

INTERNATIONAL FINANCIAL LAW REVIEW

The Asian financial crisis

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LEGAL REPORT

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Many factors have been identified by commentators as contributing to the end, or temporary suspension, of the Asian miracle. While there may be disagreement over the relative importance of each factor, there is now general consensus that lax regulations and financial practices in some Asian countries were aggravated by undisciplined borrowing by local corporate and financial institutions. An over-reliance on short-term debt left some economies vulnerable to a sudden loss of confidence, beginning with the downturn in Thailand's fortunes in mid-1997. Doubts about the commitment and ability of certain governments to implement necessary reforms increased pressures on currencies and stock markets. Despite national differences, the crisis spread.

As a result, many parties with interests in the region are now devoting significant time and energy to restructuring local companies and their liabilities. Because the circumstances involved in this financial collapse differ from those involved in previous Asian and Latin American crises, and because many of the participants do not have previous experience with restructurings of the magnitude that will be required, innovative solutions will inevitably be needed. However, possible solutions cannot be considered in isolation from necessary structural and regulatory reforms. Without significant change in the systems that allowed the slides to occur, it will be difficult to implement viable long-term restructuring plans for many debtors.

ORIGINS OF THE CRISIS

The difficulties now evident in Asia were in some respects facilitated by the region's success in attracting foreign investment. Almost US\$700 billion was lent to Asian companies between 1992 and 1997, primarily by financial institutions from Japan, Europe and North America. While much of the region's growth was fueled by

this investment, inadequate supervision of the activities financed by these capital flows and imprudent government intervention in capital allocation led to the investment of borrowed money in speculative ventures such as real estate – and in crowded industries such as microchip manufacturing. Lack of transparency – inadequate reporting of intercompany guarantees, transactions with affiliates and financial circumstances – obscured these poor investments, and combined with implied guarantees and pegged exchange rates they created incentives for resource misallocation and unsustainable external financing. These domestic distortions were exacerbated by the availability of undisciplined foreign lending that financed bad as well as good investments.

As the extent of short-term, unhedged debt came to light, market confidence began to collapse and the feared liquidity crisis became a reality. South Korea alone lost credit totalling as much as US\$20 billion in the last few months of 1997. Capital outflows, depreciating currencies and falling asset prices increased strains on private sector balance sheets, resulting in restricted credit and heightened financial fragility, which further undermined the real sector. Nowhere has this been more acutely felt than in Thailand, South Korea and Indonesia.

The contagion effect resulted in significant currency depreciation in Malaysia and the Philippines, and fundamentally sound domestic economies such as those of Singapore, Taiwan and Hong Kong have been adversely affected by the crisis. While some regional impact was expected, the problems were exacerbated by an inability to obtain reliable information on the financial condition of local financial institutions and other business enterprises, and by non-credible responses from regional leaders, which precipitated a nervous reaction in global currency and stock markets.

While Thailand, South Korea and Indonesia

face similar problems, their situations also differ in important ways that affect their options and their chances of successful restructurings. Thailand, for example, had an exceptionally large current account deficit (8% of GDP), while South Korea's was shrinking and Indonesia's was at a more manageable level (3% percent of GDP). The capital inflows were also often used differently, with the largest share of funds in South Korea flowing to the big 'chaebol' conglomerates, while in Indonesia they went to a large number of corporates with strong political connections, and in Thailand to speculative ventures such as real estate developments. In addition, these countries called in the IMF at different stages of their crisis and have demonstrated different approaches to implementing the packages of reforms and loans designed to stabilize their economies. While Thailand and South Korea have generally moved quickly to implement the requirements of the IMF and the demands of the international financial community, Indonesia has been less willing to take such decisive steps and its economy and currency have suffered accordingly. Notable differences exist in key areas of law such as bankruptcy, foreign ownership, foreign exchange, corporate takeovers and securities, and more generally in relation to the effectiveness and enforcement of those laws. Finally, cultural differences may be reflected in the willingness of individuals to accept personal sacrifice and in social stability. All of these differences are reflected in the various responses of the international investor community which has moved more rapidly in Thailand and South Korea, but continues to adopt a more cautious approach towards Indonesia.

