Bank and Corporate Restructuring

Introduction

Weaknesses in financial and corporate sectors were at the heart of the Asian crisis. In a situation where rapid financial liberalization had outpaced institutional capacities, vulnerabilities accumulated and put at risk the solvency of large parts of the affected economies. Inadequate regulation, weak supervision of financial institutions, poor accounting standards and disclosure rules, outmoded laws, corporate recklessness and inferior governance all played their part. Together, these factors seemed to legitimize investor panic that culminated in the disorderly collapse of asset prices and exchange rates. Prompted in part by the terms of international assistance packages, the affected economies have now embarked on the complex and time consuming task of tackling these institutional deficits.

This section reviews the progress made in financial and corporate restructuring in the affected countries of Asia. To begin with, some analytical background is provided and lessons from managing crises elsewhere are summarized. Next, the approaches to restructuring that have been taken in Indonesia, Korea, Malaysia, and Thailand are described. The Philippines, on the other hand, did not experience a systemic banking crisis. Hence, the discussion of reforms in the Philippines is brief. Finally, progress to date is evaluated.

Phases of Financial and Corporate Restructuring

The resolution of financial crises typically occurs in a number of distinct phases. When a crisis erupts, an immediate priority is to stabilize the financial and payments system. Having secured these, comprehensive audits are needed to assess the extent and incidence of damage. On the basis of this information, a restructuring and recovery plan can then be developed and implemented. Restructuring can encompass many things. It may include closing insolvent institutions or merging them into viable entities, re-capitalizing viable but illiquid institutions, and developing a framework for the resolution of debts. When debt rests largely with the corporate sector, corporate financial and operational restructuring is likely to become an integral part of the overall debt resolution process. To varying degrees, recovery plans may be accompanied by policy and institutional reforms intended to promote the future efficiency of the financial system and make it less vulnerable. These plans may include measures to strengthen the regulation and supervision of the financial system as well as those to encourage capital market development.

There are many possible approaches to crisis resolution and restructuring. Each has it own attractions and potential drawbacks. The particular strategy adopted will depend, *inter alia*, on the severity of the crisis, the currency structure of debt, the profile of debtors, institutional and human capacities, the juridical context, prevailing macroeconomic conditions and fiscal constraints. There is more than one way to fix a broken banking system.

The Stabilization Phase

It is important to differentiate between circumstances in which an individual institution gets into trouble and a systemic crisis. Beyond their normal regulatory and supervisory responsibilities, the authorities would not normally intervene in the case of an isolated institution running into difficulties. But systemic crises are characterized by coordination and information failures that threaten the viability of solvent institutions as well as weak ones. If a large number of depositors panic, the entire payments system may be threatened. In these circumstances, the public interest requires that the authorities respond.

The degree of freedom that a particular monetary authority or central bank has to stabilize the financial system depends on the underlying monetary regime. If monetary autonomy has been surrendered under an exchange rate link or through the dollarization of domestic transactions, the authorities may find it difficult to contain panic and stabilize the system. This is because they cannot provide liquidity support to ailing institutions beyond what their foreign exchange reserves will allow. One possibility would be to draw on contingent credit lines negotiated prior to a crisis, but these would generally be insufficient to offer the degree of comfort needed when an entire banking system is under threat. For these reasons, exchange rate links or pegs are inadvisable in the context of a weak financial system. Too often, weaknesses in financial systems have undermined fixed exchange rate regimes.

Where there is monetary autonomy, the scope for action is increased. Faced with the threat of depositor runs, the authorities can provide liquidity support to distressed institutions under its "lender of last resort" responsibilities. The terms on which liquidity is provided can vary. To mitigate problems of moral hazard, liquidity support in the form of loans should ideally only be provided to viable institutions. Such loans should be collateralized, charged at premium interest rates, and attract seniority.

The issue of whether the authorities should sterilize such liquidity support is a matter of some debate. The IMF's emergency assistance programs in Asia's crisis-hit countries were based on the view that monetary tightening was needed to stabilize depreciating exchange rates. A contrary view is that, in the midst of a crisis, high interest rates are likely to further impair liquidity, increase investor panic and make matters worse for the financial system. In these circumstances, raising interest rates might serve to undermine rather than support the value of the domestic currency.

In addition to providing liquidity, the authorities may wish to take more direct steps to stem panic and restore stability. In doing so, they may choose to act at an institutional and a system level. The nationalization of insolvent banks, and the capital backing that this implies, can go a long way toward allaying depositors' concerns. But closing banks without first clarifying what will happen to depositors' money will likely heighten panic. To prevent funds fleeing from institutions that are perceived to be weak to those perceived to be strong (normally, government-owned banks or foreign banks), the authorities may also choose to extend blanket guarantees on deposits. While such guarantees can help to avert panic, they may later prove costly to the taxpayer. While carefully structured, formal deposit insurance schemes might help decrease the risk of a crisis, once a crisis is underway they have limited remedial value. In Korea, for example, blanket guarantees were needed despite the existing limited deposit insurance scheme.

Stabilization of a banking system threatened by depositor panic will of itself do little to ensure a resumption of normal business. Stabilization has the much more limited objective of stemming the flight of capital from individual institutions and from the system as a whole. But only when this has been achieved can the rehabilitation of bank balance sheets begin.

The Diagnostic Phase

An accurate diagnosis of the depth and incidence of banking sector distress is essential for the design of an effective recovery plan. Ideally, audits should help the authorities decide which institutions are viable and which are effectively insolvent. In conducting audits, the value of assets and liabilities should, to the extent possible, reflect a realistic market assessment of the situation rather than arbitrary accounting conventions. At a macro level, comprehensive institutional audits are required to provide an early indication of the scale of resources that may need to be mobilized to meet reasonable capital requirements. Only once this information is available can sensible decisions be made about the mechanics and timeframe of a detailed recovery plan.

Dignostics are essential, but there is likely to be a severe shortage of information in the midst of a banking crisis. Secondary markets for bank assets may be missing or thin, making valuations difficult and sometimes subjective. Rapidly evolving macroeconomic circumstances are likely to have a decisive influence on debt servicing capacities and may exert an influence on judgments about the viability of individual institutions. Finally, disclosure problems are likely to be acute. Managers and debtors may both wish to understate the extent of difficulties. For these reasons, and others, audits are likely to be prone to error, and initial assessments of the extent of difficulties may be radically revised as more information comes to light.

In these circumstances, the line between insolvency and illiquidity may need to be drawn reasonably broadly, at least initially. While permitting banks that could be insolvent to continue to operate may further jeopardize depositor funds, and ultimately raise the costs of rehabilitation, closing banks that are potentially viable can also be costly. As monitoring and supervision is strengthened, informational problems should recede, allowing a clearer distinction to be made between insolvency and illiquidity.

Restructuring Strategy: Government or Private Sector Led?

Once the financial system has been stabilized and an initial assessment has been made of the scale and depth of financial distress, a recovery plan can be drawn up and the restructuring process begun. Restructuring then begins with the implementation of the recovery plan. One simple way of characterizing restructuring approaches is in terms of the role played by government and markets.

Government has played a prominent role in resolving some crises, not only setting the policies, but effectively leading and guiding the restructuring process through financial support, nationalization of troubled institutions, establishment of centralized agencies to manage NPLs and facilitate corporate debt workouts. In other cases, government has chosen to set policies and a general framework, but then let market forces lead the process. These different approaches can have very different implications for how fast the restructuring progresses, who bears the costs, and what kind of financial system eventually emerges.

An advantage that is claimed for a government-led approach is that it can deliver quick results in terms of reducing the non-performing assets of the system and re-capitalizing viable institutions. Government-led approaches have most to commend them when human and financial resources are to hand and institutional capacities are high. The greater the disarray in markets and the larger the scale of the problem, the more a government-led approach makes sense.

But government-led approaches entail risks. They create substantial fiscal obligations and impose a heavy burden on the taxpayer. They may effectively bail out negligent owners and managers, and invite a recurrence of reckless behavior. System efficiency may also be compromised if government ends up owning and controlling a large part of the banking and financial system. Of course, these are not inevitable consequences of a government-led approach. Careful attention to fiscal limits, equitable cost sharing arrangements, incentive structures and an exit strategy that maximizes the recovery value of assets increase the chances of a successful government-led approach.

