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Viewpoint

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How to Accelerate Corporate and Financial Sector Restructuring in East Asia

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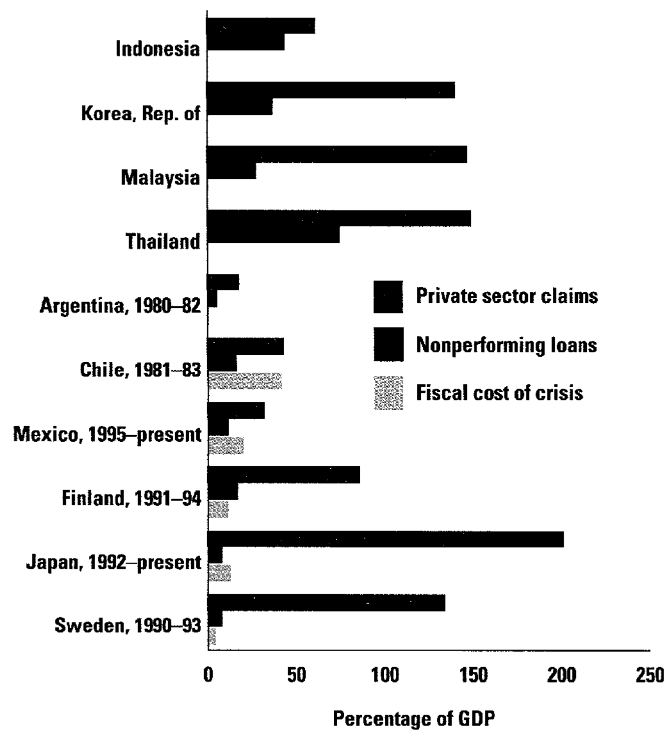
Resolving systemic banking and corporate distress is not easy. The large scale of the East Asian financial crisis has made the task even more daunting in Indonesia, the Republic of Korea, Malaysia, and Thailand (figure 1). Two years into the process, bank and corporate restructuring is still a work in progress (Claessens, Djankov, and Klingebiel 1999). Governments should act to accelerate it. Besides adopting common policy reforms—improving financial regulation and supervision, corporate governance, and bankruptcy procedures—and shoring up banks' capital positions, governments could take or facilitate three additional steps: Set up competitive, privately managed specialized funds, to hold nonperforming loans and depoliticize restructuring. Allow auctions as an alternative to negotiations, to speed debt restructuring. And allow employee ownership participation schemes, to reduce workers' resistance to changes in ownership. This Note reviews current approaches to financial restructuring and explains the proposed mechanisms for accelerating the process.

FIGURE 1 THE EAST ASIAN CRISIS—LARGER THAN MANY



Source: Claessens, Djankov, and Klingebiel 1999.

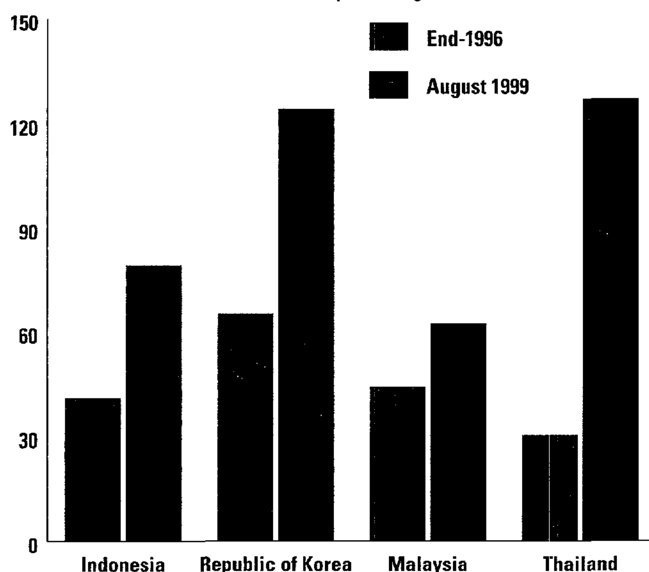
Although governments have spent substantial sums to clean up balance sheets, banks remain inadequately capitalized in all four countries (table 1). While Korean and Malaysian banks may be able to cover their capital shortfall from retained earnings in a reasonable time, that is not the case for banks in Indonesia and Thailand. But even in Korea and Malaysia letting banks fend for themselves will be risky. Self-recapitalization makes banks less willing to absorb losses and so hinders corporate restructuring. Because capital-constrained banks shift assets into government