NEED FOR PROMPT, INNOVATIVE SOLUTIONS

There are many lessons to be learned from Asia's rapid economic decline, but probably the most critical are the hazards associated with delay in implementing necessary structural reforms and with the need for innovative solutions. Unlike the Latin American debt crisis of the 1980s where the majority of the debt was owed by sovereign entities to other countries and to commercial banks, today's highly liquid and dispersed international financial markets are not suited to the three-pronged approach that was implemented then. This involved:

- negotiations between sovereign debtors and the IMF to implement a loan and restructuring programme;
- negotiations between sovereign debtors and sovereign creditors though the formalized Paris Club process; and

- renegotiation of the terms of sovereign or private sector financing with private international lenders through the informal London Club process.

Asia's previous debt crises were also different in that they mostly involved restructuring of asset-based companies such as real estate or shipping enterprises. Today's more complex transactions often finance corporate conglomerates and infrastructure projects, and include a wider variety of financing techniques and parties, including bondholders many of whom have not previously experienced a debt crisis. The solutions required are of a more sophisticated nature.

However, despite these complexities, prompt action is important. Delay in instituting necessary reforms risks further currency devaluations, and the continuation of the liquidity crisis limits the options of going concerns and jeopardizes their longer term viability. As the economic crisis worsens, the risk of a possible debt moratorium increases, along with social upheaval that may ultimately threaten regional security.

Some have therefore questioned the wisdom of negotiating first with Asian governmental authorities, rather than quickly bringing borrowers and creditors together and pressuring banking institutions to take losses, securitize bad debt and extend maturities to re-stimulate growth. South Korea, for example, has moved quickly to establish a restructuring programme to roll over short-term debt and has stabilized much more quickly than Indonesia where protracted negotiations and unfulfilled promises have virtually paralyzed the process. However, without such government-led programmes, the requisite stability for private sector restructuring would be impossible to achieve. The complexity of the problems facing many countries in Asia today are in many ways unique and require new approaches and innovative solutions.

RESTRUCTURING TECHNIQUES DEPENDENT ON STRUCTURAL REFORM

Consensual restructurings are generally more desirable than enforcing remedies since they usually cost less, they can be accomplished more quickly, they generally provide greater returns, and they are more conducive to maintaining long-term business relationships after the crisis ends. There are a variety of restructuring techniques that might be employed, either individually or in combination, based upon the specific situation.

These techniques include:

- asset sales;
- rescheduling debt amortization;
- securitization of distressed debt or assets;
- new money from financial or strategic investors;
- debt for equity swaps;
- segregation, or "ring-fencing", of specified assets to repay creditors;
- capital markets transactions, including issuing high yield, exchangeable or convertible securities, exchange offers and consent solicitations; and
- mergers and acquisitions.

While these options offer much promise, continuing currency and stock market volatility coupled with the urgent need for structural reform, continue to inhibit the more rapid development of private sector restructuring efforts. Parties are for the most part unable to value assets or build meaningful financial models, which are often prerequisites to successful restructurings. The recent, innovative purchase by ABN-AMRO of Thailand's Bank of Asia, where ABN-AMRO paid a provisional price of US\$190 million for a 75% controlling stake and agreed to postpone final valuation until the year 2000 due to the current market uncertainties, appears thus far not to have been imitated in other transactions.

Another barrier to the restructuring process is an apparent state of denial by many troubled companies. Such companies are rejecting viable solutions such as asset sales, mergers, or debt for equity swaps, or making unrealistic demands for premiums on the pre-crisis value of assets they wish to sell. This phenomenon may be exacerbated by the fact that many companies in Asia are family-owned, resulting in emotional responses or matters of 'face'. Until an effective bankruptcy law subjects these companies to possible reorganization or liquidation, these difficulties are unlikely to be resolved in the near future.

The restructuring process can also be impeded by the continued involvement of original lenders harbouring unrealistic expectations of recovery or yielding to unique pressures of their own. Differences in banks' internal costs of funds or country exposures, for example, can hinder a restructuring if the best course of action in the circumstances requires additional funding. For both debtors and creditors, the development of a distressed debt market would overcome at least some of these difficulties, as the holders of debt purchased in the secondary market would be less likely to be subject to these considerations.

