhat better, with two out of four agencies—Spain and the US—achieving their objectives. The few successes suggest that AMCs can be effectively used, but only for narrowly defined purposes of resolving insolvent and unviable financial institutions and selling their assets. But even achieving these objectives required many ingredients: an asset that could be readily liquefied (real estate), professional management, political independence, appropriate funding, adequate bankruptcy and foreclosure laws, good information and management systems, and transparency in operations and processes.

Source: Klingebiel, 2001.

Besides the AMCs, governments also have played a large role in corporate restructuring, as state-ownership of financial institutions has risen sharply due to nationalization and other restructuring. If AMC holdings and state-owned financial institutions are considered together, the state owned on average some 50 percent of financial assets in crisis-affected East Asian countries in the middle of 1999, and this figure has risen further subsequently. In Indonesia, as of January 2000, State-owned banks and IBRA together held about $42 billion out of the $60 billion in domestic corporate sector claims, with the share of NPLs held by the State even larger. Meanwhile, State-owned and controlled banks represent more than half of Korea’s total banking system assets and an even larger share of the nonperforming assets. This State ownership, while perhaps inevitable, has often further delayed the restructuring process.

Voluntary workouts outside government-sponsored and in-court frameworks

There has been much restructuring of SMEs outside the government-sponsored programs and formal in-court processes. In Korea, for

example, the less distressed, smaller *chaebols* were not included in the out-of-court program, but actually underwent significant restructuring as they had little access to new financing. In 1998, Korean banks' lending to SMEs fell by almost 10 percent, while their lending to larger corporations rose by 9 percent. Philippine SMEs have found it more difficult to obtain financing because they were unable to use their most important assets—i.e., inventories and accounts receivable—as collateral to obtain bank loans. In general, the lack of new financing for many smaller publicly-listed firms and most SMEs and the pressure on them to repay loans have meant that they have been forced to restructure on their own, through asset disposition and operational adjustments, including labor shedding. These hard-budget constraints result in speedier corporate restructuring. However, this is not necessarily the most efficient approach, as restructuring has been applied unevenly and without proper consideration of financial viability and financing needs.

Some governments have tried to counter the cutback in banks' loans to SMEs by developing special programs or restructuring approaches (Box 8). But in spite of these measures, many SMEs have often been heavily affected due to their links to larger firms, which have cut them off from suppliers' credit or even forced them to extend financing. In Korea, for example, SMEs bore the brunt of the crisis as many of them were suppliers to large *chaebols*. Thus, the number of SME failures climbed to 8,200 in 1997 and 10,500 in 1998.

Box 8: **Special Programs and Restructuring Approaches for SMEs**

Governments have responded to SME distress with streamlined approaches for resolving SME debt and arranging financing:

- In Korea, as the recession deepened in 1998, the authorities strengthened banks' incentives to lend to SMEs and improved SMEs' access to credit. Important policies were to require the rollover of loans and expansion of credit guarantees to reduce the default risk on banks' books, and apply a lower risk weight in the calculation of Bank for International Settlements ratios than do collateralized loans.
- In Malaysia, company borrowers with total outstanding credits of less than RM50 million can seek financing support from the Loan Monitoring Unit of the central bank while the company pursues restructuring.
- In Thailand, where about 600,000 SMEs accounted for some 40 percent of NPLs, CDRAC introduced a simplified process to reach agreement in an SME within 45 days and identified more than 12,000 SME cases for monitoring and follow-up. By end-July 2001, 73 percent of these cases were completed or being processed, while the remaining 27 percent were subject to legal action. In addition, the Bank of Thailand (BOT) set targets for financial institutions to resolve 15,000 SME cases each month. BOT also led a consortium to purchase promissory notes issued by creditworthy SMEs at a discount. It has priced the facility at below the average cost of funds to the banks in order to encourage its use.
- In Indonesia, no special measures were taken to tackle SMEs' financing problems.

Source: Various sections of this web site.

Another voluntary channel for restructuring has involved mergers and acquisitions (M&As). The number of M&As, particularly those that are cross-border, increased sharply in the affected countries following the crisis. Total cross-border M&As, defined as acquisitions of more than 50 percent of equity by foreign investors, increased from some $3 billion in 1996 to about $22 billion in 1999. The biggest rise was seen in Korea, accounting for $13 billion of M&As in 1999, and Thailand, which saw $4 billion in M&As. For the four countries (Indonesia, Korea, Malaysia, and Thailand) as a group, the rise in M&As managed to offset a decline in FDI in greenfield projects (those designed to build new means of production), keeping overall FDI resilient. Malaysia, which had a history of significant FDI, however, saw a decline in M&As following the crisis.