A market-led approach to restructuring has, in principle, three main attractions. First, by drawing on private rather than public resources to facilitate restructuring it helps limit costs to the taxpayer. Equitable cost sharing arrangements under a market led approach should help mitigate problems of moral hazard and create incentives for more efficient monitoring. Second, a market-led approach generally works better in recovering the value of non-performing and bad loans than a bureaucratically administered system. Competition in the acquisition and disposal of assets should eventually make for more efficient debt workouts. Finally, a market-led approach should enhance systemic efficiency and safety. These benefits follow if market players who are better capitalized and managed are able to increase their market share at the expense of those that are weak and a potential threat to system stability.

In practice, a mixed approach is often followed, even where a market-led strategy might otherwise be favored. In developing economies, especially, there are usually a number of constraints that limit options. For example, the highly qualified and skilled personnel needed to steer banks out of their difficulties are often in short supply. In these circumstances, punishing managers and owners for their earlier mistakes may deprive the process of needed expertise. Likewise, markets are unlikely to work well in the midst of a financial crisis. Disposing of NPLs at the fire-sale prices that extremely bearish markets would dictate may serve only to increase the costs of restructuring. Also, the private sector simply may not have the resources needed to re-capitalize illiquid banks or an appetite for risk on the required scale. In these circumstances, public capital and other incentives may be needed. For these, and other reasons, crisis-hit countries often choose to blend elements of market-based and government-led strategies.

The Mechanics of Restructuring: What Works?[1]

In the process of rehabilitating and restructuring a crisis-stricken financial system, difficult strategic issues are interlaced with a variety of complex technical considerations. Among other matters, the following need to be addressed in any recovery plan: What criteria should be applied in carving out viable from non-viable institutions? Under what circumstances should institutions be nationalized, and when should they be closed? What should be the timeframe and terms for the divestiture of intervened institutions? Should banks be left to work out their bad loans, or should they be relieved of this responsibility to allow them to focus on their core business? If bad loans are to be taken off banks' balance sheets, how should this be done and under what financing arrangements? Over what timeframe should re-capitalization take place, and what should be the target capital standards? Should forebearance be extended to loan loss provisioning and other areas? Should foreign capital or strategic partners be invited to assist the recovery process? Should a voluntary or compulsory framework be used for debt resolution and what guidelines should be set? What adjustments to regulatory standards are needed and how can supervision be improved?

[1]This section draws on the findings of Dziobek and Pazarbasioglu, 1997.

Initial conditions, available human and capital resources, industrial structure and political priorities will matter. But the accumulated global experience in resolving banking and financial crises suggests that some approaches are likely to work better than others. Here success needs to be defined both in terms of the restoration of liquidity and solvency, and a recovery in the profits of banks and corporations. If restructuring and re-capitalization strategies fail to restore profitability to sick banks, durable benefits cannot follow.

In terms of institutional and structural arrangements, the role of the central bank may be less important than is generally believed. Indeed, where central banks have been charged with the responsibility of restructuring, but have also provided extensive liquidity support, progress has been halting and slow. Where the responsibility for restructuring has instead been devolved to an autonomous agency or left with banks themselves, recovery has been faster and often more enduring.

Evidence seems to suggest that the creation of "hospital banks" and specialized loan workout agencies also help resolution and restructuring. Leaving bad loans on bank balance sheets restricts their ability to lend and requires bank managers to attend to debt collection, an activity to which they may not be particularly well suited. Although it can be argued that banks are likely to have a more intimate knowledge of their borrowers than others, and so should be left to recover bad loans, these arrangements can lead to a conflict of interest. Bank managers may be tempted to treat customers leniently, especially if they have long-standing relationships with them. Writing off loans will also entail diluting owner's equity, something managers may be reluctant to do. In a context of systemic banking problems, coordination problems are better handled by agencies that are dedicated to debt recovery.

The way in which non-viable banks are handled is also crucial. Where non-viable institutions have been closed or merged with a larger viable entity, the restructuring of the banking sector has tended to be more successful. Extending resources and forbearance to non-viable banks may temporarily help support liquidity and buoy confidence. Ultimately, however, it raises the costs of restructuring, and slows progress. A case in point is the US Saving and Loan (S&L) rescue experience. It has been estimated that forbearance induced excessive risk-taking by S&L's bank owners and multiplied rescue costs fivefold (Herring, 1998). Where governments own banks, nationalize them in the process of guaranteeing deposits, or acquire equity in the process of re-capitalization, a clear exit plan is essential. Privatization and divestiture usually defray the fiscal costs of restructuring and help promote greater efficiency.

For illiquid but viable banks, a variety of financial measures has been used to help rehabilitate balance sheets. Here the evidence about what works and what does not is more equivocal. For example, bond-loan, bond-equity, or equity-loan swaps are ubiquitous features of re-capitalization and restructuring exercises. Sometimes they have been successful and sometimes not. This is not surprising since the terms of these operations can vary widely.

Beyond restructuring, narrowly defined, there are important issues about regulation and supervision. If the regulatory and supervisory environment tolerates malfeasance, unfit and improper management, and fails in the enforcement of proper prudential safeguards, then restructuring and re-capitalization efforts will ultimately fail. The banking system will remain vulnerable and will again succumb to difficulties. All too often, crises have been replayed because insufficient attention is paid to these factors.

Who Should Pay?

The long-term success of restructuring exercises also seems to be related to the cost sharing arrangements that they embody. Ultimately, the costs of non-performing and bad loans have to be shared between the owners of banks, their creditors and depositors, deposit insurers (if any) and taxpayers. Needless to say, all possible measures should be taken to recover asset values from borrowers. This may require replacing the senior management of distressed banks, especially when their incompetence has contributed to difficulties and/or they have close connections to borrowers. The retention of incompetent management will undermine governance and may seriously jeopardize the chances of restoring market confidence and operating profitably.

In apportioning the costs of re-capitalization and restructuring, those who stood to gain from risk-taking should, to the fullest extent, bear responsibility. This implies that owners should first be invited to infuse new capital into distressed banks. If they are unable to restore capital adequacy, their equity stakes should then be diluted or extinguished. New owners should not be allowed to acquire banks or bank assets at excessively discounted prices, although determining a “fair price” in the midst of a crisis may not be easy. Where there has been malfeasance by owners, seizure of their personal assets might be called for. If equity has been fully extinguished, the holders of subordinated debt in distressed banks should have their claims written down or canceled. Re-capitalization and restructuring exercises that absolve bank owners from blame should be avoided to deter reckless behavior in the future.

Experience also suggests that to contain fiscal costs, the feasibility of having large depositors and the creditors of banks share in the costs of restructuring should be fully explored. The restructuring of a bank’s non-deposit liabilities is one way this can be achieved. But if there are many creditors, coordinating restructuring may prove difficult. Equity swaps provide a mechanism through which cost sharing might be achieved. Although debt-equity swaps can help bank balance sheets, care should be taken to ensure that this does not simply shift stress to beleaguered creditors in an environment where there is general financial distress.

Ultimately, taxpayers may have to meet some of the costs of banking sector restructuring and re-capitalization. These can accrue directly through nationalization, the application of public funds for re-capitalization or through bad debt acquisition. But taxpayer money will also be involved if government extends guarantees of bank asset quality or rates of return to prospective investors. Similarly, incentives to facilitate debt restructuring and write-offs may cost the taxpayer.

Therefore to shelter the taxpayer, government should, within the context of a time-bound plan of action, have exhausted all reasonable measures to attract private capital. While existing owners may be able and prepared to inject fresh liquidity, new sources of capital should also be solicited. Although there may be a preference to tap the local capital market, domestic resources are likely to be in short supply in the midst of a banking sector crisis. Hence, foreign equity and debt capital can have a very important role to play in the financial rehabilitation of the sector. The technical and commercial expertise that usually accompanies direct foreign investment in banks may also prove very important for restoring their financial health. To attract new private capital, whether domestic or foreign, governments and the relevant regulatory and supervisory agencies, must work hard to improve informational flows, increase transparency, and may also wish to consider providing inducements that will make banks more attractive to investors. Removing discriminatory regulations and ownership restrictions that discourage foreign investors entering the market will help in this regard.

