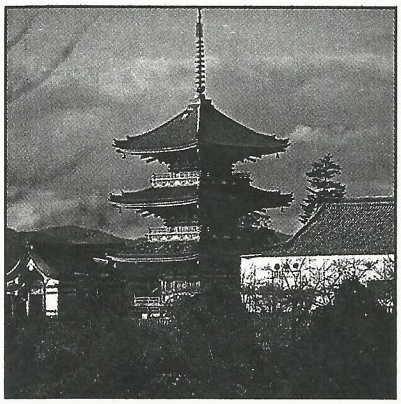
The regional impact of the Asian financial crisis



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The past year has seen significant progress in Asian countries affected by the financial crisis that began with the devaluation of the Thai Baht in 1997. Although many Asian economies remain in recession, with significant amounts of foreign currency debt impeding recovery efforts, currencies have generally stabilized and a potentially more attractive investment climate has returned. This article discusses the primary developments over the past year, with particular emphasis on financial sector reforms, securitization, corporate debt restructuring and bankruptcy law reform.

OVERVIEW OF DEVELOPMENTS IN THE PAST YEAR

Most of the affected countries in the region have generally acknowledged the need for legal and structural reform. The types of reforms vary from country to country, as do their pace and effects on the local economies. However, it is perhaps a sign of a bottoming-out of the crisis that both Moody's and Fitch IBCA upgraded their ratings of Indonesia, Korea, Malaysia and Thailand in mid-1999.

Korea has made the greatest progress in reforming its business practices and related legal framework and institutions. The Korean government has tightened accounting rules to improve transparency, loosened regulations to facilitate inbound foreign investment and strengthened the rights of minority shareholders. Also, the relationship between the government and Korea's business conglomerates, or chaebol, has weakened. Subsidies and government-directed lending previously enabled chaebol to expand into areas that could not be justified by domestic or export-oriented demand, resulting in excess capacity in several industries. The downturn and resulting government action has resulted in increasing rationalization in production. Although Korea's banking system remains weak, the government has taken positive steps to implement reforms. These include establishing the Korea Asset Management Corporation (KAMCO) to acquire non-performing loans and launching debt exchange programmes to convert short-term bank debt into longer term debt backed by a government guarantee. Cross-guarantees are also being eliminated and internationally accepted accounting standards are being enforced.

Thailand has also taken significant steps. The Thai government has closed down insolvent finance companies and banks and is selling their bad loans, in addition to consolidating and introducing recapitalization programmes for some of the weaker banks. It has also helped facilitate the restructuring of private-sector debt for the larger Thai companies requiring recapitalization, and some state-owned enterprises have been identified for prompt privatization.

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In addition, the government has introduced legislation that would strengthen bankruptcy and foreclosure laws and further liberalize foreign investment regulations.

Malaysia was perceived last year as abandoning free market orthodoxy when it imposed capital and exchange controls. However, some commentators believe that Malaysia's credit quality is currently understated because of negative perceptions of these controls, especially since expected abuses of monetary policy never materialized. Pengurusan Danaharta Nasional Bhd, the asset management company created to acquire non-performing loans from the banking system, has made significant progress and is viewed as transparent and open to investors. Furthermore, bankruptcy laws were already much more developed in Malaysia than in its neighboring countries when the Asian financial crisis hit. By establishing Pengurusan Danaharta Nasional Bhd and Danamodal Nasional Bhd, a special-purpose vehicle to recapitalize financial institutions, the government had moved to contain the banking system's asset quality problem.

Indonesia has been the slowest in the region to implement change, leaving reforms of the banking sector and the judicial system still incomplete. Although the government set up the Indonesian Bank Restructuring Agency (IBRA) over a year ago, for example, bank closings and recapitalization plans continue to be delayed. Corporate restructuring also remains a fundamental problem. At the date of writing, the only large restructurings that have been publicly reported have been for Danareska, a state-owned securities firm, and Ariawest, a telecommunications enterprise. There are initiatives under way, such as the Jakarta Initiative, to move Indonesia's companies toward restructuring discussions, but progress has been weak. One of the biggest disappointments has been with the results of the attempts to reform the bankruptcy law. With encouragement and assistance from the International Monetary Fund, Indonesia revised its bankruptcy law and established a new Commercial Court for handling bankruptcies and reorganizations. However, the Court has in practice tended to rule in favour of debtors in cases criticized by the international legal and financial community. The lack of a credible legal alternative has failed to provide the necessary sanctions to propel debtors to the negotiating table and thus has severely hampered the progress of consensual restructurings.