TABLE 1 FINANCIAL DISTRESS, STATE OWNERSHIP, AND THE PUBLIC DEBT BURDEN
Percent

Indicator	Indonesia	Republic of Korea	Malaysia	Thailand
Current nonperforming loans in banks as a share of all financial assets (1999)	34.1	15.9	17.9	27.9
Large, distressed corporations restructured out of court (as of August 1999)	17	48[a]	32	29
Capital shortfall in banks as a share of GDP (1999)	12.7	10.7	5.5	15.4
Firms with debt servicing problems (2001, projected)[b]	52.9	17.2	13.8	22.3
Public debt (including financial restructuring costs) as a share of GDP (1999)	98.3	37	48	39.3
Interest payments on public debt as a share of fiscal revenue (1999)	91.8	14	6.5	6.5
Fiscal costs of crisis as a share of GDP (1998)[c]	50	26.5	16.4	32.8

a. Excludes companies affiliated with the five largest chaebol. Such companies are restructured through a separate mechanism. Including them would significantly reduce the share of restructured firms.
b. Firms that cannot cover their interest payments from operating cash flows. The projection is based on actual mid-1999 corporate performance data and International Monetary Fund macroeconomic forecasts as of August 1999.
c. Includes the fiscal cost of recapitalization and the expected extra fiscal costs.
Source: Claessens, Djankov, and Klingebiel 1999.

FIGURE 2 STATE OWNERSHIP HAS RISEN SHARPLY



Source: Claessens, Djankov, and Klingebiel 1999.

securities, it also limits corporate lending and thus impedes economic recovery. And an undercapitalized financial sector can inspire banks to finance risky but potentially high-return projects in attempts to restore their capital.

While corporate restructuring has accelerated, corporate distress remains high and many corporations are unlikely to grow out of their problems. Moreover, much financial restructuring appears cosmetic, with restructured loans often reverting to nonperforming status. Even though operational corporate restructuring will take several more years, financial restructuring needs to be done now—and in such a way as to ensure that deep operational restructuring will follow.

The costs of financial sector restructuring are high in the East Asian crisis countries—ranging from 16 to 50 percent of GDP—and are creating large fiscal burdens. If the governments absorb all these costs, public debt will rise sharply—in Indonesia to more than 90 percent of GDP, and in Korea, Malaysia, and Thailand to 37 to 48 percent. The large fiscal outlays have caused many

BOX 1 USING ASSET MANAGEMENT COMPANIES TO RESOLVE BANKING CRISES—CROSS-COUNTRY EXPERIENCE

Two main types of asset management companies can be distinguished: those set up to expedite corporate restructuring, and those established as rapid asset disposition vehicles. A review of seven asset management companies (in Finland, Ghana, Mexico, Spain, Sweden, the Philippines, and the United States) reveals a mixed record.

Two of the three *companies set up for corporate restructuring* failed to expedite restructuring, suggesting that asset management companies are rarely good tools for this purpose. Only the Swedish asset management company managed its portfolio successfully, acting in some instances as lead agent in the restructuring. But it was aided by special circumstances: the assets it acquired were mostly in real estate, not manufacturing (which are harder to restructure), and they were a small fraction of the banking system's assets (making it easier to maintain independence from political pressure and to sell assets back to the private sector).

Rapid asset disposition vehicles fared somewhat better: two of four agencies, those in Spain and the United States, achieved their objectives. These successful cases suggest that asset management companies can be effective, but only for narrowly defined purposes of resolving insolvent and nonviable financial institutions and selling off their assets. But *specific conditions are required*: assets that are easily liquidated (real estate), professional management, political independence, skilled human resources, appropriate funding, adequate bankruptcy and foreclosure laws, good information management systems, and transparency in operations and processes.

In Mexico and the Philippines the asset management companies were doomed from the start by transfers of politically motivated loans or fraudulent assets difficult for a government agency susceptible to political pressure to resolve or sell. Both agencies failed to achieve their objectives.