The new wave of M&As was triggered in part by important policy changes in answer to the crisis. These included the liberalization of investment in nontraded sectors and changes in competition policy. Much of the M&A activity has, as a result, been directed to such activities as wholesale and retail trade, real estate, and financial services. As such, M&As will have an important impact by increasing competition and introducing modern operational practices. Cross-border M&As have been less of a direct force in corporate restructuring, however, in part because their size has been small relative to the total debt to be restructured. Also, the benefits of M&As are longer term, making the process less important as a stimulus for short-term economic recovery. But in some deeply affected sectors, including wholesale and retail services and real estate, M&As have been useful in bringing in capital and expertise. They have also helped particularly with the reprivatization of nationalized financial institutions, which over time will help directly and indirectly with the restructuring of the countries' financial sectors.

Outcomes in financial and operational restructuring

So far, corporate restructuring has achieved only modest results. Nominally, Korea has made the most progress, as debt-equity ratios have fallen by more than half since 1997. This was partly a direct result of government policies that required corporations to bring their debt-equity ratio down to 200 percent. But it has been suggested that the progress in lowering debt-equity ratios among Korean *chaebols* has been achieved partly using various accounting measures, including overvaluation of affiliated party transactions, and revaluations of securities and foreign exchange holdings. Further, reflecting the limited desire of corporations to adjust their financial structures, much of the new equity raised during the period when

the Korean stock market was experiencing a sharp recovery in 1999 was used to acquire new assets rather than to retire debt. In the other crisis-affected countries, there has been little progress in reducing leverage, which actually increased in many cases as currency devaluation has raised the foreign currency components, debts have been rescheduled, and new equity has been scarce. In Indonesia, Malaysia, Philippines, and Thailand, the weighted average leverage of selected publicly listed corporations (those included in composite indexing) at the end of 2000 was still above that in 1995 and 1996 and sometimes greater than the peak levels of 1997 (Table 5).

Table 5: **Debt-Equity Ratios of Selected Listed Companies (weighted average)**

Year	Indonesia	Korea	Malaysia	Philippines	Thailand	Average
1995	2.4	4.7	2.1	1.7	4.4	3.1
1996	2.6	4.7	2.4	1.7	4.5	3.2
1997	4.2	6.0	2.6	2.0	7.0	4.3
1998	3.4	4.7	2.6	1.8	6.1	3.7
1999	3.7	2.8	2.7	2.0	6.0	3.4
2000	4.4	2.1	2.5	2.1	6.3	3.5
Average number of firms	259	200	456	182	317	1,414

Note: Staff calculations using Bloomberg data; composed of corporations whose stocks are included in the composite indexes of the respective markets. For Korea, only the companies comprising the KOSPI 200 (Korean Stock Price Index) are included. Companies with negative reported equity values are excluded.

In large part, this lack of improvement in debt-equity ratios reflects the amounts of debt financing—in the form of bank loans and bonds—going to weak corporations, and the limited debt-for-equity conversions. A large share of claims is still held by often weakly capitalized commercial banks. These banks have few incentives to engage in debt-for-equity conversions as they are often able to carry restructured, but still poorly-performing, loans at low provisioning requirements. Also, commercial banks and AMCs often prefer to rollover claims rather than convert them to equity as they lack the skills to manage the latter process.

The lack of improvement in leverage also reflects an unwillingness of corporate owners to dilute their claims and invite in more outsiders. This is aggravated by a general shortage of equity in the region. Following an initial increase in prices, domestic stock markets have been in decline in the last two years and foreign investors have shown limited interest, at least recently, to commit resources. Low stock prices deter controlling shareholders even more from converting debt into equity or from issuing new stock.

At least nominally, the structure of debt financing has improved somewhat. The median share of long-term debt out of total debt has

increased by some 10 percentage points since 1995 in Korea and may have risen by even more in the Philippines. In Indonesia, Malaysia, and Thailand, progress has been more limited, and there has even been some decline in the share of long-term debt among Thai corporations. Improvements in the share of long-term debt have, however, not always been due to normal market forces. In Korea, most restructuring as of mid-2000 involved extensions of maturities, and lowering of interest payments and other financial relief measures. Further, these aggregate numbers hide large changes in the financial structures of corporations. As they have restructured, *chaebols* in Korea increased their reliance on corporate bonds while decreasing that on bank debt. For non-*chaebols*, on the other hand, the proportion of corporate bonds fell, while the proportion of bank debt in total debt surged. As many bonds were issued by weak (but perceived as too big to fail) *chaebols*, they had to be restructured, with banks absorbing some of the losses. Daewoo and Hyundai have been the most notable, but not only, examples. In Malaysia, there was a similar situation. The financial restructuring schemes adopted in the workouts typically involved one or a combination of the debt restructuring and capital reduction methods.