Concerns remain about the region's two biggest economies, Japan and China. Japan is entering its ninth year of recession, and China appears poised to follow. Bad debts in China may amount to as much as $500 billion. The default and abrupt closure of Guangdong International Trust & Investment Corporation (GITIC) in October 1998 with $4.37 billion of debt was a dramatic indication of the scope of the problem. All the elements that precipitated the Asian financial crisis – an interventionist government, weak credit policies, policy-directed lending, lack of transparency and an uncertain legal system – are present in China. Following the GITIC meltdown, Chinese authorities took rapid action aimed at reassuring the international investor community, including establishing an asset management company and streamlining the central bank's regional organization. However, the general credit squeeze has now worsened and, when coupled with continued restructuring of state-owned businesses and increased competition from regional experts, it may ultimately lead to devaluation of the Renminbi.

FINANCIAL SECTOR REFORMS

The paralysis afflicting Asia's financial markets through much of 1998 has now begun to ease, although there is still a long way to go before pre-crisis levels of liquidity return. Essentially sound companies have found themselves held back by the severe credit squeeze that hampers their ability to trade out of the crisis. Until the corporate debt overhang is resolved, insolvent banks and financial institutions are purged from the system and salvable ones are recapitalized, the capital flows necessary to fund recovery in the region will remain elusive.

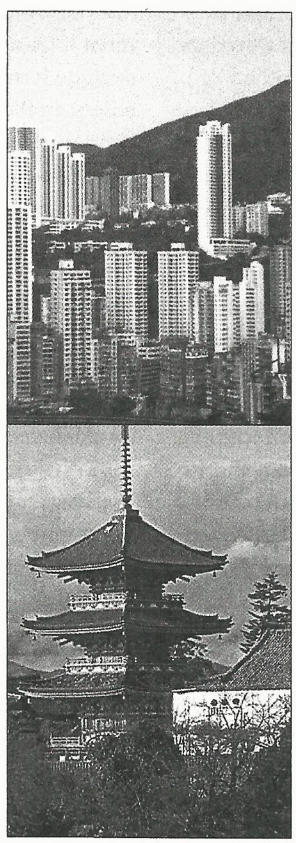
A key problem facing the region's domestic banks and the overall reform plan is determining the true amount of non-performing loans. There has been a consistent tendency to underestimate such loans, hindering efforts to structure appropriate recovery plans for the banking sector. Korea has probably gone furthest towards a successful restructuring of its banking industry, but analysts remain concerned that the Financial Supervisory Board's estimate of only 7.4% of loans as non-performing could escalate to more than 20%. The Korea Asset Management Corporation was established to acquire the sector's non-performing loans, and the new Financial Supervisory Commission has taken steps to eliminate the policy of government-directed lending. Some government guidance still exists to support loans to small- and medium-size businesses, but it is being phased out as the economy recovers. However, potential foreign investors have remained cautious of the threat of hidden bad loans, delaying discussed takeovers that would inject much needed capital.

Thailand has also instituted an aggressive programme to reorganize and recapitalise its banking sector. The Ministry of Finance and the Bank of Thailand have instituted new standards and regulations to provide better monitoring and guidance of the financial institutions, including standards for recognizing non-performing loans. Importantly, banks will be required to pursue borrowers who can pay but simply do not. There is also a more open climate for foreign investment. Temporary measures were passed to allow for greater foreign ownership of financial institutions to facilitate the recapitalization of banks and finance companies.