***Source:* Klingebiel forthcoming.**

observers to question the sustainability of public debt as interest payments threaten to take up a large share of fiscal revenue.

State ownership has increased sharply in the crisis-affected countries. Through support for weak financial institutions and acquisition of nonperforming loans by publicly owned asset management companies, the state now controls an average of about 100 percent of GDP in financial assets, up from 45 percent before the crisis (figure 2). Governments have had limited success in selling off such assets: they have sold only five banks, and asset management companies have sold only 2 percent of corporate assets.

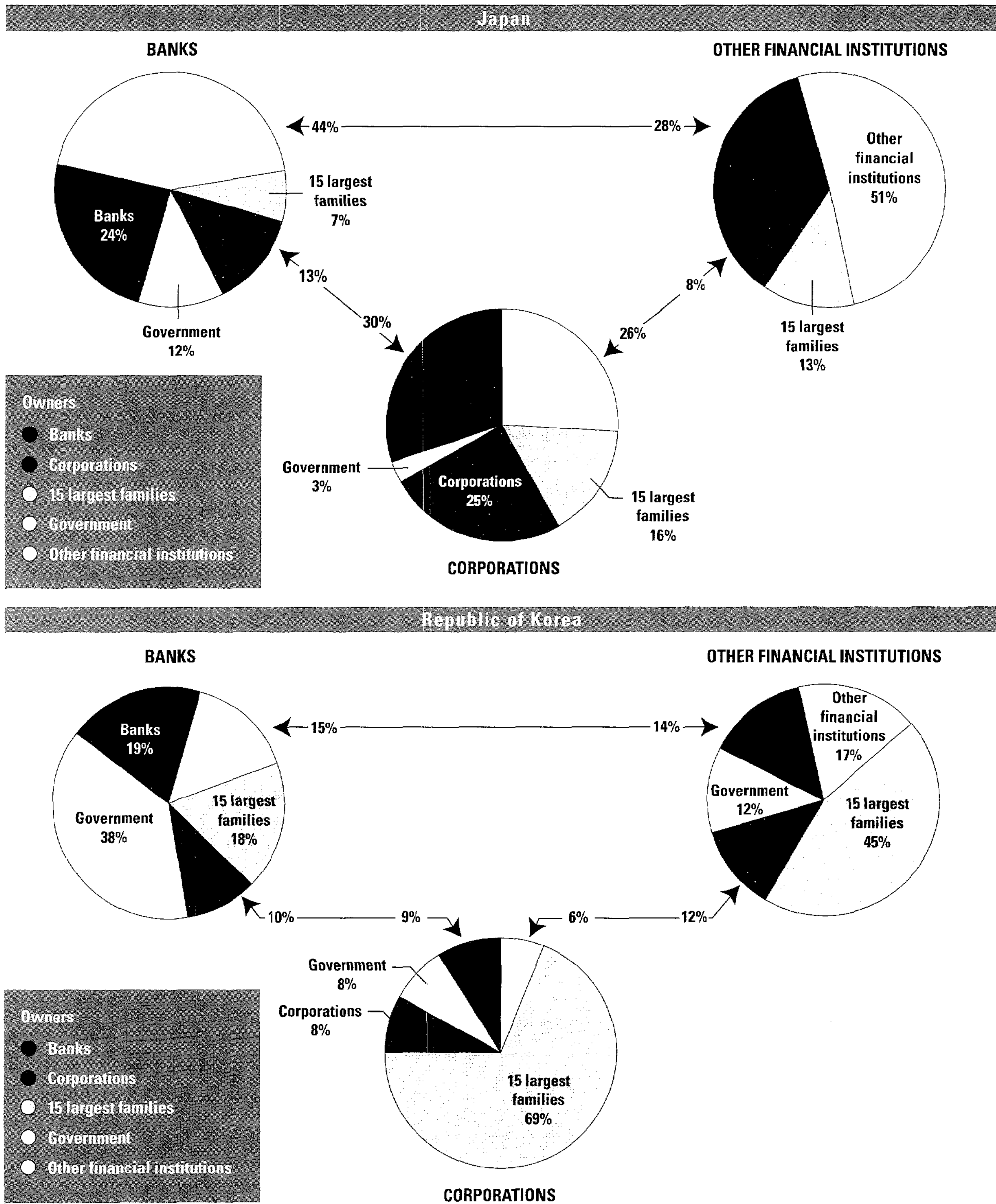
The countries have made some progress in policy reform, but much remains to be done. Financial sector regulations—such as loan classification and provisioning guidelines—still trail international best practice, and the rules for dealing with weak financial institutions (a factor contributing to the crisis) need further tightening. Improvements are needed in the governance structures of banks and corporations to ensure that resources are used most productively. And bankruptcy and reorganization procedures need further strengthening and streamlining.

