EAST ASIA UPDATE

Progress on Financial and Corporate Restructuring

THE WORLD BANK
East Asia and Pacific Region
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EAST ASIA UPDATE

Progress on Financial and Corporate Restructuring

This paper was prepared by Swati Ghosh, Lead Economist, East Asia PREM, drawing on inputs from country economists and sector specialists in the region. The paper benefited from advice from Amar Bhattacharya, Senior Adviser, PREM Vice Presidency, and was prepared under the general guidance of Homi Kharas, Chief Economist of the East Asia and Pacific Region.
INTRODUCTION

Growth in East Asia, including that of the crisis-affected countries has strengthened progressively—despite the magnitude of the shocks experienced during the financial crisis and their effects on the balance sheets of financial institutions and corporates. Growth of the crisis-affected countries was around 7.1 percent during 1999-2000, and although growth slowed in 2001 (to 3.5 for the region as a whole and 2.7 percent in the East Asia 5 countries), primarily due to adverse conditions in the external environment, it has since gained ground. For 2002, growth in the crisis-affected countries is expected to average 4.8 percent\(^1\).

Progress on financial and corporate restructuring has contributed to the consolidation of growth. Indeed, countries which have made the most progress on corporate and financial sector restructuring, notably Korea and Malaysia—have experienced the strongest growth performance since the crisis. However, growth has not been sufficient to redress the problems in the balance sheets of financial and corporate sectors. Although progress has been made in reducing vulnerabilities, especially in the banking sector, progress on corporate restructuring has been slower and more uneven across countries. In most counties, debt-to-equity ratios remain high relative to international norms and continue to pose a threat in the event of a major shock.

A sustained effort is needed to complete the corporate and financial sector restructuring agenda, especially since the cases that remain are the more difficult ones. Such efforts are important not only to further reduce potential vulnerability in the kind of uncertain global economic environment we are witnessing today, but also to position East Asia for productivity-led growth that must be the basis for sustained improvements in income over the longer-term.

RESTRUCTURING AND REFORM

Financial sector developments in the crisis-affected countries

Overview

Although the initial conditions and specific approaches differed across countries, all the crisis–hit countries\(^2\) adopted similar policies that aimed at improving the structure of the financial sector and reducing its vulnerability. To prevent the collapse of the system, all countries provided a blanket deposit guarantee and liquidity support to financial institutions. Each country adopted some form of asset management strategy to address the non-performing loan problems, assigned a high priority to upgrading supervisory and regulatory standards to international best practice and sought to re-capitalise financial institutions based on those norms. In the process, bank closures or mergers programs were initiated to establish stronger financial systems. Also standards of governance were upgraded. Countries are now at different stages in terms of the progress made in each of these elements.

Asset quality and capital positions. Countries have made a great deal of deal of progress in stabilizing the financial sector and in reducing non-performing assets in financial institutions—

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\(^1\) East Asia includes China, Vietnam, four South East Asian nations (Indonesia, Malaysia, Philippines, Thailand), several small economies and four NIEs (Hong Kong (China), Korea, Singapore, Taiwan (China)).

\(^2\) The Philippines did not experience a systemic crisis during 1997-98.
thereby in principle strengthening the ability of these institutions to perform their financial intermediation role. As of June 2002, non-performing loans in financial institutions were under 15 percent of total loans in all countries, except for the Philippines (Table 1). And, with the exception of the Philippines, they have all been on a declining trend. The commercial banking sector has also started to see a return to profitability in most countries: with the exception of Thailand, average rates of return on assets and equity in the banking sector turned positive in 2001 (Table 2). Even in Thailand, where the average rates of return are still negative, there has been considerable improvement in banks’ profitability over the past three years and their pre-provision profits have become positive. Average capital-asset ratios are now sizably higher than the BIS-recommended ratio of 8 percent of risk-weighted assets in all countries.