Although financial restructuring provided corporations with some temporary relief, this often did not lead to sustainable financing, in which firms are able to cover interest expenses from operating income. The weighted ratio of earnings before interest and taxes with depreciation added (EBITDA) to interest payments for publicly listed corporations reached a low in 1998 in the five crisis-affected countries as interest rates were high and earnings were depressed (Table 6). Except in the Philippines, the weighted coverage ratio has recovered since. However, by 2000, the ratio still had not reached its 1995/96 level, except in Korea. And these ratios themselves are inflated to the extent firms obtained financial relief, through rescheduling or lower interest rates, lowering their actual interest payments, and increasing the coverage ratio. Further, while interest rates in the region are now below historic averages, thus alleviating debt service burdens, they are likely to rise as economies recover.

This poor interest coverage is also reflected in the fact that the share of corporations with nonviable financial structures, as measured by interest coverage of less than 1, although below the peak of 1998, remains high. About 27 percent of corporations in the five countries could not make interest payments from operating income in 2000 (Table 7), with the Philippines being the most vulnerable.

Table 6: **Interest Coverage Ratio of the Selected Listed Companies** (weighted average)

Year	Indonesia	Korea	Malaysia	Philippines	Thailand	Average
1995	6.5	3.2	9.5	12.0	5.9	7.4
1996	6.3	2.8	6.5	11.3	5.0	6.4
1997	4.3	2.9	5.4	7.6	3.4	4.7
1998	-1.1	1.9	3.1	5.2	1.2	2.0
1999	-0.9	3.1	3.5	3.8	1.7	2.6
2000	2.6	4.1	5.0	3.5	2.9	3.5
Average number of firms	316	200	516	182	341	1,555

Note: Staff calculations using Bloomberg data; composed of corporations whose stocks are included in the composite indexes of the respective markets. For Korea, only the companies comprising the KOSPI 200 (Korean Stock Price Index) are included. Interest coverage ratio was computed as EBITDA divided by Interest Expense.

Table 7: **Share of Selected Listed Companies with Interest Coverage Ratio of Less than One** (%)

Year	Indonesia	Korea	Malaysia	Philippines	Thailand	Average
1995	4.9	4.5	6.1	21.0	13.8	10.0
1996	7.3	9.2	9.6	24.3	15.6	13.2
1997	16.3	13.0	14.6	27.7	25.8	19.5
1998	37.1	24.2	33.8	41.3	41.9	35.7
1999	33.5	10.5	29.1	45.2	32.4	30.1
2000	29.1	9.9	27.5	43.3	24.2	26.8
Average number of firms	316	200	516	182	341	1,555

Note: Staff calculations using Bloomberg data; composed of corporations whose stocks are included in the composite indexes of the respective markets. For Korea, only the companies comprising the KOSPI 200 (Korean Stock Price Index) are included. Interest coverage ratio was computed as EBITDA divided by Interest Expense.

The limited progress is all the more worrisome since, compared to international levels, interest coverage ratios in the crisis-affected East Asian countries remain low. For comparison, the average interest coverage in the US (in 1996) was around 5, and in order to earn an A-rating based on Standard & Poor's rating requirements, a US company typically needs a ratio of operating cash flow to interest of more than 8.

What Remains to be Done?

As the analysis above indicates, there is still much restructuring to be carried out, both financial and operational.

Financial restructuring

A large share of corporate sector debt is still to be restructured. The total amount of nonperforming assets in the five crisis countries remains

high. While much debt has been taken off banks' books by AMCs, and thus relieved the financial system, on net and using officially reported figures, the NPL share of debt today is not much lower in Korea compared to the end of 1999 (Table 8). Only in Thailand has the share of NPLs declined—by some 15 percentage points since end-1999. What is even more disconcerting is that this lack of progress in reducing NPLs has taken place in a benign international and a positive domestic environment. Interest rates have been low and there has been a resumption of economic growth. The task of speeding up restructuring will be even more challenging as the world economy faces a period of slower growth. Financial data on listed firms also suggest that many corporations do not have viable financial structures in terms of leverage, share of short-term debt, and interest coverage.