Over time, fiscal costs may be defrayed by the sale of assets that the government or its restructuring agency acquires from distressed banks. Similarly, costs may be partially recovered through the recovery of the net worth of banks in which the government or restructuring agency intervenes, and which are eventually returned to the private sector.

In assessing the extent to which governments should extend fiscal support for banking sector restructuring there are likely to be important inter-temporal tradeoffs. Early and decisive intervention by government may lower the ultimate costs of restructuring and re-capitalization if it prevents the owners and managers of insolvent banks from gambling further with depositors' funds. But in a context of general financial distress, governments may have limited capacity to finance large up-front costs in a non-inflationary way. Delay is therefore tempting since it reduces the fiscal burden in the short run and may even allow some institutions to nurse themselves back to health if initial shocks are reversed. Unfortunately, accumulated experience suggests that forbearance and delay can deepen troubles and raise the costs that must be borne by the taxpayer (Herring, 1998). Accordingly, where markets cannot be relied upon to resolve difficulties, mobilizing taxpayer support for decisive and early government intervention is crucial. This is only likely to be possible if taxpayers can be convinced that ultimate cost sharing arrangements will be equitable and efficient.

Corporate Restructuring: What's the link?

Not all financial crises entail corporate sector distress. Banks can run into trouble for a variety of other reasons. Perhaps the domestic currency value of their foreign borrowings balloon with a depreciation, or their lending is over-concentrated in a particular region or sector of the economy that goes sour. But where non-performing loans and bad debts originate with corporate borrowers, the problems of banks cannot be resolved independently of the factors that impair the capacity of corporate borrowers to service and repay their debts. Easing these constraints will improve the quality of bank assets, bolster their capital and encourage them to resume lending.

There are many different dimensions to corporate restructuring. There is a distinction between financial and operational restructuring. The former entails a financial workout, while the latter focuses on a viable business strategy to secure profits. Ideally, these aspects of restructuring should be dealt with in tandem, since the benefits of financial restructuring are unlikely to prove durable in the presence of operational weaknesses.

Corporate difficulties may be resolved by the market or within special purpose frameworks intended to ease coordination problems. Market solutions entail mergers, acquisitions and bankruptcies within an established framework of company law. Special purpose frameworks may be either voluntary or compulsory. Voluntary frameworks are usually preferred since they provide an opportunity for the rehabilitation of asset values and a recovery of debt. The role of such agencies is crucial when there are many interlocking debtors and creditors. Negotiations among these parties are usually guided by a set of well-defined rules. These would normally assert creditors' rights, while providing some breathing space during which businesses enjoy a stay on their debt. The rules are likely to require that debtors submit plans for financial and operational restructuring to creditors for their approval. To help resolve coordination problems, majority voting on these and other matters is the norm. To the extent that voluntary arrangements work, both debtors and creditors should benefit. If they fail, or no agreement can be reached, resolution of debts would normally occur through bankruptcy proceedings. Therefore for voluntary arrangements to work, there should also be a credible threat of action under binding foreclosure and bankruptcy procedures. If these do not exist, voluntary frameworks are unlikely to achieve much. Normally, some combination of market and special purpose frameworks for debt resolution will be applied.

In cases where there are a few large creditors, who may wield considerable political and economic influence, voluntary procedures like these may not be so appealing. In these circumstances more direct involvement by government in the process of corporate restructuring may be called for.

The issue of what role banks should play in the resolution of corporate debt is not a straightforward one. While banks may have "insider" knowledge of their clients, they may have little expertise to offer on how their businesses can be operationally restructured. In attempting to resuscitate bad and non-performing loans, banks can make matters worse. For example, to avoid provisioning and a dilution of equity, some banks may be willing to lend into arrears, even where businesses are not viable. Ultimately, this only increases overall costs. But in other cases, illiquid banks may attempt to foreclose loans and seek earlier repayments from creditworthy borrowers, thus undermining their viability. Incentive incompatibilities often mean that there are risks in letting banks lead corporate debt restructuring.

Finally, there is the issue of timing. Corporate sector debt resolution and restructuring cannot really begin until a resolution strategy has been determined for the banking system. To some degree, banks may also need to replenish their capital before they can agree to debt stays or to reschedule non-performing debts owed to them.

Bank and Corporate Restructuring in the Affected Countries

In assessing progress on financial and corporate restructuring, it is important to bear in mind that initial conditions differed in Indonesia, Korea, Malaysia, and Thailand. These conditions are summarized in Table 1. Partly as a result of differences in initial conditions, different approaches to re-capitalization and restructuring emerged in the four countries. The situation in the Philippines is somewhat different, and is dealt with separately.

Indonesia

Before the crisis, Indonesia had an exceptionally fragmented financial system. It had numerous banks and small regional financial institutions. These structural features of the financial system posed a challenge for supervisory authorities and the proliferation of institutions signalled underlying regulatory weaknesses. In addition, legal lending limits were widely flouted by private commercial banks whether directly or by routing loans to insiders (bank owners and associated business groups and companies) through non-bank finance companies. However, the initial dependence on foreign funding for the banking system was lower compared to Thailand and Korea. Neither did the level of credit as a proportion of GDP give immediate cause for alarm. However, the non-banking private sector had borrowed extensively from foreign banks and, for the economy as a whole, the exposure to foreign currency debt was very large.

STABILIZATION. As the Indonesian currency came under pressure in late 1997, an attempt was made to prevent a full-scale crisis by closing 16 banks. But what the authorities hoped would be interpreted as decisive action backfired. An absence of communication about how depositors, creditors, borrowers and owners would be treated served only to heighten panic. The withdrawal of deposits from the banking system, which had begun with the devaluation in July 1997, continued unabated and capital outflows ensued. Bank Indonesia, the central bank, then responded by extending liquidity support to banks in the form of overdrafts. In January 1998, a blanket deposit guarantee was issued to stem the flight of funds from the banks (Table 2). By this time, however, much damage had already been done, with capital being shifted either to "safe" state-owned banks or abroad. Wary external creditors limited or halted credit lines, compounding the difficulties experienced by the banking sector at large.

GOVERNMENT OR PRIVATE SECTOR LED? The Indonesian approach to banking sector restructuring has been government led. Recog-

Table 1: **Initial Conditions, 1997**

Item	Indonesia	Korea	Malaysia	Philippines	Thailand
External debt/GDP[1]	53.9%	33.5%	42.6%	56.13%	72.6%
Short term foreign currency loans/ foreign reserves[1]	2.32	3.25	0.81	1.88	1.62
Main financial institutions Early 1997	238 banks (including 10 foreign banks)	26 commercial banks 30 merchant banks 52 foreign banks	48 banks (including 13 foreign banks) 39 finance companies 7 discount houses	53 commercial banks 117 thrift banks	29 banks (including 14 foreign banks) 91 finance companies
CAR	8% target, 87% of banks complied	8% 7.25% actual avg.	8% target 11.4% actual avg.	10% target 16% actual avg.	8.5% target 9.81% actual avg.
Banking sector profitability	1.2% ROA avg. 17% ROE		1.3% ROA 19% ROE		
NPL/total loans, end-97	9%	5.8%	4.1%	4.7%	27%
Foreign liabilities of banks total liabilities	15%	55.17%	7.4%	31.5%	27.4%
Loans/GDP	60%	87.3%	152%	65%	150%
Corporate debt (98)	$118 billion	$444.0 billion	$120.2 billion		$195.7 billion
Debt/equity ratio (96)	2.0	3.5	1.1		2.4
Bankruptcy law	Outdated, 1908	Modern	Modern	Outdated	Outdated, 1940
Deposit insurance	None	Yes	None	Yes	None

[1]Joint BIS-IMF-OECD-World Bank data for external debt. These data differ from those in the country updates which are from national sources.
Sources: BIS, World Bank, Bank Negara Malaysia, Bank of Korea, Bank Indonesia, Bangko Sentral ng Pilipinas, Bank of Thailand.

nizing the need for a systematic approach to mounting difficulties, the Indonesian Government established the Indonesian Bank Restructuring Authority (IBRA) early in 1998. IBRA, which came under the control of the Ministry of Finance, was given sweeping powers to take over NPLs, manage and dispose of underlying assets, and re-capitalize banks. More recently, IBRA has been given the authority to file for insolvency in the commercial courts. Given the massive scale of the problems in the Indonesian banking system and general market disorder, the Indonesian authorities had little option but to pursue a highly centralized approach to the resolution of banking sector difficulties.