Table 1. NPLs of Crisis-Affected Countries

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(a) First line uses “stringent” definition of NPL; second line excludes transfers to IBRA. (b) NPL figures use FLC since Dec 1999. (c) Includes commercial banks, finance companies, merchant banks, and Danaharta. (d) Refers to commercial banks. (e) First line includes commercial banks, finance companies, and estimated NPLs transferred to wholly-owned private AMCs. (f) NPL series used by BNM, which is net of provisions and excludes interest in suspense.

3 Data for August and September 2002 indicate that NPLs in the Philippines declined slightly, but it is too early to say whether this is a trend.

4 In the case of Thailand there has been some implicit forbearance on loan loss provisioning which has helped Thai banks meet the 8 percent capital adequacy ratio.
Table 2. Indicators of the health of the banking sector
(in percent)

|                | 1997    | 1998    | 1999    | 2000    | 2001    | Latest | available
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- These averages however mask considerable variation in performance across banks, especially in Indonesia and Thailand. In Indonesia, only two of the seven jointly recapitalized banks were able to meet the 8 percent capital-adequacy ratio at end-2001. In Thailand, while the largest Thai banks are likely to be able to earn enough over the next few years to fully provision for their losses on an economic basis, other banks remain under-provisioned and undercapitalized on an economic basis but were able to meet the capital regulatory requirement as a result of implicit forbearance regarding the valuation of restructured loans and collateral value.

- Also further progress remains to be made outside the commercial banking sector in all countries. Even in Korea, for instance, where the average NPL of the financial system was 4.2 percent of total loans at end June 2002—the proportion of NPLs in securities companies were as high as 45.9 percent of total loans (and the average NPL for the non-bank sector as whole was 10.4 percent of total loans). Similarly in
Malaysia, while the NPLs of commercial banks declined to under 10 percent\(^5\) of total loans in June 2002, NPLs of merchant banks stood at 26.6 percent\(^6\) of total loans.

- The level of total distressed assets\(^7\) remains high in several countries, reflecting on-going weaknesses in the corporate sector and the quality of the corporate restructuring (new and re-entry NPLs), as well as the pace of corporate restructuring—including, in some cases, slow progress in asset disposal in centralized AMCs. (see Corporate Restructuring section below). Such continued weaknesses in the corporate sector pose risks to the financial sector and to sustained economic growth in the region. For instance, in Thailand new and reentry NPLs continue to enter the system at a rate of about 7-8 percent while the NPL reduction to total loans (excluding transfers to AMCs and write-offs) has slowed from an annualized rate of 9 percent in 2001 to around 5.5 percent in 2002. Indonesia has the highest level of distressed assets at 48.5 percent of total loans (in mid-2002), followed by Thailand at just under 30 percent, and around 24-25 percent in the Philippines and Malaysia (Figure 1).\(^8\)

**Restructuring and consolidation.** Progress on the consolidation of the financial sector has continued, although again the extent has varied across countries. In Malaysia, the merger and acquisition phase of the banking sector was largely completed by end 2000. Much remains to be done, however, in terms of strategic plans and integration issues for each banking group. The authorities have also launched reform programs in the insurance and stock broking industries. In Korea too financial sector consolidation has gained momentum, with the government-led Woori Financial Holding Company, which comprises four weak commercial banks and a merchant bank, now fully operational. The Korean investment trust sector has also undergone significant restructuring, although the two largest companies—Korea Investment Trust Company and Daehan Investment Trust Company—continued to record depleted capital despite an injection of public funds totaling 7.9 trillion Won. In the Philippines, progress has been made over the past year in resolving two of the three most problematic banks.

Progress in the privatization of nationalized commercial banks also continues. In Korea, Hana Bank, officially selected as the preferred bidder for the sale of Seoul Bank in August 2002, finally signed a merger agreement with Seoul Bank the following month. Seoul Bank had been

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\(^5\) This figure, moreover, is net of provisions.

\(^6\) Net of provisions and excluding interest in suspense.