In its most resolute step to date towards rehabilitating its banking sector, in March 1999 the Indonesian Government closed 38 banks, took over a further seven and agreed to offer financial assistance to another nine. The government also reached agreement to restructure around $7 billion in debt owed by Indonesia banks to foreign bank creditors, $3.8 billion of which is under a debt exchange agreement that exchanges bank debt maturing between April 1 1999 and December 31 2001 into new loans guaranteed by the Indonesian central bank. Under a similar arrangement last November, foreign banks exchanged around $2.7 billion of eligible foreign debt for new loans guaranteed by the central bank. Although the bulk of foreign debt remains to be addressed, such developments have led to cautious optimism from the international investor community.

SECURITIZATION

The need for new capital has made asset-backed securitization and mortgage-backed securitization attractive alternatives for banks and other financial institutions. It has been projected that asset-backed securities may more than double in Asia this year to US$2 billion, as compared with approximately US$752.5 million for 1998. The increase is likely to come mainly from Hong Kong and South Korea, although evolving laws and regulations in other countries are increasingly more conducive to securitization transactions as well.



Asset-backed securitization is gaining a solid footing in Korea. With a new asset-backed securities (ABS) law in place and the economy now on an upswing, interest in securitization is growing. Recent global transactions include a $697 million CLO for the Export-Import Bank of Korea in December 1998 and a $106 million CBO/CLO for the Industrial Bank of Korea in February 1999. The domestic markets are even more robust. The passage in September 1998 of the Act on Asset-Backed Securitization was key for domestic ABS. The law established rules for setting up a special purpose entity and conditions for the true sale of assets, and it was passed with tax incentives to encourage securitization. Currently, only financial institutions, certain governmental entities, and top-tier corporations are allowed to securitize, but that list is expected to expand. Several elements render domestic securitization an attractive option in Korea. Domestic investment trusts, insurance companies and pension funds are extremely liquid, and most are restricted to investing in highly-rated securities. The government's decision in late 1998 to limit institutional investors' extensions of credit to the chaebol will add to the market interest in issues by smaller companies, especially highly-rated ABS issues. Finally, issuers are more likely to securitize their won-denominated receivables locally than globally, since obtaining a won-dollar swap would be difficult under current market conditions. Conversely, there are also many pitfalls to counter the current enthusiasm for securitization in Korea. One reason that domestic issuance has taken off so quickly relative to global issuance is that domestic securitizations generally do not meet international standards. For example, the true sale conditions are weak, and the law does not require trustees or backup servicers. There is also the danger that the assets being securitized are non-performing and that their low-grade is disguised by guarantees that cannot be honored.

While lagging behind Korea, other Asian countries have also begun to develop their own securitization markets. In Thailand in May 1999 Lehman Brothers Holdings completed STaRS (Senior Tradable Residential-backed Securities), the first mortgage receivables securitization in Thailand. The securities are collateralized by interests in approximately 6,800 residential mortgages that Lehman Brothers acquired from the Thai Financial Restructuring Authority. STaRS could add significant momentum to the Thai structured finance market as it introduces recent securitization financing technology, adapted to meet Thai market and regulatory considerations. In the Philippines, the Philippine Stock Exchange in May 1999 approved for the trading of securitized debts instruments in the secondary market. Following suit, Malaysia is also seeking to encourage more securitization transactions. Bank Negara, Malaysia's central bank, announced in May that it will soon issue securitization guidelines to clarify the regulatory and supervisory treatment of asset-backed deals. Although these guidelines are meant to launch securitization in Malaysia, they are likely to be very general. Much would still depend on the central bank, which in the future will issue administrative measures regarding types of assets that can be securitized and what sort of debt securities can be issued by a special-purpose issuer. And in fact, these announcements represent a reversal by Bank Negara, which until recently was decidedly unsupportive of securitization ➡

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Not everyone sees securitization in Asia as a positive development. Securitizations in mature markets like Europe and the United States generally use underlying assets that are good assets, such as prime real estate or loans with proven records of cash flow. But in Asia, more often than not bad debts are being packaged with a government guarantee, constituting a government bailout. Weak bankruptcy laws in many countries, reducing or eliminating effective legal recourse against the underlying obligors, exacerbate the problem by increasing the risk of non-payment.