Without the stability brought about by legal,

regulatory and structural reform, it will be difficult to move forward on restructuring at any level. Rebuilding the financial sector is particularly important to restore investor confidence, and fundamental reform of the corporate sector is required to improve transparency and to provide adequate tools to remedy corporate distress. There needs to be firm commitment on these institutional reforms to develop competitive market structures, sound regulatory regimes, price reforms, risk mitigation measures and effective financing mechanisms. To achieve these fundamental changes:

- the financial and corporate sectors must be better regulated, more transparent and adequately capitalized to regain the confidence of investors, both foreign and domestic;
- proper supervision of the financial sector must be instituted, especially regarding loan concentrations, leverage and capital, collection practices and the integrity of underwriting standards;
- the quality, quantity and consistency of the information that governments, financial institutions and financial regulators make available in the marketplace must be improved;
- governments must dismantle the nexus among bureaucracies, banks and big business, which precipitated too much lending based on borrowers' business or political connections rather than on creditworthiness;
- clear and consistent accounting standards must be instituted; and
- legal and regulatory reform needs to occur – revising takeover laws, foreign ownership laws and bankruptcy laws will provide the incentives and the tools to facilitate the restructuring process.

For these reasons, IMF bailouts and loans extended by the World Bank contain conditions demanding structural reforms tailored to the subject country's individual circumstances. Failure to comply with these conditions puts the availability of these loans at risk and could thus deepen the crisis faced by the recipient country.

IMF PROGRAMMES

The current crisis led to IMF bailouts of Thailand, Indonesia, and South Korea on terms that reflect their similarities as well as their differences. (Malaysia has rejected IMF assistance in order to maintain greater autonomy over its economic policies.) All three programmes have called for a substantial and immediate rise in interest rates to slow capital flight and currency depreciation, and for strong measures to stabilize each country's financial system quickly.

South Korea's programme for example involves rolling over short-term debt through a government-guaranteed, IMF-backed debt exchange programme, which has begun to inject much needed liquidity into the banking market. Weak banks and other financial institutions are being closed down and their good loans recouped, while others are being recapitalized and required to develop restructuring plans. These measures are carried out by government instrumentalities that bear some similarity to the Resolution Trust Corp. established in the US to deal with the savings and loan crisis of the 1980s. These countries are also required to comply, under differing time-frames, with internationally-accepted practices for capital adequacy standards, accounting and disclosure, and government interference in lending decisions and setting interest rates is being eliminated. Other institutional changes are also underway to strengthen the regulation and supervision of the financial sector and to improve corporate governance, accounting and public disclosure. The terms of the bailouts also demand increased transparency in the government sector, including enhanced competition through better trade access, and the removal of subsidies and other barriers to create a more level playing field for private sector activity and to open markets to foreign participants.

The main differences in the IMF structural reforms address each country's market weaknesses: for example South Korea is obliged to relax labour laws, Indonesia to remove subsidies on food, oil and utilities, and Thailand and Indonesia to implement new bankruptcy laws. Fiscal austerity programmes also vary from country to country. In each case a fiscal adjustment to cover the carrying costs of financial sector restructuring and to help restore a sustainable balance of payments has been implemented, largely by reducing public investment in projects with low economic returns. In Thailand, this translated into an initial reduction in expenditures of 3% of GDP; in Korea, 1.5% of GDP; and in Indonesia, 1% of GDP. To address the enormous foreign debt burden aggregating US\$74-US\$80 billion in the corporate sector of Indonesia, where the lending is much more dispersed than in other countries, the government is examining proposals based on the Ficorca programme that was successfully used by Mexico following its 1983 debt crisis. Under this programme businesses were allowed to stretch out payments, according to restructuring plans agreed with foreign creditors, by depositing debt payments in local currency into a government trust fund at certain exchange rates. In turn, the trust fund paid the foreign creditors in the required foreign currency, usually US dollars.