But durable economic recovery in the East Asian economies will require more and deeper corporate restructuring and improvements in the allocation of investable funds. Without sharply accelerated financial restructuring, the risk of a downturn is high in some countries.

Three strategies for financial restructuring

Three approaches to financial corporate restructuring can be distinguished. Countries can use a *centralized, government-led* approach by focusing asset recovery in one public agency, an asset management company (box 1). Centralizing assets may help consolidate skills and resources and ease the monitoring and supervision of workout practices. As claims are consolidated, leverage over debtors may be increased and perverse links between banks and corporations broken, allowing better collection of loans. Yet an asset management company holding a large share of corporate claims is difficult to insulate from political pressures. Moreover, transferring loans breaks the links between banks and corporations—links made valuable by banks' privileged access to corporate information. And if an asset management company fails to actively

FIGURE 3 CONCENTRATION OF OWNERSHIP AFFECTS EASE OF CORPORATE AND FINANCIAL SECTOR RESTRUCTURING



Note: Percentages refer to relative shares of concentrated control. Concentrated control refers to owners with stakes of more than 5 percent.
Source: Claessens, Djankov, and Klingebiel 1999.

manage the assets it holds, it can undermine credit discipline in the entire financial system.

The *decentralized, creditor-led workout* approach relies on banks and other creditors to resolve nonperforming loans. Since banks know the borrowers, and since their own survival depends on asset recovery, they may be better able and more willing than asset management companies to maximize recovery value and avoid future losses. Furthermore, banks can provide new loans during debt restructuring.

To be successful, however, decentralized debt workouts require limited or no ownership links between banks and corporations (since otherwise the same party would be both debtor and creditor), adequately capitalized banks, and proper incentives for banks and borrowers. The slow pace of restructuring in Japan is due in part to the extensive ownership links between banks, other financial intermediaries, and corporations (figure 3). The heavy cross-ownership led to a deadlock of claims that took a long time to break. Decentralized debt workouts also require that banks be adequately capitalized, so that they have the loss absorption capacity needed to engage in corporate restructuring. Allowing banks to recapitalize through increased earnings over a long time horizon (through implicit or explicit forbearance) limits their ability to engage in rapid corporate restructuring.

Finally, countries can adopt restructuring strategies predicated on the *recovery of economic activity and growth*. This approach relies on fiscal stimulus and external demand to increase growth and thereby lessen the need for corporate and financial restructuring.

The record in East Asia

Most East Asian crisis economies are pursuing a mix of the three approaches. Indonesia, Korea, and Malaysia have transferred large amounts of nonperforming loans to asset management companies. But this centralized approach has yet to show much success. Most asset management companies in East Asia are warehousing assets or trying to restructure corporations rather than pursuing their main objective, disposing of assets; this is much like the experience in developing countries. Many of the prerequisites for successful asset management companies are missing in East Asia; for example, many of the assets transferred are corporate, not real estate assets, which tend to be easier to restructure. In addition, the large state ownership stake has made restructuring susceptible to political interference. And the state can hardly be expected to force through corporate restructuring measures that would lead to large layoffs.

The decentralized approach suffers in many East Asian countries from ownership links between banks and corporations, weakly capitalized banks, and disincentives to deep restructuring. In Korea the many relationships between entities has hampered the resolution of financial distress for corporations and financial institutions (see figure 3). Such relationships are also prevalent in Malaysia and Thailand.