WHO IS PAYING? In September 1998, IBRA announced a detailed plan for financial restructuring. The September action plan included

Table 2: **Institutional Arrangements**

Item	Indonesia	Korea	Malaysia	Thailand
Depositor guarantee	Explicitly unlimited January 98.	Explicitly unlimited and unconditional November 97.	Explicitly unlimited January 98.	Explicitly unlimited August 97.
Central Bank role	Independent, new Central Bank Law 1999. Supervisory agency. Direct capital injections in distressed FIs.	Independent Supervisory agency to 1998 when FSC took over.	Accountable to MOF. Supervisory agency. Contributes finance to Danamodal for recapitalization.	Independent, new Central bank law drafted. Supervisory agency. Contributes capital indirectly via FIDF.
MOF	Fiscal policy	Fiscal Policy	Fiscal policy	Fiscal policy
Support/Restructuring Authority	IBRA	Financial Supervisory Services	Bank Negara	Bank of Thailand FRA
Asset Management	Unit within IBRA	KAMCO	Danaharta, separate agency, for NPLs above RM5 million, (approximately 70% of NPLs are >RM5 million).	Unit within FRA for "bad" assets from finance company. Radanasin Bank for good assets from finance company.
Recapitalization	Direct from BI or via IBRA. Private sources.	Via Korea Deposit Insurance Corporation	Danamodal. Private sources.	Bank of Thailand via FIDF. Private sources.
Corporate Restructuring	Jakarta Initiative, mechanism for out of court workouts. Frankfurt Agreement for debts to foreign commercial banks. INDRA—scheme to guarantee access to foreign exchange.	Voluntary, out-of-court workouts favored. Corporate Restructuring coordination Committee to resolve cases.	CDRC—out of court debt restructuring of debts above RM50 million involving at least 3 banks.	CDRAC—out of court debt restructuring
Other	International audit firms conducted audits of banks.		Creditor committees. Special fund for SMEs. Foreign investment banks act as advisors to Danaharta.	Special fund for SMEs.

Source: Bank of Korea, Bank of Thailand, Bank Negara Malaysia, Bank Indonesia, World Bank, KAMCO, IBRA, Danaharta, Danamodal.

measures to evaluate and rank banks based on their capital-adequacy ratios (CARs). Banks with a CAR above 4 percent would be allowed to continue to operate and banks with a CAR below –25 percent were to be shut down, with owners' equity to be extinguished. The viability of other banks would be assessed on the basis of their business plans and the quality of their management. For successful banks, re-capitalization to a 4 percent CAR level would be offered, with government contributing 80 percent of necessary funds, conditional on existing or new owners contributing the remaining 20 percent. Re-capitalization of banks would be financed through the issuance of government bonds. Given the scale of problems in Indonesia, a large part of the cost burden has had to be borne by taxpayers. Although terms for the eventual divestiture of banks acquired by IBRA have been outlined under the September scheme, divestiture is still a long way off.

REFORMS. The government has taken measures to improve the legal and regulatory framework needed to support voluntary debt settlement arrangements. In particular, it has now promulgated a new bankruptcy law and established commercial courts (Table 3). Additional measures will be taken to strengthen the judiciary so that the courts may handle litigation under the new bankruptcy code. A master plan has been adopted to bring regulation and supervision of the Indonesian banking system into line with the Basle accords. Restrictions on foreign investment in the banking sector have been eased in an effort to attract new sources of capital.

CORPORATE RESTRUCTURING. While the approach to bank restructuring in Indonesia has been government led, the approach to corporate restructuring has had more private sector involvement. Under new bankruptcy laws, responsibility has been passed to debtors and creditors to arrange debt settlements among themselves. The government has also sponsored the Jakarta Initiative, and its associated task force, to facilitate voluntary out-of-court settlements, modeled on the so-called London rules. In this approach, indebted companies reorganize and restructure their operations in order to return to profitability. In turn, creditors agree to reschedule loans or to accept conversion of debt to equity. This scheme was combined with the Frankfurt agreement, an arrangement under which foreign commercial banks could negotiate settlements with Indonesian debtors. The Indonesian Debt Restructuring Agency (INDRA) was established as a means of guaranteeing access to foreign exchange for indebted companies. The initial terms on which foreign currency would be made available did not appeal to corporations, so the terms were revised in late 1999 to better reflect market conditions and settlements outside of the INDRA framework.

Korea

In Korea, weaknesses in the financial system first became apparent in 1996 as the profits of banks and *chaebols* began to fall. Signs of vulnerability included a dependence by banks on short-term foreign funding and, at a macroeconomic level, this was reflected in a high ratio of short-term debts to reserves. In Korea,

Table 3: **Recovery Plans**

Item	Indonesia	Korea	Malaysia	Philippines	Thailand
Legal and juridical changes	New bankruptcy law enacted April 1998. Special court opened August 98.	Revisions to laws for the corporate sector.	None.	Revisions to the bankruptcy law.	Revised bankruptcy and foreclosure laws March 98. Special bankruptcy court opened in August 99.
Regulatory changes CAR target	4% (September 1998 plan), 8%, 2001.	8%.	9%.	10%.	8.5% for banks. 8% for finance companies.
NPL definition	Arrears > 3 months	Arrears > 1 month	Arrears > 6 months	Arrears > 1 month	Arrears > 3 months
Loan-loss provisioning as of March 99	100% non-collectible 50% doubtful 15% substandard 5% special mention 1% current loans	100% loss 75% doubtful 20% substandard 2% special mention 0.5% current loans	100% non-collectible 50% doubtful 20% substandard 1.5% special mention 1.5% current loans	100% loss 50% doubtful 25% substandard 5% special mention 2% current loans	100% non-collectible 50% doubtful 20% substandard 2% special mention 1% current loans target date, end 2000
Legal lending limit as of March 99	30% to unrelated single borrower until 2001, 25% until 2002; 20% thereafter; 10% of equity to related group or affiliates.	15% of equity to single borrower; 25% to group (from 1 January 2000); indirect exposure not > 40% of equity.	25% of equity to single borrower or group.	25% of equity to single borrower. Intergroup lending, the lower of investment book value plus deposits, or <= 15% of total loans.	25% of Tier-1 capital for loans to single borrower or group.
Foreign ownership rule as of March 99	100% of shares	100% of shares of publicly listed companies	30% of shares	40% of shares, BSP approval for larger share	25-49% of shares, up to 100% subject to BOT approval
Management	BI uses CAMEL* to rate banks	Limited focus on asset quality, ROE	BN uses CAMEL to rate banks	BSP uses CAMEL to rate banks	BOT does not use CAMEL
Asset acquisition	Bond loan swaps	Bond loan swaps	Bond loan swaps	Not applicable	Bonds loan swaps
Asset disposal	Maximize recovery values. Four year target.	Maximize recovery value, and dispose as fast as possible.	Maximize recovery value. No time frame.	Not applicable.	FRA—quick disposal.
Recapitalization	Liquidity injection. Recapitalize to 4% CAR, 80% government funds, 20% from existing or new owners.	KDIC injects capital in the form of KDIC government guaranteed bonds.	Danamodal purchases equity with bonds.	Not applicable.	Government funds for recapitalization to 2.5% Tier-1 capital.
Estimated fiscal cost	Rp550 trillion (based on March 99 data). Rp300 trillion (29% of GDP) November 98 (World Bank).	25% of 1998 GDP.	RM48.4 billion (18% of GDP) November 98 (World Bank).		B1,583 billion (32% of GDP) November 98 (World Bank).

Note: Intervened includes institutions which were subsequently closed.
*Capital, Asset Quality, Management, Earnings and Liquidity: A method used to evaluate a bank's financial health.
Sources: Bank Negara, Bank Indonesia, Bank of Thailand, IBRA, Danaharta, IMF, World Bank, Bangko Sentral ng Pilipinas.

corporate debt-equity ratios were also very high by international standards. This reliance on debt finance reflected the presence of linked banks that made behest loans to *chaebol* members without proper appraisal or due diligence.