\(^7\) Distressed assets here are defined as non-performing loans on balance sheet, plus NPLs transferred to off-balance sheet AMCs.

\(^8\) Note that the gross NPL series for Malaysia is used in computing total distressed assets in Figure 1, and not the Bank Negara Malaysia series that is net of provisions.
nationalized in 1998 after the government injected 5.6 trillion Won of public funds into the bank. This deal is expected to imply further consolidation of the banks and bolster more competitiveness of domestic banks. While Indonesia is further behind, here too progress is being seen: the recapitalization of four state banks has been completed, although the Government’s strategy for these banks has not yet been fully articulated; IBRA’s equity stakes in the nationalized or BTO banks are being reduced with the recently completed sale of a 51 percent stake in BCA in March 2002, the re-launching of the majority sale of Bank Niaga, and the successful sale of Bank Bukopin, a jointly recapitalized bank.

Country details

Indonesia

Asset quality and capital positions. The reported NPL ratio of Indonesian commercial banks has fallen steadily from 40 percent at the end of 1998 to around 12 percent at the end of 2001, mainly reflecting loan write-downs and early asset reclassifications resulting from debt restructurings. However, serious concerns remain about the quality of the loan restructuring at recapitalized and state-owned banks. A Bank Indonesia survey disclosed instances of restructured loans that did not comply with the regulatory requirements for such treatment. Anecdotal evidence also suggests that banks may be restructuring loans so as to reverse prior loan-loss provisions. Such “cosmetic” restructuring would have the effect of easing pressure for corporate restructuring and delaying the debtor’s return to economic viability, thereby creating a large stock of “hidden” or “latent” NPLs.

Asset recovery. Although IBRA’s activities are central to stimulating economic recovery and supporting fiscal sustainability through the divestment of its huge loan and equity holdings (distressed loans held, as of mid-2002, amounted to Rp 262 trillion or about US$ 29.8 billion9), it had, until recently, disposed only about 14 percent of the face value of loans purchased10. In August 2002 though, IBRA announced its largest ever NPL (“big bang”) sale. About Rp 23 trillion is to be received for a face value of Rp 82 trillion offered—yielding a 28 percent recovery rate. However, while IBRA’s large loan sale initiative is new, its long standing corporate debt restructuring efforts have yielded little, as the sale of restructured loans have not been significantly enhanced vis a vis the sale of its un-restructured loans.

Restructuring and consolidation. Some progress has also been made in terms of the restructuring and consolidation of the banking sector. The recapitalization of four state banks (Bank Mandiri, BNI, BRI and BTN) has been completed, although neither the Government’s restructuring or divestment strategies for these banks have been fully articulated yet. An independent study of bank BTN was concluded in March and the government has decided to substantially restructure the housing bank. As for banks BNI and BRI, the Government will soon announce their divestment strategy, while the largest state owned bank, Mandiri, continues on its restructuring, ahead of its fourth quarter IPO launch.

There are four nationalized or BTO banks (BCA, Danamon, Bank Niaga and Bank Bali), in three of which (Danamon, Bank Niaga and Bank Bali) IBRA has 97-99 percent equity stakes.

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9 At an exchange rate of Rp 8,785/$.
10 IBRA possesses three types of assets: (i) AMC (Asset Management Credit)—managed loans and non-core assets transferred to IBRA from closed (or frozen) and re-capitalized banks; (ii) AMI (Asset Management Investment)—held rights to the assets (industrial and real estate assets) pledged to IBRA in settlement of outstanding liabilities; and (iii) BRU’s (Bank Restructuring Unit) equity assets in the banks owned by the government as a result of its bank re-capitalization program.
The Government completed its sale of a 51 percent stake in BCA in mid-March 2002, decreasing IBRA’s remaining equity stake from 60 percent to 9 percent. The Government has also re-launched the majority sale of Bank Niaga, which is expected to be fully concluded by early November. As the Bank Niaga sale is finalized, IBRA will seek Parliamentary approval to offer up a majority stake in Bank Danamon in the hope that the sale can be successfully closed during the first quarter of 2003.