Despite several rounds of recapitalization, banks in all four crisis countries remain undercapitalized because of their nonperforming loan portfolios. Coordination problems among creditors remain large, delaying restructuring. Furthermore, many creditors are weakly capitalized (Indonesia, Thailand) or face poor incentives (many banks in Korea are government owned, and banks in Thailand have extensive links with corporations). Moreover, it is questionable whether banks will be strong enough relative to corporations. Because of the social and political consequences of enterprise restructuring, and "too big to fail" arguments, banks may be unable to hold their own, especially against the large conglomerates in Korea.

Finally, the incentive framework in which banks and corporations operate remains weak. Rules for loan loss provisions, loan classification criteria, and disclosure still allow banks to carry nonperforming loans. And bankruptcy systems are too weak to force borrowers to come to the table with good restructuring proposals.

BOX 2 JAPAN'S APPROACH TO RESOLVING ITS BANKING CRISIS—COSTLY AND DRAWN OUT

The Japanese banking problem started in the late 1980s, when deregulation allowed large corporations to switch from bank to capital market financing, eroding banks' profitability. Having lost their low-risk customers, and aided by lax regulation and extensive deposit guarantees, banks aggressively expanded into real estate (which rose from 15 to 35 percent of total lending in 1970–88). Fueled by bank funds, real estate and stock markets expanded rapidly until 1990, when the collapse of real estate and equity prices turned many loans nonperforming and reduced banks' capital positions.

Financial sector restructuring. The government was slow to address the problem in any comprehensive way. In 1992 it relied on assisted mergers and explicit forbearance to cope with bank losses, hoping for quick recovery of the economy and the real estate market. As small financial institutions and savings and loan companies showed signs of acute distress—partly as a result of gambling to recover losses—the government followed with a ten-year "rehabilitation" plan, predicated on a recovery of land prices. But land prices failed to recover, and nonperforming loans continued to grow in size and number.

The government tried a new approach in 1994–95. It closed some credit cooperatives and savings and loan companies. It also created an asset management company, which ended up warehousing the assets of failed credit cooperatives rather than disposing of them. Facing growing international pressures, the government introduced legislative reforms, limited the operations of weak financial institutions, and strengthened the deposit insurance scheme. But it left accounting rules and the supervisory framework unchanged.

The government continued to expect that banks could grow out of their problems by widening their interest spreads, thus taxing depositors and borrowers for the recapitalization costs. But several more banks failed, prompting the government to extend an unlimited guarantee on all deposits in 1996. In 1997 several prominent securities companies failed, requiring significant liquidity support from the Bank of Japan. Only in early 1998 did the government pass emergency measures, making more public funds available, creating a framework to resolve banking problems, requiring banks to recognize bad loans, and removing tax barriers to workouts.

Corporate restructuring. For much of this period financial institutions with weak capital positions avoided making loan loss provisions or writing off loans and did not force corporate restructuring. Moreover, they lacked many of the tools for dealing with debt restructuring expeditiously (including insolvency laws). Their usual practice was to stretch out maturities and carry loans indefinitely. The web of relationships between core shareholders and main customers ensured that aggressive collection efforts remained rare. Very low interest rates reduced the costs of carrying nonperforming loans, which continued to be concealed. Existing corporate management generally remained in place, no matter how inefficient, and nonviable corporations even received new money.

Only recently have large firms, having faced massive losses in 1998, started significant efforts to restructure, while temporary special loan guarantees have given small firms some breathing room. As a result of banks' improved capital positions and stronger accounting rules and regulations, bank-led informal reorganizations have also picked up recently. While these are encouraging signs, many reforms remain to be undertaken, including overhauling the bankruptcy codes.

Hopes for recovery pinned on growth. Following the collapse of the asset price bubble in 1990, Japan's GDP growth averaged only 1.5 percent a year, compared with 4.5 percent during the previous decade. The authorities' strategy for banking sector recovery was predicated on a resumption of growth that would restore banks and borrowers to financial strength. Yet despite large and repeated fiscal stimulus packages (which boosted gross public debt from 70 percent of GDP in 1990 to 120 percent in 1999) and a loose monetary policy (with overnight rates at 0 percent), durable growth has yet to occur.

Source: International Monetary Fund 1998.