Problems first emerged among merchant banks, which were predominantly owned by *chaebols*. These institutions had accumulated large intra-group exposure and were vulnerable to deterioration in *chaebol* profitability, and to a depreciation of the exchange rate. Operational and financial problems in some *chaebols* surfaced in 1996 and, as the Korean currency began to tumble in late 1997, these spilled over to affect the merchant banks. At around the same time, commercial banks, which had large exposure to *chaebols*, and were dependent on foreign funding, also experienced difficulties.

STABILIZATION. The Korean authorities acted quickly to stem financial hemorrhaging. In late 1997, they suspended 14 out of 30 merchant banks. The remaining merchant banks were then required to follow a time-bound action plan to increase their capital adequacy ratio to 8 percent by June 1999. Two major commercial banks were *de facto* nationalized in December 1997, and three more were nationalized in 1998. Another five have since been closed and five more have merged to form two new commercial banks. The Korean central bank also provided liquidity support to banks and, to avert panic, a blanket deposit guarantee was introduced in addition to the existing deposit insurance scheme.

GOVERNMENT OR PRIVATE SECTOR LED? The Korean approach to financial and corporate restructuring has been largely government led. Government direction and coordination was thought to be essential to balance the influence wielded by the *chaebols*. The powers of the Korean Asset Management Company (KAMCO), in existence prior to the crisis, were extended to acquire, manage and dispose of banks' NPLs and bad debts. The Korean Deposit Insurance Corporation (KDIC) became the designated vehicle for re-capitalization, using public funds, although limited private sector participation in the re-capitalization process has also been invited.

WHO IS PAYING? The Korean Government has been careful to balance taxpayers' interests with the need to stabilize and rehabilitate the financial system. Public funds for re-capitalization have been available only conditional on the dilution of existing owners' equity and management changes. As a result, the government has now acquired control over four of the five largest commercial banks and has equity in many others. However, merchant banks, which play a smaller role in the financial system, have had to raise funds on their own.

KAMCO's strategy has been to remove bad assets from the balance sheets of banks at a realistic discount, and then to attempt to maximize recovery value as quickly as possible. KAMCO's operations have been financed through the issuance of government guaranteed bonds that have replaced NPLs on bank balance sheets. These bonds have been purchased by the Bank of Korea and by private investors. In acquiring an interest in the banks that it has assisted, the KDIC has swapped bonds for equity. These bonds have a maturity of between 3 to 7 years and pay a market coupon. These arrangements allow banks to rebuild their balance sheets by substituting safe for risky assets and also enhance their cash flow by paying the banks interest.

REFORMS. Prior to the crisis, prudential regulations in Korea fell below international standards. Supervision of the financial system was fragmented, allowing institutions to exploit regulatory gaps. To deal with these problems, financial sector supervision was consolidated into the Financial Supervisory Commission (FSC) in early 1998. Later this became the Financial Supervisory Service (FSS) with new management. The FSS has operational autonomy, can license and de-license financial institutions and has supervisory responsibility. Regulations governing the operations of banks have also been strengthened and are being brought in line with the main Basle recommendations.

CORPORATE RESTRUCTURING. To provide an enabling environment within which corporate restructuring could proceed more easily, the Korean Government introduced a number of legislative amendments and policy changes. For the smaller *chaebols*, restructuring focused on voluntary debt settlements along the lines of the London rules and has been led by designated lead banks. The five largest *chaebols*, on government initiative, have entered into specific agreements with their lead banks, with debt resolution agreements being closely monitored by the FSS. This process has been centrally coordinated and guided with, on occasion, direct government intervention. The Corporate Restructuring Coordination Committee (CRCC) was established to resolve differences where settlement plans could not be agreed upon among debtors and creditors. So far 48 cases have been registered with the courts. The FSS and CRCC will oversee the restructuring of Daweoo's debts. Domestic banks are likely to face huge costs in additional write-offs.

Malaysia

Difficulties in Malaysia, while serious, were never as troublesome as in Indonesia, Korea or Thailand. At the onset of the crisis, NPL ratios were at comparatively low levels and debts were concentrated among a comparatively small number of debtors. Although credit to GDP and foreign funding ratios were high, leverage in the corporate sector was moderate, at least by regional standards. Nevertheless, in the wake of the Thai devaluation, substantial capital outflows, a depreciating currency and deteriorating business conditions created problems for the Malaysian banking system. Between the middle of 1997 and 1998, NPL ratios in the banking system doubled.

STABILIZATION. The Malaysian Government responded quickly to escalating difficulties. A blanket deposit guarantee was issued in January 1998, and liquidity support was extended during the first half of 1998 through a reduction in statutory reserve requirement ratios. Although no commercial banks were closed, some were merged, as were some non-bank financial institutions.

GOVERNMENT OR PRIVATE SECTOR LED. The Malaysian approach to banking sector restructuring has been essentially government led but within a market framework. By the middle of 1998, two special purpose agencies had been established to manage problems. Danaharta, an asset management company, was given the responsibility of acquiring NPLs of value greater than RM5 million from banks, with a view to managing them, enhancing their value and eventually disposing of them. A separate agency, Danamodal, was assigned the responsibility of re-capitalizing illiquid but viable banks.

In principle, Danaharta's and Danamodal's operations are guided by commercial criteria. The assets acquired by Danaharata are purchased at a discount to their face value that is related to their security and worth. Their subsequent management and disposal is intended to maximize recovery values. Danamodal's capital has been made available only to viable institutions and on the condition of a dilution of existing equity, and a strategic role for Danamodal in restructuring assisted banks' operations.

WHO IS PAYING? Danamodal's and Danaharta's operations have been financed to a large extent by issuing bonds, which enjoy government guarantees. Danaharta received start-up equity from the Malaysian Government and additional debt capital was obtained from the Employee Provident Fund (EPF), a national pension scheme owned by Malaysian wage earners, and Khazanah, an investment trust. The cost of the equity provided by the government would be indirectly borne by taxpayers. Danaharta's financial operations essentially involve swaps of government guaranteed zero coupon bonds for NPLs. The maturity of the swap arrangement can be extended at Danaharta's discretion. While this does not immediately assist the selling banks' cash flow position, it replaces loans of poor quality by essentially riskless assets, and eases constraints on lending. The eventual cost of these operations to the taxpayer will depend on how successful Danaharta is in disposing of the assets it acquires, and the terms on which Danamodal divests the equity it acquires in the process of the recapitalization of assisted banks.

REFORMS. At the outset of the crisis, Malaysia already had modern bankruptcy and foreclosure laws, and a supporting juridical system. In the wake of the crisis the major reform emphasis in Malaysia has been on strengthening banking and corporate supervision. While some regulatory standards have been tightened others have been relaxed to ease the liquidity position of banks. The government is also sponsoring major consolidation within the banking industry that is intended to allow domestic banks to compete more effectively with international banks once access to the retail market is opened up under Malaysia's WTO obligations.

CORPORATE RESTRUCTURING. As elsewhere, Malaysia has instituted a voluntary system for corporate debt resolution. The Corporate Debt Restructuring Committee (CDRC) was set up to facilitate out-of-court restructuring for viable companies with over RM50 million of debt owed to at least three institutions. The CDRC has set various rules to guide restructuring, but there are no penalties for non-compliance. As in the other countries, some corporate debt settlements are also being reached outside of this framework.

The Philippines

The Philippine case is somewhat different. As in other economies, there had been a period of financial liberalization prior to the crisis. But this had been accompanied by a concerted effort to strengthen regulation and supervision following earlier banking sector difficulties. The property and financial sectors were overheated, but not so severely as in the other affected countries.

When the peso fell in 1997, the Philippine authorities responded by extending liquidity support to the banking system. While the NPL ratio has increased significantly, reaching 15 percent of total loans at its peak in late 1999, this is much smaller than the peak ratios observed elsewhere. While there is genuine concern about the level of NPLs, the Bangko Sentral ng Pilipinas, the country's central bank, is not about to undertake any general measures to resolve them. Instead, banks themselves will have to work on improving the quality of their asset portfolios. This has led to some consolidation activity in the banking sector.