IBRA’s equity stakes in the seven recapitalized banks (BII, Lippo, Universal, Bukopin, Prima Express, Artemedia and Patriot) range from 59 percent to 95 percent, and is on average 74 percent. Only two banks—Lippo and Bukopin—achieved an 8 percent CAR as of end-2001. Bank Bukopin was the first re-capitalized bank to have been successfully sold. As part of a recently concluded rights issue to further re-capitalize Bank Indonesia International (BII), a new management team was installed and its founding shareholders’ interest sharply diluted. Additionally, IBRA has engaged an experienced international project management team to merge Bank Bali (a BTO) with the operations of the four smallest capital deficient banks (Universal, Patriot, Artemedia and Prima Express) by the end of 2002. Concurrent with the completion of the Bank Danamon sale, the Government is set to launch a majority stake sale of Bank Lippo. If successful in the sale of Banks Niaga, Danamon and Lippo, the Government would be left with a majority stake only in the newly merged Bank Bali, Bank BII, and possibly with some residual minority interests in its other (sold) banks.

Bank regulation and supervision. Progress, albeit slow, also continues to be made in strengthening the central bank’s (BI) supervisory capacity. Work is ongoing to strengthen the full-time on-site supervision capacity in all larger banks, implement risk-based supervision and address the deficiencies related to the Basle Core Principles for Effective Supervision. Recent efforts at BI have also centered on improving the quality of data available to supervisors, and it has adopted an important new transparency ruling, requiring each bank to publish individual bank data on a regular basis. However, a sizeable agenda remains to bring bank supervision up to international standards.

Some advances have also been made on the establishment of a new independent consolidated supervisory agency (OJK: Financial Services Authority) to assume responsibility for the supervisory functions with respect to banks, capital markets, pension and insurance—currently undertaken separately by BI, BAPEPAM and the Ministry of Finance respectively. Comprehensive FSA legislation has been drafted and is currently being finalized in line with other efforts including the development of a new lender of last resort function and establishment of a new deposit insurance agency. Implementation will partly depend on how quickly the legislation is debated in Parliament and voted upon.

Medium-term strategy. Through the establishment of the Financial Sector Task Force in October 2001, the Minister of Finance has acknowledged the need to address the development of a comprehensive medium-term financial sector strategy. Key issues to be considered include: the future consolidation of the banking system; broadening access to financial services, including the role of rural financial intermediaries; the transition from the blanket guarantee to a sustainable deposit insurance scheme; the establishment of a Financial Supervisory Authority (FSA) to integrate and strengthen the current separate regulatory and supervisory regimes in banking, capital markets, insurance and pension sectors; and the development of a government bond market to improve both public finance and banks’ liquidity. Separate efforts have been on-going in each of these areas: what remains is to link each through a coherent plan.
Korea

Asset quality and capital positions. The NPLs of commercial and specialized banks fell to 2.4 percent at end June 2002 from 8 percent just a year ago. NPLs in the non-bank sector however remain relatively high at 10 percent of total loans as of June 2002—although here too there has been progress in reducing the ratio of NPLs over the past year. The NPL ratio for the financial system as a whole stood at 4.2 percent in mid-2002. The profitability and capital position of the Korean banking system has also continued to strengthen. As of March 2002, average bank capital stood at 11.6 percent of risk-weighted assets. The average rate of return on assets turned positive, while the rate of return on equity rose sharply in 2001. In the first half of 2002, moreover, the banking sector registered net profits of 4.05 trillion won, which was nearly equal to that for all of 2001. There is some concern, though, that a few of the state-owned banks with substantial corporate exposures have sometimes been unwilling to move on large problem borrowers and accept reductions in their claims. In addition, provisioning levels may not be adequate in the case of some of these large problem companies. As discussed below, notwithstanding the considerable progress Korea has made in corporate restructuring, an analysis of corporates’ interest coverage ratios at end-2001 suggests that a still sizable proportion of mainly larger corporates remain vulnerable and banks may be underestimating the potential risks.