To speed restructuring, countries are trying to enhance the decentralized approach, including by making out-of-court systems more demanding. But such steps may not suffice, and some can create their own risks. Thailand, for example, is encouraging banks to set up private asset management companies, some managed by independent advisers. But private asset management companies can be a mixed blessing. Transferring loans to an asset management company does nothing to strengthen banks' capital position, and it can allow banks to hide losses by using above-market prices for the loans.

The resurgence of growth now under way in some East Asian countries may fade once initial inventory rebuilding and recovery of consumer demand have run their course. And a combination of high growth and continued low interest rates is unlikely when demand for investment funds rises again. The Japanese experience shows that a growth-oriented strategy is risky when bank and corporate distress are systemic (box 2).

All this suggests that the financial restructuring strategies being pursued by the East Asian crisis economies are unlikely to bring deeper financial restructuring and institutional reform. Moreover, the barriers to achieving these goals remain—the concentration of corporate control in the hands of a few families, the strong political connections of these families, and the extensive links between banks, nonbank financial institutions, and corporations. The risks are high of a stalemate and a situation similar to that in Japan—where banks continue to carry nonperforming loans and corporations delay needed structural adjustments while the government tries and fails to reinvigorate growth through fiscal stimulus.

Making growth last—three additional steps

East Asian governments need to consider three additional steps to accelerate and deepen the restructuring process:

- Specialized investment funds to break the links between interested parties.
- An auction process to deal with the nonperforming loans of small corporations.
- Employee ownership to reduce workers' resistance to, and thus to accelerate, restructuring.

Specialized investment funds

Viable corporate financial restructuring will have to involve debt-equity swaps in which banks acquire shares of corporations. That puts a heavy burden on banks, which lack the technical capacity to deal with large-scale restructuring of corporations and corporate debt. If banks end up holding the converted equity—which would be necessary in some countries to ensure viable corporations—they will become unstable and more akin to mutual funds.

To relieve banks of these problems and facilitate restructuring, a government could create a class of specialized investment funds. These could be privately managed (with a mix of domestic and foreign management), venture capital–like funds, possibly organized by industry, and established explicitly to buy nonperforming loans, restructure distressed assets, and manage the converted equity. Equity shares already held by banks could also be transferred to them. The funds would be owned by the government, with financing possibly coming from the banks as well. Their managers would work under performance contracts whose payout depends on the valuation of the assets under management at a final, future date (for example, three years away).

These funds would differ from most asset management companies in three ways. First, they would focus on corporate restructuring, including taking control of corporations when warranted. Second, they would be managed by the private sector, with a mix of domestic and foreign management. Third, governments could create several of these vehicles, which could then compete for the purchase of nonperforming loans from banks.

Competition and early involvement. The funds could compete in buying nonperforming assets

from financial institutions and would provide for a transparent process of taking assets off banks' balance sheets. To accelerate and deepen corporate restructuring, the funds would participate early in the restructuring process to help shape the deal and give the banks the advantage of investors' specialized restructuring skills.

A fund would participate directly in the workout process between banks and a corporation, negotiating as a potential equity investor in the restructured corporation. It would take over part of the corporation's bank loans and swap claims for equity, leaving the banks to lengthen maturities and provide some interest relief and working capital. Banks would not engage in debt-equity swaps.

Having the fund enter the negotiations at the same time as the banks would improve the prospects for viable restructuring deals, as the fund would be under pressure to earn realistic, risk-adjusted rates of return. It could also enhance the banks' negotiating power by making debt relief and debt-equity swaps available at the same time as debt restructuring and new money.

Transfer prices and values would be determined in negotiations between the banks and the fund in competition with other funds and other investors. The banks would be recapitalized by the government based on a fixed portion (say, 75 percent) of their losses. This approach would thus link government support for bank recapitalization to explicit progress in corporate debt restructuring and make transparent the losses incurred by the banks in achieving the restructuring.

After an initial period the funds could be allowed to trade shares in corporations with one another in an over-the-counter market. Later, shares of the funds themselves could be traded. The structure of the funds, as privately managed but publicly owned entities, would allow assets to be recycled to the general public over time. One model for selling assets back to the public is the Hong Kong model of disposing assets acquired during a period of market support. Another is distribution to the general public of shares in the funds; this would create a market for the funds that could provide signals for adjusting the performance contracts of fund managers.