Despite earlier reform efforts, weaknesses remain in the Philippine banking system. The Banking Secrecy Act continues to act as an impediment to effective supervision. Prudential regulations and supervision are still some way short of international best practices. In response to these weaknesses, regulations are currently being revised to make them at least as strict as the Basle recommendations and supervisory capacities are being gradually strengthened. Regarding corporate restructuring, no specific new measures have been taken to handle distress.

Thailand

At an aggregate level, Thailand entered the crisis with a high ratio of loans to GDP, and large exposure to foreign exchange liabilities. Much of this exposure was short term and by the middle of 1997 available foreign exchange reserves were insufficient to meet maturing obligations. As asset values fell and activity in the real economy slowed, non-performing debt escalated to worrying levels. A very large number of creditors and debtors quickly became embroiled in trouble. The situation of finance companies as well as banks gave cause for concern. Finance companies had allowed worrying mismatches to develop on their balance sheets. They had lent long to highly vulnerable domestic real estate and equity sectors, while borrowing short in foreign currency.

STABILIZATION. Once the depth and incidence of problems became apparent, the Thai Government issued a blanket deposit guarantee to bank depositors and other creditors in August 1997 and extended liquidity support to institutions in difficulty. Liquidity support was provided in the form of loans from the Financial Institutions Development Fund (FIDF) and through direct capital injections. The majority of Thailand's troubled financial companies were promptly suspended and closed in late 1997, as was one commercial bank. Troubled state banks were re-capitalized with public funds, with a number of other banks coming under the management control of the Bank of Thailand, the central bank. As part of the stabilization effort, the Bank of Thailand also directed the merger of weaker banks and finance companies with stronger entities in "lifeboat" operations.

GOVERNMENT OR PRIVATE SECTOR LED? Having stabilized the banking system, the Thai authorities opted for a more market-led approach to resolve bank and corporate difficulties than has been adopted in the other affected economies. Under the Thai arrangements, the government has set terms for re-capitalization that place heavy responsibilities on existing owners. To qualify for Tier-1 capital support, private investors must match the government's equity investment. To qualify for Tier-2 support, banks must agree to accelerated provisioning and resolving of NPLs. Government guaranteed bonds have been issued to finance the re-capitalization scheme. These terms, and associated capital adequacy targets, are intended to compel banks to find additional sources of private capital. The authorities have also largely left it to individual banks to resolve NPLs and to restructure their operations. Private asset management companies are allowed, as are debt resolution units within banks.

WHO IS PAYING? From the outset, the Thai authorities have been concerned to minimize the burden that falls on the taxpayer. While some public money has been used to help re-capitalize state banks and provide Tier-1 and Tier-2 capital under the August 1998 re-capitalization program for private banks, it is intended that much of the burden of re-capitalization be borne by the private sector, including existing owners.

REFORMS. Changes in regulation and supervision are ongoing. New bankruptcy and foreclosure laws have been promulgated, and restrictions on foreign investment in the domestic banking sector eased. The legal and regulatory framework for bank supervision will be revised in 2000, and supervisory capacity is being upgraded. The restructuring and re-capitalization process is being driven by a timetable for the strengthening of capital adequacy ratios, and provisioning requirements.

CORPORATE RESTRUCTURING. Small and medium sized companies account for more than two-thirds of corporate debt in Thailand. This is a far larger proportion than in the other affected countries. Corporate debt restructuring is therefore potentially a logistically complex and time-consuming process. The government has created a voluntary framework for debt settlements, oversight for which rests with the Corporate Debt Restructuring Advisory Committee (CDRAC), and has introduced a number of tax measures to encourage speedy restructuring, but the actual resolution process is left to debtors and creditors.

An Assessment of Progress

Indonesia

Indonesia is still in the early phase of restructuring. NPLs still make up about 80 percent of total loans and most banks have yet to reach a CAR of 4 percent. Many banks continue to operate only with the assistance of Bank Indonesia. The process of re-capitalization is ongoing and the government intends to issue more bonds to support the process in 2000. The current objective is for all banks to reach a CAR of 8 percent by the end of 2001. Concerns about the credibility of IBRA and the solvency of Bank Indonesia are hindering the process of banking sector restructuring. In the present circumstances, it may be difficult for banks to raise capital, either from domestic or foreign sources, but the prospect of a more stable macroeconomic environment and positive growth in 2000 should help ease constraints.

By December 1999, only 58 cases had been resolved under the auspices of the Jakarta Initiative (Table 4). More generally, too, there has been limited progress in resolving corporate debts. The bulk of debt in the Indonesian economy, including the liquidity support earlier provided by Bank Indonesia, is now effectively controlled by IBRA, which, in a difficult political context, has so far been reluctant to use its powers fully. There have also been allegations of collusion and corruption made against IBRA officials. In January 2000, IBRA was given a broader mandate to file insolvency petitions and instructed to play a more active role. The government also intends to play a more direct role in the Jakarta Initiative Task Force.

So far IBRA has raised Rp9.1 billion in assets. It estimates that it may able to dispose of as much as a further Rp24.7 trillion of the assets under its control by end 2000. However, while there are now visible signs of progress, this constitutes only 4.4 percent of the assets under IBRA's control. IBRA has also restructured Rp28 trillion of NPLs, which are about 10 percent of the total. Difficulties lie ahead, however, in recovering BLBI (Bank Indonesia liquidity credits) loans.

Reforms of the legal, regulatory and supervisory framework for banks are underway. An audit of Bank Indonesia under the new central bank law has been conducted. Bank Indonesia has adopted a time-bound program of follow-up actions including improving its financial position, strengthening its internal controls and improving information systems. A strategy to bring prudential regulations for banks and supervisory techniques in line with the Basle Committee's recommendations has been adopted. A similar strat-

Table 4: **Progress**

Item	Indonesia	Korea	Malaysia	Thailand
Main financial institutions Early 1997	238 banks	26 commercial banks 30 merchant banks	48 banks 39 finance companies 7 discount houses	29 banks 91 finance companies
Closed institutions	66 banks	21 merchant banks 5 commercial banks	None	56 finance companies 1 bank
Intervened financial institutions	23 recapitalized 12 banks under IBRA	5 commercial banks nationalized (1 sold)	10 banks recapitalized	65 finance companies and 18 banks managed
Merged institution	4 state banks 8 private banks proposed merger	2 merchant banks 5 commercial banks	4 banks 14 finance companies	4 banks
NPLs acquired and managed/total	66%	25%	36%	…
Corporate debt • agreements/ in process	Applications from 323 firms with $23.4 billion and Rp14.7 trillion in debts, by December 99 to the Jakarta initiative. 58 agreements by December 99. 959 active cases under IBRA, with $6.9 billion and Rp60.3 trillion in debt.	Out-of-court 92 cases registered. In-court 48 cases registered. 5 largest *chaebols* have signed special agreements with lead banks. 6-64 largest *chaebols* have agreed workout plans with creditors.	54 cases registered with CDRC, RM32.6 billion in debt. 10 of these transferred to Danaharta.	B1,160 billion. 22,755 cases in process with CDRAC.
• completed, cumulative total		46 out-of-court and 19 in-court cases completed.	19 cases, RM14.1 billion, February 2000.	B762.7 billion, 120,433. cases (CDRAC September 99).
Committed public funds	Rp599 trillion issued in bonds for liquidity support, and recapitalization, end 99. Rp140 trillion expected to be issued in 2000.	W59.8 trillion spent. Additional costs of W12 trillion expected.	RM28 billion limit for government guaranteed bonds. RM18 billion issued by end 99.	B1.1 trillion in liquidity support plus B800 billion limit on bonds for recapitalization. B38.4 billion in the capital support schemes.
Private capital	Foreign capital $56 million (EIU).			B905 billion total public and private capital committed as of Nov 1999 (BOT).

… = not available.
Sources: EIU, IBRA, FSS, KAMCO, Bank of Thailand, Bank Negara Malaysia, World Bank, CDRAC, Danaharta, Danamodal.

egy for non-bank financial institutions will be developed during 2000. Other planned reforms include measures to improve corporate governance by stricter disclosure rules, and the implementation of policy recommendations related to accountability and oversight. These reforms are welcome, and should bring results over the next two years.