Table 8: **Share of NPLs, Including those Transferred to AMCs** (%)

Month/Year	Indonesia	Korea	Malaysia	Philippines*	Thailand
December 1998	...	...	15.0	11.0	...
June 1999	...	...	16.4	...	...
December 1999	...	19.7	15.8	12.7	40.5
March 2000	...	21.5	15.6	...	39.0
June 2000	...	21.2	15.4	14.5	33.9
September 2000	61.7	20.3	14.9	...	31.0
December 2000	57.1	20.3	14.5	14.9	26.8
March 2001	57.2	19.9	15.6	16.6	26.5
June 2001	55.2	19.3	16.6	16.6	25.1
September 2001	...	...	...	...	25.3

. . . = not available.
*The Philippines does not have a centralized AMC. Numbers refer to the banking system.
Source: ARIC Indicators.

Thus, the task of financial restructuring continues. In principle, financial restructuring can be accomplished relatively quickly, as rapid financial restructuring of some corporations has shown. In Korea, for example, through court-supervised receiverships and out-of-court workouts, the controlling shareholders and management of many *chaebols*—including some of the biggest precrisis names—have completely lost out or seen their shareholdings severely diluted and their managerial discretion circumscribed. These types of financial restructurings, and their signaling value toward other controlling shareholders and managers, have helped to accelerate operational restructuring. It is important, however, that all financial restructuring is undertaken in a way that ensures that deep operational restructuring will follow. In particular financial restructuring needs to alter the incentive structures of the owners,

creditors, and managers such that they will want to pursue sustainable operational restructuring. While much of the financial restructuring to date may have been the appropriate response to a systemic crisis and did achieve some temporary financial stabilization, its potential for promoting real, operational restructuring remains to be proven. Data on the performance of corporations in crisis-affected countries to date suggest too little improvement.

Operational restructuring

It is clear that the easiest part of operational restructuring has already been completed. The rapid disposition of noncore assets, simple forms of labor reductions, and fast price and wage adjustments occurred early in the crisis. Helped by a recovery in aggregate demand in 1999 and 2000, data on profitability and other performance indicators suggest that this restructuring has resulted in some gains. Following the sharp decline in 1998, publicly listed firms saw some recovery in their return on assets (ROA) in 1999 and 2000 (Table 9). ROA was positive for Korea, Malaysia, and Philippines in 1999 and 2000. The average ROA for the five countries, however, was still negative in 1999 and zero in 2000. In 1998, return on equity (ROE) had seen an even sharper decline than ROA, as interest burdens exceeded operating incomes. Paralleling the increase in ROA, ROE recovered in 1999 and 2000, although in Thailand it was still negative in 1999. For the five countries as a whole, though, the weighted average ROE increased from a low of -6 percent in 1998 to reach 5 percent in 2000.

ROEs in Table 9 do not cover companies with negative equity value. On average, as the bottom part of this table shows, between 20 and 30 percent of listed companies in the sample remained loss making in 2000.

This pattern in profitability suggests that restructuring over the past few years has achieved operational gains through increased efficiency, divestiture of unprofitable businesses, and adjustment in prices. Profitability has a large cyclical component, however, and it is consequently hard to separate the effects of restructuring from those due to an overall beneficial environment during 1999-2000. Conversely, the recent decline in profitability of East Asian corporations may be a result of the global and regional economic slowdown rather than an easing off on restructuring. Although it is difficult to pinpoint the exact contribution of operational restructuring, it is clear, also from anecdotal evidence, that the process must continue, as it typically takes several years to complete.

Table 9: **Profitability of Selected Listed Companies: Return on Assets and Equity**

Return on Assets (%, weighted average)

Year	Indonesia	Korea	Malaysia	Philippines	Thailand	Average
1995	4.0	2.0	4.0	5.0	2.0	3.0
1996	3.0	0.0	4.0	5.0	2.0	2.8
1997	-1.0	0.0	2.0	3.0	-5.0	-0.2
1998	-25.0	-1.0	-2.0	2.0	-2.0	-5.6
1999	-3.0	2.0	0.0	1.0	-5.0	-1.0
2000	-3.0	1.0	1.0	1.0	0.0	0.0
Average number of firms	316	200	516	182	341	1,555

Return on Equity (%, weighted average)

Year	Indonesia	Korea	Malaysia	Philippines	Thailand	Average
1995	12.6	11.4	12.5	12.7	13.4	12.5
1996	12.5	2.6	12.1	12.8	10.9	10.2
1997	-3.4	-1.6	8.5	8.0	-36.4	-5.0
1998	-19.3	-1.0	-3.3	6.6	-13.1	-6.0
1999	10.0	7.3	3.2	3.5	-32.9	-1.8
2000	8.2	5.5	5.1	2.0	4.6	5.1
Average number of firms	259	200	456	182	317	1,414