Asset recovery. By August 2002, Won 157 trillion had been used for financial sector restructuring (through KAMCO and KDIC in purchasing NPLs, through the provision of capital to banks, and through deposit insurance payments.) Of the total, some Won 77 trillion was used for capital injections, 26 trillion for deposit insurance payments on behalf of bankrupt institutions, and the remaining 54 trillion for purchase of distressed assets. The Public Fund Oversight Committee (PFOC), together with the KDIC and KAMCO, endeavors to ensure that the injected funds are recovered by actively engaging in resale of assets, bankruptcy dividend payments, and damage claim rewards. As of August 2002, Won 50 trillion had been recovered.

Restructuring and consolidation. Financial sector consolidation has gained momentum. The government-led Woori Financial Holding Company, which comprises four weak commercial banks and a merchant bank, is now fully operational. Progress has been made in several areas: plans for consolidating information technologies among banks within the Company have been implemented, and its own consolidated AMC, which was established in November 2001, is operational. Peace Bank, a member bank, was transformed to a credit card company, and its banking business was transferred to Woori Bank, the largest member bank at end-2001. The first private financial holding company was also formed around Shinhan Bank in September 2001, and the nationalized Cheju Bank became a member bank, following the sale of 51 percent of its shares in early April. Finally, the consolidation of Kookmin Bank and Housing & Commercial Bank has been completed.

A key issue facing Korea with regard to the restructuring and consolidation agenda is the need to press ahead with the sale of the government’s shares in nationalized banks. Here, too, progress has been seen over the past year. Hana Bank, officially selected as the preferred bidder for the sale of Seoul Bank in August 2002, finally signed a merger agreement with the Seoul Bank the following month. Seoul Bank had been nationalized in 1998 after the government injected 5.6 trillion won in public funds into the bank. This deal is expected to imply further consolidation of the banks and bolster more competitiveness of domestic banks. As the financial condition of banks to be privatized has improved, including a sharp increase in operating income in 2001 and early this year, the government has resolved to step up the pace and complete bank privatization over the next 3 years. Woori Financial Holdings Company and Chohung will be the primary targets for reducing government-held stakes to less than 50 percent by the end of 2003. As part of bank privatization, the Woori Holding Company finished an IPO amounting to 11.8 percent of its total shares in late May, and these have begun to be transacted in the stock market.
since late June. The Parliament has also passed an amended Bank Law (effective from late July 2002) to allow large industrial corporations to increase their shares in banks from the present 4 percent to 10 percent, while freezing their voting rights to the present 4 percent level to limit their influence over banks’ lending decisions. The law allows large corporations specialized in the financial industry to increase their holdings up to 100 percent.

The investment trust sector has also undergone significant restructuring, including introduction of mark-to-market pricing of bond funds, injection of public funds and the purchase of defaulted Daewoo bonds. But the two largest companies—Korea Investment Trust Company and Daehan Investment Trust Company—continued to record depleted capital despite an injection of public funds totaling 7.9 trillion Won. After the government finished negotiations with the consortium led by AIG, several foreign investors, including Prudential Financial of the U.S., have shown interest in the purchase of Hyundai Investment Trust. In the insurance industry (comprising 42 companies), 9 companies with solvency margins of less than 100 percent have been restructured. Two have been sold, two have been transferred to Korea Life Insurance, and two are under negotiation for sale. Seoul Guarantee Insurance is under normalization with injection of a total of 10.3 trillion Won of public funds. To date 20.8 trillion Won of public funds have been injected into the insurance industry. Ending long disputes over the fate of the Korea Life Insurance, the consortium led by Hanwha, a Korean Chaebol, purchased 51 percent stake in the ailing insurer for 823.6 billion Won. The sale price of Korea Life, with an asset value of 23 trillion Won, including 3.5 trillion Won in public funds injected by the Government, has been fixed at 1.6 trillion won. The Government also plans to induce both mutual savings and finance companies to restructure themselves in order to become regional financial institutions with enhanced credibility.