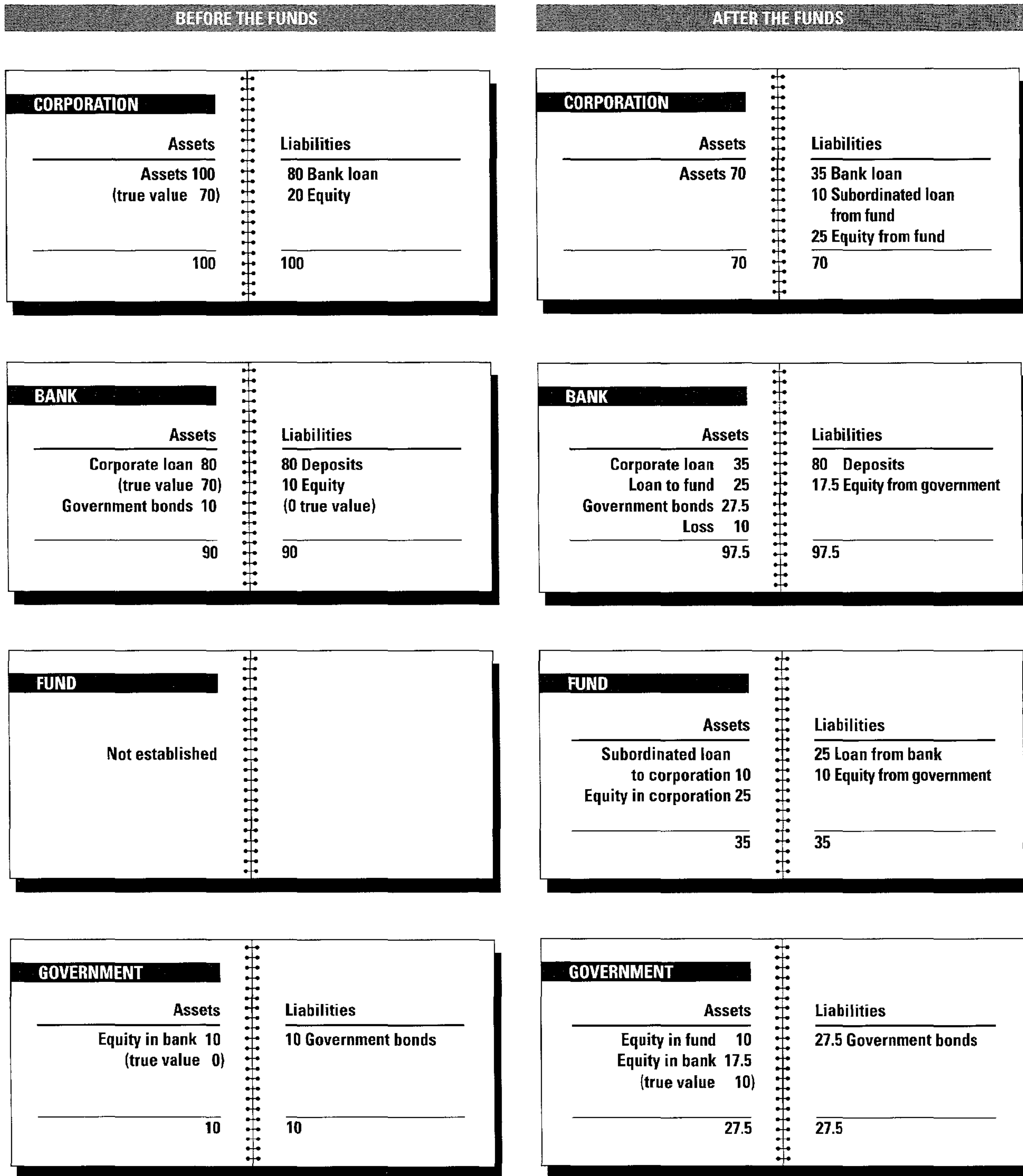
The fund in action. Consider the following example. A corporation has US$80 in a bank loan but a market value of assets (present value of salable assets or future cash flows) of US$70—and thus a negative equity of US$10. As a consequence of the financial distress of its corporate borrower, the state-owned bank is undercapitalized: it has an outstanding loan of US$80 that is worth US$70, holds US$10 in government bonds, and has US$80 in deposit liabilities. Thus while its notional equity is US$10, its true value is zero (figure 4).