Percentage of Companies with Negative Returns

Year	Indonesia	Korea	Malaysia	Philippines	Thailand	Average
1995	3.5	7.1	6.3	10.3	4.5	6.4
1996	4.7	23.2	6.6	10.0	13.1	11.5
1997	36.3	30.0	15.5	17.1	57.5	31.3
1998	37.7	27.6	33.8	30.8	37.9	33.6
1999	22.0	11.0	27.7	30.3	40.2	26.3
2000	27.3	20.5	21.6	30.4	28.9	25.7
Average number of firms	316	200	516	182	341	1,555

Note: Staff calculations using Bloomberg data; composed of corporations whose stocks are included in the composite indexes of the respective markets. For Korea, only the companies comprising the KOSPI 200 (Korean Stock Price Index) are included. ROE = Net Profit(Loss)/Total Stockholders' Equity. In the case of ROE, companies with negative reported equity values are excluded.

The need to undertake deeper operational restructuring is all the more necessary as the profitability and cash flows of East Asian corporations has traditionally been low by international standards. The average ROA for a panel of 35 countries was some 6.5 percent in 1999, while the five East Asian countries before the crisis had an ROA of less than half of this, at only about 3 percent. Also, operational margins, that is, EBITDA as a percent of sales, for East Asian corporations were only two thirds of the average level achieved by this panel of 35 countries in 1995/96. Data thus suggest that the operational restructuring of

debtors has been less than successful and that much of the more difficult restructuring has often been postponed, at least for the large corporations.

Other evidence also suggests that relatively little operational restructuring has occurred for the large corporations and that corporate restructuring deals continue to emphasize financial over operational restructuring. For example, examination of the JITF deals concluded during 2000 shows a large reliance on term extensions, conversions into equity, or convertible bonds. Other more fundamental restructuring took place on average in only 5 percent of deals over the whole of 2000, a figure that fell steadily to only 2 percent in the last quarter of that year.

This limited effectiveness of operational restructuring relates to the main agent put in charge of the process in the countries. In many cases, management has not been changed and existing owners have remained in control. Banks are typically not imposing much operational restructuring on large corporations. They are not only reluctant to take measures such as selling off nonperforming assets or converting debt into equity, they are also lax in forcing corporations to close nonviable businesses, sell overvalued assets, and undertake other forms of operational restructuring.

The large role of government in the restructuring process, through the nationalization of banks and establishment of AMCs, has meant that, on average, governments now own (directly or indirectly) corporate sector assets equal to more than 75 percent of GDP in four of the crisis-affected East Asian countries. This transfer of distressed assets has in most cases been effective in isolating financial sector problems and providing financial relief to corporations. It has, however, not necessarily led to operational restructuring.

Experiences from other countries suggest that AMCs are best used for financial rather than operational restructuring. One reason is the lack of expertise and skills at commercial banks and AMCs. But political factors also limit the ability of publicly owned agencies to force through difficult restructuring. For instance, governments are reluctant to fire excess workers and close nonviable businesses. More generally, they have practiced various forms of regulatory forbearance vis-à-vis banks and other financial institutions to soften the impacts of financial and operational restructuring. This has not only involved the mitigation of social impacts, but also the propping up of large distressed companies, often those controlled by the politically well-connected. In addition,

governments have to continue to balance the interests of various constituencies, such as demands for wage increases from workers, with the viability of the corporate sectors.

Operational restructuring should be left to the private sector because it is better skilled for the task and enjoys more freedom from political pressure. Encouraging quick divestiture of assets by AMCs, state-owned banks, as well as private banks would thus be the most effective approach to accelerate operational restructuring. Banks should not be allowed to continue carrying nonperforming or poorly restructured loans at low provisioning levels and should be encouraged to divest assets.

A reflection of the slow progress of corporate restructuring in East Asia has been the weak stock market performance of the region's corporations. Following an initial rebound, there has been a steady decline in most countries' equity prices. Several market indexes have now fallen to half of their precrisis levels and some markets are only marginally above the absolute lows of 1998. This decline has been led by financial institutions, where prices have been tumbling since 1998, but has become broader based since early 2000. In the fall of 2001, several markets reached levels not seen since the midst of the crisis in late 1997 and early 1998. In US dollar terms, the declines in stock prices have been even sharper as currencies have depreciated.

What Are the Constraints and Policy Issues Going Forward?

It will take a package of measures to speed up corporate restructuring, including financial sector reform, better restructuring mechanisms, altering the lead agent undertaking restructuring, and making changes to the corporate governance and competition frameworks.[2]

To better restructure workout firms, further improvements are needed in the incentive framework under which financial institutions operate.