Malaysia

Quality of assets and capital positions. The ratio of non-performing loans of the financial system fell to a low of 15.5 percent\(^{11}\) of total loans in 2000. With the economic slowdown in 2001, it rose again to 16.6 percent, but has since come down to reach 15.6 percent in June 2002. Much of the increase in NPLs that occurred during 2001 took place in the commercial and merchant banks. While the NPLs of the former have come down again—to 9.9 in June 2002 from 10.5 at end 2001—those of merchant banks have remained high at 26 percent of total loans\(^{12}\). Thus much more progress is needed in reducing NPLs in the non-commercial bank sector, and more specifically in merchant banks. The rates of return to equity and assets of commercial banks have continued to improve and although still below pre-crisis levels, they are now relatively high. The risk weighted capital adequacy ratio of banks rose from 11.8 percent at end 1998 to 12.5 percent at end 1999, where it has broadly remained as of end 2001.

Asset recovery. The asset management company’s (Danaharta) average asset recovery rate on its loans is expected to be 57 percent. (Total NPLs acquired and managed by Danaharta amounted to RM 47.7 billion at end June 2002). Danaharta has been launching property tenders to maximize the recovery value of the assets under its management. It also completed its first exercise to securitize its performing loans using a special purpose vehicle, Securita ABS One Berhad. The securitization exercise involved Securita issuing RM 310 million worth of AAA-rated Senior Notes backed by approximately RM 595 million worth of performing loans that had been sold to Securita by the Danaharta group of companies.

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\(^{11}\) The NPL numbers used by BNM, which are net of provisions, were 9.7 percent of total loans in 2000, 11.5 percent in 2001 and 11 percent in June 2002.

\(^{12}\) These NPL numbers are, moreover, net of provisions, as calculated by BNM.
After the financial crisis, the Government undertook an effort to bring about a consolidation of the financial industry with the objective of inducing greater competitiveness and efficiency. Ten banking groups applied and were granted anchor bank status, having met all the set criteria. To ensure banks are well capitalized, the Central Bank had imposed end-December 2001 as the deadline for the banking sector to increase capital to the minimum requirement of RM2 billion for domestic banking groups.

The authorities have also launched reform programs in the insurance and stock broking industries. The many small brokers in the highly fragmented brokerage industry are being encouraged to consolidate into universal brokers in line with international trends in the industry. Commissions and fees have been made fully negotiable. Consolidation in the insurance industry will be brought about by a planned increase in capital requirements.

**Prudential regulations and supervision.** In 2000 Bank Negara Malaysia (BNM) issued guidelines on the management of credit risk covering market risk, interest risk and operational risk. These guidelines were formalized in mid-2001. BNM implemented a number of other measures including an increase in minimum capital requirements, adjustments to the computation of risk-weighted capital, guidelines on internet banking, and a new liquidity management framework. Work is also under way to develop and implement a framework for consolidated supervision of financial conglomerates, including the legal and regulatory systems for group structures, intra-group transactions, corporate governance, capital adequacy, and other prudential requirements. These changes are in line with the longer-term vision of the financial sector as outlined in the Financial Sector Master Plan released in March this year. This is a 10-year, 3-stage plan which envisages a period of capacity building in the financial sector, followed by a period in which domestic competition is increased and culminating in a final stage which will see greater deregulation and increased participation of foreign institutions.