Korea

Korea has made good progress in restructuring its banking system. By the end of 1999, NPLs were only 10 percent of total loans. The risk weighted CAR for commercial banks had reached a respectable 9.8 percent by the middle of 1999. These improvements in the quality of bank assets and in their capital backing have helped bring about a resumption of real credit flows to the private sector. In 1999, the growth of the stock of real private sector credit was close to 18 percent.

Despite these positive developments, Korean banks are not yet completely out of the woods. As yet, there is little evidence that banks have taken the measures needed to improve their procedures for credit analysis and risk management. Lingering operational weaknesses leave Korean banks prone to a repetition of their earlier mistakes. Also, a second wave of bad debt write-offs and loan provisioning will now be needed following Daewoo's insolvency. Unless private sources of capital can be found, this will add to the costs that are being borne by the Korean taxpayer. It is estimated that the re-capitalization of Korea's banks will cost at least an additional W12 trillion.

There has been mixed progress on debt resolution in Korea. Although plans for debt resolution are far advanced, their full implementation is still awaited. The five largest *chaebols* have submitted Capital Structure Improvement Plans to the FSS. The next 60 largest *chaebols* and other large corporations have also signed debt renegotiation agreements with their creditor banks. For this group, it is estimated that about 40 percent of debt has now been resolved. Progress is being monitored by the FSS. Encouragingly, those agreements that have been reached have required operational as well as financial restructuring. Of the cases registered with the CRCC, about half have been settled. Not all agreements have been voluntary, and bankruptcy actions have also been used. Of the 48 cases filed with the bankruptcy courts, 19 have been resolved.

Korea has undertaken some important reform measures aimed at eliminating the abuses that characterized governance of the *chaebols* and connected banks. These include prohibition of cross-subsidiary guarantees on debt, consolidation of the financial statements for *chaebols*, compliance with international accounting standards, and reinforcement of voting rights of minority shareholders. It is still too early to say what impact these changes might have. Foreign investors have been allowed easier access to the Korean domestic banking sector but as yet only one comparatively small transaction has taken place. Newbridge Capital bought the government's 51 percent stake in Korea First Bank for W500 billion, and may invest another W200 billion in the bank over a two-year period.

Malaysia

In Malaysia, NPL and capital adequacy statistics suggest that there has been considerable progress made in nursing the banking system back to health. NPLs, classified on a three-month basis, had fallen to 11.7 percent of total loans by November 1999. These reflect delinquent loans, all less than RM5 million, that individual banks have been left to resolve on their own. By June 1999, Danaharta had already removed all non-performing debt larger than the RM5 million, and it is now in the process of managing the process of restoring and recovering value. Danaharta now has control of RM45.5 billion of assets, including RM35.7 billion from the banking system, constituting about 43 percent of initial NPLs in the system.

The banking system's capital levels have also recovered sharply. By December 1999, the CAR had reached 12.5 percent. This suggests that on a system-wide basis, the Malaysian banking system now has enough capital to provision adequately for NPLs. The operations of Danamodal have greatly assisted the process of recapitalization. Danamodal has now provided a net RM5.3 billion of capital to banks in which it has strategically intervened, after repayment by some banking institutions.

Debt resolution is also moving forward in Malaysia. Nearly 70 applications have now been received by the CDRC covering just under RM36 billion of debt. Voluntary agreements under CDRC have covered about 40 percent of this debt. Some cases have been transferred to Danaharta, with the remainder expected to be settled by the middle of 2000. An area of concern is that agreements to date have focused mainly on financial restructuring and contain few operational measures intended to ensure future viability. Another concern is that the disposal of the assets acquired by Danaharta has been slow. So far, disposal has focused mainly on a small amount of foreign loans. Initially a 50 percent recovery rate on face value was achieved but the most recent tender achieved a 71 percent recovery rate. Property assets have also gone out to tender.

Some restructuring is taking place outside the framework of Danaharta, Danamodal and the CDRC. Assessing progress here is difficult given the absence of regular reporting. According to calculations by the World Bank, 1999, about 25 percent of listed firms were unable to service their debt towards the end of 1999. The corporate sector appears to be consolidating rather than expanding. However, with sustained recovery now underway, the cash surpluses needed to service debts should expand, and conditions for corporate debtors and their creditors alike should improve.

Malaysia has adopted a pragmatic approach to reform. To help banks out of their difficulties, provisioning standards were eased and forebearance and prudential restrictions on lending were relaxed. However, these measures have been accompanied by a number of steps intended to strengthen the supervision of banks, and to improve corporate governance.

Looking ahead, a major government-led consolidation of the Malaysian banking system is promised by the end of 2000. All institutions had submitted merger plans by the deadline of 31 January 2000 and 10 financial groups are to be formed. The constitution of the new consolidated banking groups was announced by Bank Negara in early February. The objective of consolidation is to create larger and stronger domestic banking institutions that will be better able to compete when full liberalization of the domestic banking sector occurs in 2003. However, experience elsewhere shows that bigger does not necessarily mean better. If banks are to become more efficient then they must operationally restructure too, improving their systems of risk and credit management. Furthermore, there are some risks associated with financial conglomerates. More complex financial groups may be more difficult to supervise and if institutions are created that are considered “too big to fail,” the overall safety of the financial system may be inadvertently weakened.

Thailand

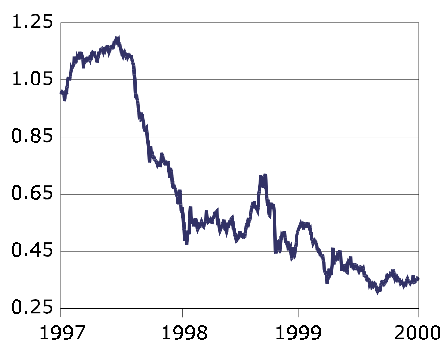
Thailand's market-led approach has not delivered dramatic results in terms of a reduction of NPLs on banks' balance sheets. It is estimated that at the end of 1999 the NPL ratio (three months definition) was still about 38 percent. However, this ratio had come down from nearly 50 percent in the space of six months, and further reductions can be expected as growth consolidates in 2000. The main difference between Thailand's experience compared to Korea's and Malaysia's is that in those two countries a large portion of NPLs have been removed from banks' balance sheets and placed with special purpose agencies. In Thailand, this has not happened and NPLs have been left largely for banks to resolve. While a few private commercial banks have set up their own asset management units, the actual transfer and disposal of NPLs has so far been slow.

In Thailand, the CAR for all commercial banks, including foreign bank branches, had reached 15.2 percent by September 1999. While the corresponding CAR for domestic banks is likely to be considerably lower, no details are available. Under the government's re-capitalization program, domestic banks have been given a timetable over which to comply with stipulated capital adequacy targets. To date, domestic banks have focused their energies largely on raising private capital. While some mergers have taken place, and some banks have successfully attracted fresh capital, it is likely that many domestic banks remain under-capitalized. Few banks have taken up the government-sponsored re-capitalization scheme. Only B35.5 billion in Tier-1 (equity) and B2.9 billion in Tier-2 (debt) capital has been issued. This compares with an estimated total of B900 billion in public and private capital that has been raised directly since August 1998 by public and private financial institutions. The limited use of the government's re-capitalization scheme reflects owners' reluctance to have their equity diluted.

As evidenced by the NPLs that remain on banks' balance sheets, debt resolution is progressing comparatively slowly. Despite new bankruptcy laws, debtors still seem to have the upper hand and have been effectively stalling resolution. There is also anecdotal evidence to suggest that Thai banks have been lending into arrears in the hope that economic recovery will generate the cash debtors need to service their debts. To the extent that this is true, it means that financial and operational restructuring at a grassroots level lags. Moreover, it suggests that banks have yet to strengthen credit analysis and risk management. While growth will certainly facilitate debt servicing, growth alone is unlikely to provide the additional capital needed by Thailand's banking system. World Bank estimates (World Bank, 1999) suggest that an additional B200 billion will need to be raised. While this figure may be reduced if growth accelerates, it is unlikely that growth can generate all the additional capital that will be needed by the Thai banking system.