CORPORATE DEBT RESTRUCTURING

Consensual debt restructuring is obviously a preferable alternative to legal proceedings. It is generally faster, less expensive and more likely to result in higher returns than enforcement or liquidation proceedings. However, progress is often hampered by stubborn, unrealistic or inexperienced creditors or (more frequently) debtors. The lack of effective legal recourse can sometimes enable recalcitrant debtors to play a waiting game unless they need cash or value their reputation in the international capital markets.

Korea's situation is illustrative of the dangers of restructuring debt in an uncertain legal climate. In response to state pressure and threats by domestic banks that defaulting debtors will be forced into bankruptcy, Korea's chaebol plan to undertake restructuring to reduce their debt/equity ratio to 200 percent by the end of 1999. To meet this debt reduction target, the chaebol are likely to seek concessions from creditors, including debt-for-equity swaps and debt restructuring. As good companies with strong cashflows and earnings have little incentive to convert debt to equity, some predict that the banks will be left holding the worst stocks. With relatively weak bankruptcy laws still on the books, creditors may have few options other than to comply. More loans are expected to go bad as companies, receiving new capital under a restructuring programme, fail nonetheless. Domestic banks last year agreed to forebear from foreclosing on bad loans for companies suffering from short-term cashflow problems due to the economic recession, in the hope that they would quickly recover. However Korea's Financial Supervisory Board now concedes that some of these companies are still likely to fail, worsening the problems at some of the biggest banks such as Korea First, Chohung, SeoulBank, Korea Exchange and Hanvit, which had concentrated on lending to the corporate sector.

Corporate debt restructuring remains one of the key factors influencing the pace of economic recovery in Thailand. The Corporate Debt Restructuring Advisory Committee (CDRAC), established in October 1998, has reported 75 cases of successful restructuring involving aggregate debt of $4.6 billion. The amount of debt being handled by the 98 advisers approved by CDRAC totals $36 billion, as compared with non-performing loans of about $72.5 billion in January of 1999. Unsatisfied with this progress, Thailand has developed a programme of carrots and sticks to speed the process along. Thai financial authorities announced in May 1999 measures to encourage heavily indebted companies to reach agreement with their bankers. A total of 667 have enrolled in a central bank-sponsored debt restructuring mediation programme, attracted by tax incentives and central bank assistance in helping them to avoid court proceedings. In addition, the Stock Exchange of Thailand (SET) issued an ultimatum to financially troubled listed companies to speed up and complete rehabilitation and restructuring, or face delisting, and it threatened to blacklist the companies' executives. There are currently 51 listed companies classified under REHABCO, the entity charged with grouping together companies that are financially distressed and in need of rehabilitation, among which the best known and most closely watched are Alphatec Electronics, NTS Steel, Thai Modern Plastic and Thai Nam Plastic. The SET has also eased key regulations in order to facilitate debt restructuring for the troubled companies. Back door listing is allowed when the non-listed company is engaged in a business which is related to the company it is taking over, or when the business is deemed "beneficial to the country's economic development". Another relaxation of rules permits companies to exclude losses from the computation of shareholders' equity to the extent they result from debt restructuring, particularly when a debt-for-equity swap is involved. Debt-for-equity swaps have in fact been integral to the debt restructurings for several Thai firms, including United Communication Industry, Srithai Superware and Land and House. It is perhaps noteworthy that nearly all of the progress in restructuring so far has involved firms that are potentially viable but need more credit to operate – a powerful incentive to negotiate. As of mid-1999 there has been only one key restructuring agreement – for Alphatec – resulting from insolvency proceedings having been filed by creditors.