STATUS OF RESTRUCTURING PROCESS

It is apparent that restructuring is occurring most rapidly in South Korea, where the government has offered to guarantee certain obligations of its banks and merger and acquisition activity is underway. This progress results from the greater confidence in commercial institutions, which are perceived to be more transparent and otherwise more comparable to those found in developed economies, and from the rapid and decisive action taken by the government to stem capital flight and restore liquidity to financial markets. It has, for the most part, diligently adhered to the terms of its IMF loan and has instigated necessary structural reforms of the financial sector, including 'merge or die' programmes that have already pushed forward the restructuring of financial institutions. Importantly, South Korea has moved decisively towards legal reform that will speed up corporate restructurings, including introducing legislation that would allow hostile corporate takeovers.

Although Thailand may not have progressed as far as South Korea, it has seen some private sector activity as the government has moved rapidly to push financial institutions and corporates towards restructuring and urgently needed reforms. For example, under Thailand's former bankruptcy laws, liquidation was the only practical option for companies that were unable to pay their debts. Although weaknesses remain, particularly with respect to lengthy procedural delays, the new bankruptcy law permits a debtor to be reorganized under the supervision of a bankruptcy court, thereby encouraging restructuring of corporate debt. There are also signs of a movement towards pre-packaged bankruptcy proceedings, where before the bankruptcy filing, the parties to the action submit a restructuring plan to the court that has been agreed to by the debtor and sufficient creditors to override any dissenters. Finally, financial institution debt registration programmes, swift bank closures and mergers, and other government-led efforts may also contribute to the success of Thailand's debt restructuring efforts. Private investors are starting to examine opportunities created by the reforms and a distressed debt market is emerging.

Indonesia, however, is lagging behind in its reform and restructuring efforts, resulting in prolonged currency and stock-market volatility and delayed private sector restructuring efforts. In the banking sector the government has tried to restore confidence in the local banking market by establishing a local bank deposit and credit guarantee programme, closing insolvent banks

and managing others under the Indonesian Bank Restructuring Agency (IBRA). Liberalization of foreign ownership restrictions for local banks has also been a positive step towards the many structural reforms necessary in Indonesia. Establishment of a steering committee of foreign debtors and efforts to establish Ficorca-style programme and debt registration requirements seem to indicate the government's willingness to tackle the burden of corporate indebtedness without resorting to bailouts. However, lack of an effective bankruptcy law and a reliable court system for enforcement has severely impeded restructuring efforts. While a new bankruptcy law will come into effect in August, with provisions covering both bankruptcy and restructuring, it remains unclear how effectively the law will be administered. Impediments to optimal restructuring tools such as debt for equity swaps are also impeded by provisions in Indonesia's company law. Mostly, however, Indonesia's stabilization efforts have been hampered by a lack of commitment to appropriate policy actions, exemplified by the widely criticized Exchange Board proposal. This has resulted in considerable market volatility making private sector restructuring near impossible. Without rapid remedial action the problems could escalate, with wider implications for the country, its immediate neighbours Singapore and Malaysia, and indeed the whole region's eventual return to economic stability. Indeed, at the time of writing, Indonesia is showing signs of social unrest.

CONCLUSION

The various countries affected by the crisis are in different stages of the restructuring process, reflecting their internal differences and the resultant confidence levels of the affected parties. Difficult and unpopular reforms have made

a decisive start on the longer term tasks of restructuring and regulating the financial sector and of increasing domestic competition and transparency across the region. Market confidence is returning to Thailand and South Korea. However, Indonesia is lagging significantly behind in almost all respects, and some commentators still believe that the worst may be yet to come for Malaysia and China. Delay seems to present the greatest risk for the region as the prospect of, for example, Indonesia's declining further or China's devaluing the renminbi, present significant dangers. Either event could significantly adversely affect neighbouring countries and reverse some of the progress that has already occurred.

Greater emphasis on implementing structural reforms will hasten the process of restructuring and precipitate a return to economic health in the region. It is tempting in times of crisis to overlook the fact that the most important elements of Asia's past development achievements remain largely in place. High savings, a commitment to education and technological progress and an outward orientation provide a solid foundation for economic recovery. However, lack of transparency, an absence of clear, consistent bankruptcy legislation and resistance to foreign intervention will be the main impediments to corporate rehabilitation. Until these important structural reforms are realized, it will be difficult to bring together all of the parties necessary to achieve successful restructurings in many countries in the region.

(The author would like to express his appreciation to Susan Turner for her assistance in the preparation of this article.)