This incentive framework for banks includes accounting, classification, and provisioning rules, i.e., financial institutions need to be asked to

[2] For further country-specific details regarding legal and financial changes needed, see ADB (2001a; 2001b).

realistically mark their assets to market. Loan classification criteria in some crisis-affected countries are still not forward-looking enough to force financial institutions to come to grips with problem debtors quickly (Table 10). In Malaysia, banking institutions were given an option of reporting NPLs using either the standard of three months or six months past due. But they were not required to use forward-looking criteria. In Korea, the Government tightened loan classification requirements for firms that had undergone restructuring, bringing them under the new "forward-looking criteria," but only in late 2000. Indonesia still does not have tight criteria for loan provisioning and interest accruals. Not all countries limit the upgrading of restructured loans until the corporation has a sustained record of repayments and viable financials. Other barriers to corporate restructuring such as tax and accounting rules need to be addressed. Governments should continue to review issues such as the tax treatment of mergers and debt-equity swaps, personal liability of state-owned banks' management in extending relief, protection for public shareholders, transfer taxes, and other policies, and evaluate whether they serve a useful public policy purpose or only hinder restructuring.

In addition, the prudential and legal system needs to limit forbearance and ensure that undercapitalized financial institutions are properly disciplined, while giving an incentive to banks to come to grips with their problem loans. Marginally capitalized banks tend to engage more

Table 10: **Regulatory and Loan Restructuring Frameworks, as of early 1997 and mid-2000**

Country	Loan Classification Early 1997	Loan Classification Mid-2000	Loan Loss Provision Early 1997	Loan Loss Provision Mid-2000	Interest Accrual Early 1997	Interest Accrual Mid-2000	Overall Index Early 1997	Overall Index Mid-2000
Indonesia	2	3	1	2	1	2	1.3	2.3
Korea	2	3	3	3	3	4	2.7	3.3
Malaysia	2	2	1	2	3	3	2.0	2.3
Thailand	1	3	1	2	1	4	1.0	3.0

Note: Countries are scored on a scale of 1 to 4 for each variable, with 4 indicating best practice and 1 indicating furthest away from best practice, as follows:

Loan classification
1 = loans considered past due at more than 360 days
2 = loans past due at more than 180 days
3 = loans past due at more than 90 days
4 = repayment capacity of borrower taken into account

Loan loss provisioning
1 = 0% substandard, 50% doubtful, 100% loss
2 = 10–20% substandard, 50% doubtful, 100% loss
3 = 20% substandard, 75% doubtful, 100% loss
4 = present value of future cash flow or fair value of collateral

Interest accrual
1 = up to 6 months, no clawback
2 = up to 3 months, no clawback
3 = up to 6 months, with clawback
4 = up to 3 months, with clawback

Sources: World Bank (2001); Lindgren, et al. (2000); Claessens, Djankov, and Klingebiel (2001).

in cosmetic corporate restructuring, such as maturity extension or interest rate reduction on loans to nonviable corporations, rather than debt write-offs. Incentives to undertake restructuring can be strengthened by linking government financial resources directly to the actual financial corporate restructuring undertaken by banks. For example, a capital support scheme in which additional fiscal resources are linked to actual corporate restructuring through loss sharing arrangements can induce banks to conduct deeper restructuring. A proper incentive structure also means limited ownership links between banks and corporations in order to reduce the chances of the same party being both debtor and creditor.

A framework to support out-of-court corporate restructuring efforts must be backed up by an efficient court-supervised process.

The fact that the frameworks for out-of-court corporate workouts have been more effective in Korea and Malaysia than in Indonesia and Thailand is in part a reflection of clear differences in the ability of each country's insolvency and creditor rights system to impose losses on debtors. In Korea, where the bankruptcy regime was quite credible to begin with, many controlling shareholders have seen their shareholdings severely diluted and managerial discretion controlled. But, even there, bankruptcy has affected SMEs much more than the large corporations and some heavily indebted corporations have been able to avoid bankruptcy for long periods. Bankruptcy has also been an effective threat in Malaysia. In other affected countries, there is a more widespread inability to force out existing shareholders and bankruptcy is not a viable threat.

While the formal bankruptcy regimes in the region today are much improved compared to a few years ago, legal enforcement remains limited. There are technical and political reasons for this, as courts are overworked and understaffed, and often subject to political pressures. Anecdotal evidence of the uncertainties introduced by the courts is plentiful. Although it will take time, further reforms to enhance the efficiency and integrity of the bankruptcy process, including the introduction of specialized bankruptcy courts, will be necessary. In the meantime, the London-type approaches can be tightened in some of the crisis-affected countries, outside arbitration should be pursued more actively, and market-based alternatives to current debt resolution mechanisms could be explored.[3]

[3] See, for example, Hausch and Ramachandran (2001).