**Philippines**

**Asset quality and capital positions.** While the Philippines did not experience a systemic financial crisis during 1997-98, financial volatility and weak economic activity since then have contributed to deterioration of the banking system. The asset quality of banks has declined over the past several years. Commercial bank NPLs surged from 4-5 percent of loans at the end of 1997 to 13 percent by early 1999. They drifted higher in 2000 and then rose more quickly during 2001 (from 15 percent of total loans at end 2000 to 17.3 percent at the end of 2001) and the first part of 2002 (to 18.1 percent of loans), reflecting the sharp economic slowdown, market instability and interest rate increases (although some part of the increase in NPLs may also reflect tighter reporting standards). The NPL coverage ratio (loan-loss reserves to NPLs) for commercial banks at end-June 2002 was 47.3 percent. However, the situation is much worse if the lack of provisioning for repossessed assets (ROPOA) is recognized. Given marginal provisioning for ROPOA, the NPA coverage ratio is reported to be only 31.8 percent at end-June 2002.

The reported capital adequacy ratio appears reasonably high at 16.8 percent of the banking system at end March 2002. However, inadequate provisioning for non-performing assets and the continuing deterioration in asset quality suggest that capital may be overstated. Adjusting for provisioning and other factors, including deferred charges and equity investments, would reduce the effective CAR well below the reported value. The central Bank (BSP) has been strengthening BIS capital standards since July 2001. It introduced a new risk-based capital adequacy requirement for banks, effective July 2001, an important step in bringing the quality of the authorities’ prudential regulations closer to international standards set by the Basle Committee. (As per the new framework, the CAR of commercial banks at end September 2001 was estimated to be 13.2 percent, compared to 15 percent under the earlier framework). It also
required banks to report their accounts on a consolidated basis starting September 2001. To tighten provisioning requirements and regulatory oversight, banks are also being required to reappraise their foreclosed assets every two years (this was made effective in January 2002).

**Restructuring and consolidation.** The authorities have made progress over the past year in resolving two of the three most problematic banks. Equitable Bank has recovered most of the deposits it had lost, repaid all of its liquidity support, and arranged for an injection of Tier II capital (though profitability remains poor). In the case of the Philippine National Bank (PNB), the Government has reached a preliminary agreement with the private owner to convert much of the earlier emergency liquidity support into equity, so that both will own equal shares in the bank. (The remaining amounts would be swapped for real estate or converted into medium-term loans). With the financial flexibility provided by this agreement, PNB is planning to implement a two-pronged, Good Bank-Bad Bank strategy to rebuild the bank. The Good Bank will focus on rebuilding franchise and developing new profitable businesses (developing consumer banking, increasing low cost deposits, improving FX remittance business etc.), while the Bad Bank will focus on reducing NPLs and enhancing the value of acquired assets for sale. Mid-year financial results point to a lowering of losses over the previous year, and in early August PNB settled its PHP 10 billion debt with PDIC, achieving another milestone towards rehabilitation. However, it remains to be seen if this performance can be sustained in the medium-term as the management continues to implement the rehabilitation strategy, particularly with regard to addressing the huge non-performing assets problem. The ownership of the United Coconut Planters Bank, the third large problematic bank, remains unresolved and continues to be a hindrance in getting new investors to infuse fresh capital into the bank to meet the BSP minimum capital requirements.

To deal with problem banks effectively, a more fundamental reform is needed. Under the present system the regulatory authorities have difficult taking over and closing banks, primarily because they are not explicitly empowered to intervene in distressed banks without shareholder approval. This framework allows bank owners to block or delay enforcement actions by securing temporary restraining orders from the courts or even by unilaterally declaring bank holidays for up to 30 days. Moreover, owners can bring court cases against regulatory and supervisory staff. This situation makes it difficult for the central bank to enforce prudential regulations. Because the central bank’s powers are in practice tightly circumscribed, bank owners do not face the incentives to manage risks properly. And when banks become distressed, the central bank often finds that it has little option but to extend liquidity support and negotiate longer-term solutions with the owners.