The fund now engages in three-party negotiations with the bank and the corporation, reaching a debt restructuring agreement to be implemented in two steps. In the first step, to restore the corporation to financial viability, the bank loan is reduced to US$45, of which US$35 remains in the form of a bank loan and US$10 is exchanged for subordinated debt to the bank.[1] The bank then swaps US$35 of the remaining debt for a US$25 equity stake in the corporation and writes off US$10 by reporting a loss of this amount in its profit and loss statement.

In the next step the fund swaps a loan of US$25 for the bank's US$25 equity stake, and US$10 in government bonds for the bank's US$10 of subordinated debt. The liability side of the fund's balance sheet shows a debt obligation of US$25 to the bank and US$10 in equity owned by the government.

The government then compensates the bank for 75 percent of the writeoff of US$10 by injecting additional equity capital of US$7.5 in the form of government bonds. The government's balance sheet consequently shows a liability of US$27.5 (the US$10 in old bonds and US$17.5 in new). And it shows assets of US$17.5 (old and new capital in the bank, whose true value is US$7.5) and US$10 (the initial equity stake in the fund).

FIGURE 4 BALANCE SHEETS BEFORE AND AFTER THE FUNDS



Source: Claessens, Djankov, and Klingebiel 1999.

Auctions—another option for restructuring corporate debt

Auctions could also be used to facilitate debt restructuring (see La Porta and Lopez-de-Silanes 1999; and Hausch and Ramachandran forthcoming). They may be well suited for crisis-affected countries, where bankruptcy procedures are poorly developed. A market-based auction scheme would allow relatively easy conversion of debt to equity while preserving the firm's value as a going concern. Some variants of the scheme would leave the corporation in the hands of existing owners (and managers); others would transfer it to the owner most capable of maximizing its value. Using auctions could avoid the wasteful negotiations and delays often encountered in bankruptcy procedures.

An auction is probably best suited for small debtors with few creditors where speed is essential to preserve going-concern value and the costs of formal bankruptcy and reorganization are large relative to the claims being restructured.

A complementary step to reduce employee resistance

Participation by employees and other stakeholders can help facilitate financial restructuring. In a country moving from a pay-as-you-go pension system to a more fully funded, privately managed pension fund system, assets can be reprivatized by endowing the new private pension funds with some of the assets after they are worked out by the private managers. Or corporate assets can be swapped with employee retirement funds or accrued future staff benefit obligations.

Employee participation has broad attraction. It reduces resistance to changes in ownership, including foreign sales. It softens the fear of job losses and can reduce the risk of conflict between labor unions and management. Employee ownership aids the formation of equity in the economy and can help reduce corporate debt. Where equity markets are depressed, introducing or increasing the use of employee ownership schemes can increase the demand for shares. These features are particularly appealing during financial distress, when conflicts of interest between management, owners, and employees run high and external financing is hard to come by. In some countries governments may have to remove tax impediments to enable employee ownership plans.

The financial crisis in Chile in the early 1980s is one situation in which multiple stakeholders were invited into the ownership of distressed firms. The crisis had led to the nationalization of many financial institutions and corporations. The government undertook extensive financial reform and restructuring that involved reprivatization. Because the supply of private equity was limited, the government used innovative means to sell off nationalized assets. One approach was to set up funds to purchase assets of specific companies on behalf of the workers. The purchase price for the shares was raised through bank loans secured by the purchased assets and the deposit of additional shares received by the workers as compensation. Upon repayment of the bank loans, the funds were dissolved and the shares went directly to the workers.

In the United States employee ownership plans have often been used in restructuring specific firms. Up-front restructuring costs can be reduced by granting employees equity ownership in exchange for wage concessions and sometimes job cuts. In a well-known example United Airlines negotiated significant wage concessions in return for a majority equity stake for employees. By effectively communicating the benefits of the restructuring to investors and financial analysts, the company created additional shareholder value, enhanced the restructuring effort, and gave the capital market a positive view of its strategy (Gilson 1995).

[1] The exact amounts of debt reduction and new debt would be determined in the negotiations between the banks, borrower, and fund (or funds), possibly in competition with other investors.

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