The large role of the state in restructuring, while inevitable in the first phases of the crisis, now needs to be reduced. More and earlier involvement of outside investors is necessary to achieve deep operational restructuring.

Banks—often owned by the state or operating under an extensive government safety net—and public AMCs have been slow to divest assets. Governments should reduce ownership of corporate sector assets, while banks need to be encouraged to divest through a proper prudential framework. AMCs should dispose of their assets faster with less consideration for price and state-owned banks need to be privatized to strategic shareholders. But while a larger role for private investors is called for, the process will have to be carried out in a way that assures that assets do not end up in the hands of the same owners that contributed to the problems. And it will have to take into account political sensitivities concerning foreign ownership.

Banks and public AMCs should refrain from directly managing nonperforming assets. Instead they can retain outside professionals—on some incentive compensation basis, whenever possible—to conduct due diligence, structure and negotiate corporate workouts, and manage asset sales. Banks also have limited experience in managing corporate shareholdings or exercising corporate governance. Thus, the management of converted equity should be outsourced to asset management/corporate professionals, including through equity partnerships. To dispose of assets, a menu of approaches should be available to banks and AMCs. Vehicles for offloading NPLs and managing debt have been lacking and tools such as corporate restructuring vehicles (CRVs), venture funds, equity partnerships, and others need to be used more actively. A CRV, for example, can manage debt-swapped equities temporarily obtained from commercial banks receiving initial funding from an investment group and at a later stage from the capital markets. Korea has recently assigned CRVs a formal role in the out-of-court restructuring process, including in the new corporate restructuring law. When large-scale disposal of assets is difficult, amid depressed asset prices or because of political sensitivities, solutions may have to lie in mixed public-private arrangements and other ways to effectively reprivatize assets. Under these arrangements, ownership remains for some period with the state, but there are private sector incentives in the management of the assets.

The pace of implementing corporate governance reforms must be accelerated.

The investment and financing behavior of publicly-listed companies has often been considered one of the major vulnerabilities that led to the

financial crisis. Thus, as part of the structural reform process, changes in the corporate governance framework have focused on publicly listed corporations. The changes have covered a broad spectrum of issues, including trying to ensure better discipline from the respective domestic financial systems, improving disclosure of financial transactions, adopting rules for internal management of corporations, and conducting better capital market regulation and supervision.

An important aspect of the corporate governance reforms has been improved equity rights. Table 11 summarizes the progress that has been made in enhancing the rules for equity investors in four key areas: one-share, one-vote; proxy by mail; shares not blocked; and cumulative voting possible. The table shows that all five countries have come closer to international standards in the rules governing corporations. Over this period, Korea has made the most progress, as it now satisfies three of these four key criteria for effective corporate governance, compared to only one in 1996. Significant deficiencies still remain, however, in the corporate governance frameworks of Malaysia, Philippines, and Thailand. By this criterion, Indonesia had already well established formal equity rights in 1996. In addition to these changes, countries have brought in other measures to enhance equity holders' rights. In March 2000, Malaysia adopted a code on corporate governance. In Korea, the accounting and auditing standards board was strengthened, the threshold to file a derivative action against a company was lowered, and all listed companies were required to appoint independent directors. As disclosure was a key weakness, Thailand mostly focused on reinforcing accounting and auditing standards and practices. Many new or improved accounting and auditing standards were issued, an accounting standards board was established, and disciplinary measures for noncompliance were enhanced. Thailand also clarified the roles and duties of company directors. However, progress on other critical aspects of corporate governance has been slow.

Table 11: **Equity Rights, as of 1996 and mid-2000**

	Indonesia		Korea		Malaysia		Philippines		Thailand	
	1996	Mid-2000	1996	Mid-2000	1996	Mid-2000	1996	Mid-2000	1996	Mid-2000
One-share, one-vote	1	1	1	1	1	1	0	0	0	0
Proxy by mail	1	1	0	0	0	0	0	0	0	0
Shares not blocked	1	1	0	1	1	1	1	1	1	1
Cumulative voting	1	1	0	1	0	0	1	1	1	1
Equity rights score (sum)	4	4	1	3	2	2	2	2	2	2

Note: "1" denotes that equity rights are in the law.
Source: La Porta et al. (1998) for 1996, updated on the basis of Zhuang et al. (2000 and 2001).