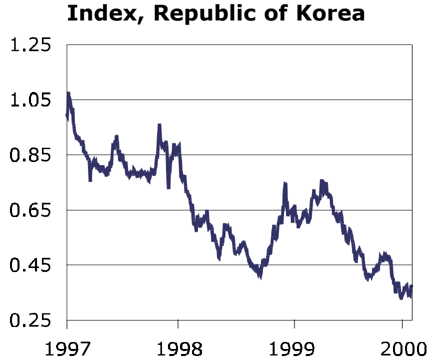
Nevertheless, there have been some positive developments in Thailand. The tempo of debt settlements managed under the CDRAC framework is now quickly picking up. An estimated 14 percent of total 1998 corporate debt is being restructured under CDRAC and another 9.4 percent of initial debt has been resolved. Also, the legal and regulatory framework for corporations has been improved. Broad-based improvements in banking laws, regulation and supervision will begin to be implemented in 2000. However, it may take some time before reforms can be fully implemented as they are intended.

Figure 1: **Ratio of Financial Index to the General Stock Price Index, Indonesia**



Source: ADB calculations derived from Bloomberg.

Figure 2: **Ratio of Financial Index to the General Stock Price Index, Republic of Korea**



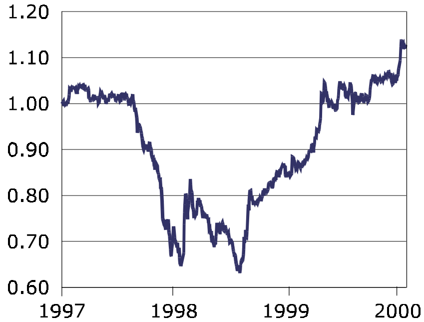
Source: ADB calculations derived from Bloomberg.

Market assessment of financial restructuring

One difficulty in assessing restructuring and recovery programs is in separating their impact from other events. One perspective of the success or otherwise of restructuring programs can be distilled from market data. Equity indexes and credit ratings, among other pieces of information, provide an indication of the private sector's assessment of the restructuring and rehabilitation process.

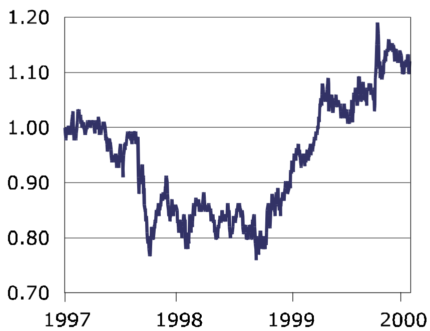
One way in which these views can be summarized is to measure the performance of financial sector (or banking sector) equity relative to broader market indexes. If financial sector equity outperforms the broader market over a period of time this would tend to suggest a bullish outlook, and might be interpreted as market endorsement of restructuring and re-capitalization efforts. On the other hand, it might be inferred from a lackluster performance that doubts remain about the effectiveness of restructuring efforts. In Figures 1-5 the ratio of the value of financial sector equity to the broader market index is shown for the period covering February 1997 through to early 2000. The ratios have been indexed to unity at the beginning of the sample to ease interpretation.

Figure 3: **Ratio of Financial Index to the General Stock Price Index, Malaysia**



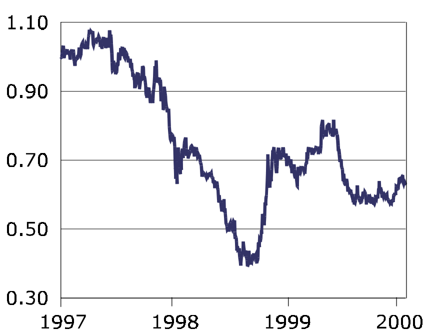
Source: ADB calculations derived from Bloomberg.

Figure 4: **Ratio of Financial Index to the General Stock Price Index, Philippines**



Source: ADB calculations derived from Bloomberg.

Figure 5: **Ratio of Banking Index to the General Stock Price Index, Thailand**



Source: ADB calculations derived from Bloomberg.

INDONESIA. The Indonesian data show that financial stocks outperformed other stocks until November 1997, suggesting that private sector investors were slow in realizing the profound difficulties that beset the banking sector. From there on, Indonesian financial stocks have under-performed the broader market. Investors reacted positively when the major restructuring program was announced in September 1998. But this optimism was short-lived and financial stocks have since lost ground relative to other sectors.

KOREA. Despite episodic recoveries, financial sector stocks in Korea have fared worse than the overall market since the beginning of 1997. By early 2000, they had surrendered something like 65 percent of their value to the overall market index. Despite the generally positive commentary on Korean banking sector restructuring, financial sector equity values would seem to indicate that market participants are not yet convinced of the earnings prospects for Korea's banks. Slow progress in restructuring the *chaebols* and concerns about the true extent of their debt are likely to have had a negative influence on the market's assessment of financial stocks.

MALAYSIA. In Malaysia, financial stocks outperformed the stock market in the first eight months of 1997, and then performed below par until September 1998. Since then, and following the commencement of Danaharta and Danamodal's operations, the market valuations of financial stocks have recovered. By the middle of 1999, Malaysian financial sector stocks were outperforming the broader market relative to the February 1997 benchmark. This development reflects a positive view of restructuring and its impact on prospective earnings.

PHILIPPINES. Financial stocks outperformed the broader market in 1999. This performance should, however, be seen in the context of a lackluster performance by Philippine equity. Over the same period, the NPL ratio has risen to close to 15 percent of total loans, and profitability in leading banks has been low due to narrow spreads, weak demand from low risk companies and increased competition from foreign banks in the corporate market. However, market participants have clearly welcomed the ongoing consolidation with mergers of large banking groups and the strengthening effect that is expected to follow in the medium-term.

THAILAND. From the middle of 1997, banking stocks have lost considerable ground to the broader market. Although they staged a recovery at around the time when Thailand's financial restructuring package was announced, they have subsequently fallen back and are now under-performing the broader market. Market participants seem to be skeptical about the pace of restructuring and, at this juncture, seem reluctant to invest in financial stocks.

CREDIT RATINGS. Sovereign credit ratings provide another barometer of general economic health, and financial sector health in particular. After the crisis, the sovereign credit ratings for all five countries were revised sharply downward to levels below investment grade. Now sovereign credit ratings for Korea and Malaysia have, in some cases, been positively reassessed (Table 5). Ratings for the Philippines are stable while Indonesia is on watch for a possible further downgrade. While sovereign credit ratings primarily reflect views about the sovereign's capacity to service its foreign exchange liabilities (including contingent liabilities that may be created in the banking system) it would be difficult to reconcile greater optimism on this matter with a bearish outlook for the financial and banking system.

Table 5: **Sovereign Credit Ratings**

Item	Indonesia	Korea	Malaysia	Philippines	Thailand
Moody's Foreign Currency LT	B3 19 March 98 B2 9 January 98	Baa2 16 December 99 Baa3 23 August 99	Baa3 3 December 98 Baa2 23 July 98	Ba1 18 May 97 Ba2 23 January 97	Ba1 21 December 97 Baa3 1 December 97
S&P Foreign Currency LT	CCC+ 15 May 98 B- 11 March 98	BBB 11 November 99 BBB- 25 January 99	BBB 10 November 99 BBB- 15 September 98	BB+ 21 February 97 BB 30 May 98	BBB- 8 January 98 BBB 24 October 97
Fitch IBCA Foreign Currency LT	B- 16 March 98	BBB- 24 June 99	BBB- 7 December 99		BB+ 24 June 99

Note: Moody's: **Baa** bonds are considered medium-grade obligations. Interest payments and principal security appear adequate for the present. **Ba** bonds are judged to have speculative elements, their future cannot be well assured. **B** bonds generally lack characteristics of the desirable investments. **Standard & Poor's: BBB** bonds have adequate protection parameters, but adverse economic conditions could lead to weakened repayment capacity. **BB** bonds have a speculative element. **B** bonds are more vulnerable to nonpayment than BB bonds. **CCC** bonds are currently vulnerable to nonpayment. **FitchIBCA: BBB** bonds are investment grade, good credit quality bonds. **BB** are speculative with a possibility of credit risk developing. **B** are highly speculative bonds, with a significant credit risk.
Sources: Moody's, Standard and Poor's, and FITCH IBCA.

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