Despite grand gestures, there is less enthusiasm over the steps being taken in Indonesia. The structural weaknesses in Indonesia's financial and legal system have been highlighted by the remarkable lack of progress on restructuring the country's estimated US$80 billion of corporate debt. With few exceptions, debtors have been able to ignore the demands of creditors with little fear of sanction. Continued political uncertainty has resulted in a lack of real commitment to reform. Nevertheless, some progress is being made. Two important successful restructurings have occurred this year, and negotiations towards a consensual restructuring of conglomerates such as Astra International are well advanced. The Indonesian Finance Ministry reported earlier in 1999 that $11 billion of bad debt is under discussion between companies and their creditors. Launched in November last year, the Jakarta Initiative is aimed at bringing creditors and debtors to the negotiating table and finding solutions to debt problems. Urged by the IMF, the Indonesian government is also formulating a pattern of corporate governance through the Jakarta Initiative. In the latest agreement with the IMF, the government pledged to strengthen the regulatory framework to encourage corporate restructuring. It has also stated that new legislation addressing the current uncertainty faced by lenders providing working capital to restructuring corporates will be enacted. More recently, IBRA has shown signs of flexing its new found strength and has published a list of the worst debtors of domestic banks, promising tougher measures if they fail to reach a loan recovery plan by the end of June. Although to date there has been little to show for it, it remains to be seen whether such initiatives will yield substantial results if political stability returns. At the time of writing, apparently free and unfettered elections have just concluded and there is cautious optimism that a truly democratic result will emerge. Markets have responded positively to the news and many are foreseeing a concomitant rise in confidence in the country's economic recovery and its commitment to necessary reforms.

BANKRUPTCY LAW REFORM

Creditors have often been extremely frustrated in their attempts in several countries to obtain legal redress in bankruptcy or rehabilitation proceedings. Not only is there a feeling of intrinsic unfairness in the process, but the lack of a credible legal threat can be a powerful weapon for a recalcitrant debtor. Fitch IBCA has noted that the Korean and Malaysian systems have been more effective than those of Thailand and Indonesia. Foreclosure and disposal of collateral in Korea is both relatively straightforward and timely. While there had been some doubts about the effectiveness of Malaysia's bankruptcy laws, subsequent amendments to the legislation have largely allayed concerns. In Thailand and Indonesia, the lack of effective proceedings required rewriting the laws. Both countries have now passed new bankruptcy and foreclosure laws.

The process in Thailand has been slow. So far, most of the big restructuring agreements have been reached out of court with creditors persuading debtors to restructure with the carrot of additional financing rather than the stick of legal action. Described as a country where keeping creditors at bay has become a national sport, the stigma of bankruptcy has been a hurdle in debates over the reforms as well as whether personal guarantees, often traditionally used to secure loans in Thailand, could be called upon under the bankruptcy regime. However, the new bankruptcy and foreclosure laws should encourage debtors to enter negotiations with creditors. These reforms establish, among other things, minimum amounts of debt required for a creditor to bring bankruptcy proceedings, clear voting requirements, and protection of the rights of creditors who give new money to insolvent businesses for the purpose of continuation of operations. Continued effort at forcing those that can pay to meet their obligations will be necessary to overcome the current tendency to ignore creditors. The Bank of Thailand reported that over 100,000 debtors whose debts range from Bt200,000 to Bt500,000 could not repay their loans. The ranges of Bt500,000 to Bt1 million and Bt1 million to Bt5 million loans have a similar number, and there are about 350,000 bad debtors in all three ranges.

Indonesia is also slowly grappling with revising its bankruptcy laws. The 1998 amendments to the bankruptcy law are aimed at making the law better able to accommodate the latest developments in business and to improve the transparency of bankruptcy proceedings. Although these changes were intended to address the concerns of creditors, debtors and the general public over the shortcomings of both the bankruptcy law and the Commercial Court, there is continuing dissatisfaction with the performance of judicial resolution of bankruptcies and there is little confidence in the judiciary that unbiased outcomes will result. The recent Dharmala test case is illustrative, where the court found that the failure to pay accelerated debt of approximately $52 million was not eligible debt under the bankruptcy law because it was not "due and payable", a decision upheld on appeal. This decision has been met with widespread dismay among foreign creditors. Some contend that the Commercial Court will not improve unless the government is willing to undertake a comprehensive overhaul of the judicial system. There remains the fear of a possible nationalistic backlash against the bankruptcy law, with many Indonesian businesses seeing effective insolvency proceedings as selling out national interests to foreigners.

CONCLUSION

Each of the countries caught by the Asian financial crisis has travelled its own path to reform and at its own pace. Although progress is evident, much improvement, especially in the case of Indonesia, is still required. Furthermore, China is now looming as the next possible source of financial pressure in the region. While all can wish for a speedy economic recovery, one hopes that it will not come at the expense of the completion of the necessary structural and legal reforms.