Still, great difficulties remain in fully enforcing corporate governance changes. Enforcement of the minority rights rules especially are still weak in many countries. In Korea, for example, although a cumulative voting system to improve minority rights was introduced in the commercial code, about 80 percent of listed companies were able to exclude it from their articles of incorporation. And as of end-2000, not a single company has brought in a cumulative voting system in electing board members. Also, more than half of the *chaebols* continue to spend more on donations than on dividends, indicating that they have not achieved a real improvement in shareholder value, as intragroup transfers frequently occur at the cost of minority shareholders. In Indonesia, the enforcement of many laws has been limited.

In addition to greater enforcement, several other reforms are still pending. These include changes to the capital markets framework; the adoption of better internal control by improving financial reporting, and audit and accounting standards; and boosting shareholder protection by upholding the rights of minority shareholders and preventing insider trading. Some of these reforms are already underway, but could be put in place faster. With better enforcement, these changes will help to improve operational performance and reduce the potential vulnerabilities of the countries' corporate sector.

Reforms have to continue to take into account the special corporate governance issues facing East Asian corporations. Specifically, the share of outside investors and nonmanager owners remains small in most East Asian corporations, limiting the traditional corporate governance problems of diffused shareholders and separation between managers and owners. Corporate governance problems arise, therefore, mainly in two areas: weak protection of minority rights and lack of market discipline. The weak protection of minority rights has sometimes allowed the expropriation of small shareholders by large controlling shareholders. This has raised the costs of external financing for these and other firms operating in the same environment and undermined the efficient allocation of investment. Reducing this problem will require improved minority rights. Without changes in these areas, financial risks will not decline, as insiders will continue to increase leverage to maximize their benefits.

The framework for competition must be improved.

Strengthening the degree of market competition in the real (and financial) sector must be part of the reform processes. These involve a wide range of trade and FDI deregulation measures, as well as

deregulation of some unnecessary domestic rules. In many countries, following the crisis, tariff barriers were slashed. In Korea, for example, effective rates were cut from 4.4 percent in 1996 to 2.8 percent in 1998. Also, progress has been made in reducing nontariff barriers, an issue on which countries such as Korea have attracted criticism from their trading partners. Meanwhile, progress has been made in liberalizing the FDI regime, including hostile, cross-border M&As in several countries. The elimination of ceilings on foreign equity ownership in several stock markets and the (near) elimination of restrictions on foreign companies or individuals purchasing land in countries such as Thailand have also enhanced the competitive framework.

Less progress has been made on improving the framework for domestic transactions. In developing countries, the main institutional barriers to domestic competition are government regulations on entry and exit of firms. In Korea, for example, an arduous bureaucratic store-opening evaluation process has contributed to low productivity in the retail sector. And in spite of many efforts by the Korean Free Trade Commission, informal cartels and exclusive supply and distribution contracts are still prevalent among the *chaebols*. Countries in East Asia also have on average a high threshold for defining market dominance—a 50 percent to 75 percent market share of the largest firm, compared to 40 to 50 percent in the European Union.

The current economic slowdown may make corporate restructuring and reform more painful, but should not be allowed to become a delaying factor.

The deterioration of the global economy further limits the strategy of simply trying to “grow out” of the banking and corporate sectors’ problems. Poorer export and growth performance limits the growing out option directly, as NPLs will not decline on account of improved corporations’ prospects alone. As noted, NPL ratios have increased in several of the crisis-affected countries as growth slowed in early 2001. The declines in growth rates may further constrain corporations' cash flows in all sectors and lead to an even bigger rise in the proportion of NPLs.

Declines in stock markets, increases in sovereign spreads, and a growing tendency for investors to pull back from emerging markets will make new external financing harder to come by and more costly. To address these challenges, it is critical that restructuring efforts are intensified. Slow-paced and low-quality restructuring will not reduce

the still high financial vulnerability of firms and financial institutions to economic shocks. Corporate and financial restructuring combined with institutional and governance reforms, thus, requires renewed efforts if the region is to benefit from the eventual recovery. This will have to involve more rapid disposition of assets by AMCs; faster progress on operational restructuring; and deeper reforms of the regulatory, supervisory, and corporate governance regimes.

Overall lessons

A key lesson from other countries' approaches to systemic crisis is that governments need to have a consistent, overall framework for banking and corporate restructuring. This includes, among others, a consistency between the institutional development of a country and the realism of certain approaches. Clearly, institutional deficiencies can rule out certain approaches in some countries, although they may be best practice in others. These best practices can include, for example, a heavy reliance on a market-based corporate restructuring approach—where banks are recapitalized and asked to work out debts. But in an environment where corporate governance and financial system regulation and supervision are weak, this may be a recipe for asset stripping or looting, rather than sustainable restructuring. Clearly, from this context alone, emerging markets will need different approaches in systemic restructuring from developed countries.

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