Improving the regulatory and supervisory framework will require that priorities be placed on a) amending the Central Bank Act and General Banking Law to enable the authorities to take prompt corrective action against distressed banks without fear of undue legal repercussions and b) implementing a comprehensive consolidated supervisory framework that incorporates risk-focused surveillance and examination techniques to address the risks inherent in a sector dominated by financial conglomerates. Although the BSP has recently entered into a Memorandum of Agreement (MOA) with the SEC—potentially impacting the review of the activities of certain financial groups—there has not been a full recognition of the scale and possible effects of the conglomerate structure of participants in the financial sector. The risks to regulated (and especially insured) institutions that result from control, either direct or indirect, by multi-activity conglomerates must be better assessed.

**Asset recovery.** The Philippines has not adopted a centralized arrangement for dealing with NPLs and repossessed assets on the books of the banks, reflecting the less severe impact of the crisis on Philippine banks and firms, the difficult fiscal situation in the interim years, and the
view of the authorities that private initiatives may be best suited to addressing the NPL situation. Following this approach, the Government is currently working on legislation that will permit banks to sell assets to a specially designed private sector AMC or special purpose asset vehicle (SPAV). This could have a positive impact, but in their commentary on the draft bill, market experts have expressed concerns about a general bias towards borrowers rights and that the proposed bill may not deliver the desired results. Once passed, it may be important for regulators to play a role in monitoring the process of transferring assets from the banks’ books to the SPAVs and the valuation of the these assets by the SPAVs. The transfer prices of the assets and the type of assets the banks receive in return will be critical in determining whether these transactions mask the true solvency position of the banks.

Thailand

Asset quality and capital positions. Headline non-performing loans in Thailand dropped from a high of about 47 percent in the first quarter of 1999 to 11.3 percent of total financial institutions’ loans by the second quarter of 2002. However, NPL reduction to total loans (excluding transfers to AMCs and write-offs) has slowed from 9 percent in 2001 to around 5.5 percent (annualized) in 2002. This decline in NPL reduction may be due to the slowdown in the number of completed restructurings as banks are now restructuring more difficult cases. At the same time, there is a high level of re-entry NPLs and new NPLs continue to enter the system at a rate of about 7-8 percent annually. While the average rates of return on assets and equity of the Thai banking sector improved very considerably since the trough reached at the peak of the crisis, at the end of 2001 they were still negative. And while the capital adequacy ratio for the banking sector stood at 12.9 at the end of 2001, this was a slight decline from the end of 2000. Moreover, the average figures mask significant variation in among banks. While the largest banks are likely to be able to earn enough over the next few years to fully provision for their losses on an economic basis, other banks remain more severely under-provisioned and undercapitalized on an economic basis. Weak banks know that they are fragile, and this shows up in both muted lending and debt rescheduling that has tended to avoid provisioning and write-downs even if the borrower’s cash flows cannot support the debt.

Asset recovery. The governance and effectiveness of the government owned AMCs could have a significant impact on the costs to the taxpayer from NPL resolution. (As of June 2002, the TAMC managed about 40 percent of the distressed loans in the Thai financial system). While the TAMC intends to restructure rather than divest the assets, it should focus on maximizing the value of its claims—which goes together with maximizing the earnings before interest and taxes produced by the underlying business assets. A competitive process, which attracts new money, technology and management to distressed firms, would support this objective. Restructured assets should also be sold back to the markets as soon as possible.

Restructuring and consolidation. Much has been done to stabilize the financial sector since the crisis. However, the Thai financial sector is now in a transition of both structure and policy, at the same time that it is nursing a gradual economic recovery. Thailand’s transition is occurring at several levels. Globalization and international standards of disclosure, governance, risk management and pricing are slowly forcing a mark-to-market of the financial sector. The transition towards marking-to-market started during the crisis with improved provisioning guidelines and accounting standards for banks (and firms). The authorities phased in the new provisioning guidelines over two and a half years—these were fully implemented at the end of 2000. The phase-in was necessary to preserve a Thai owned and controlled banking sector after the crisis. But the transition is not complete because non-transparent forbearance on provisioning and accounting for debt restructuring allow the weaker banks to maintain their status quo in the market, sapping the earnings potential and competitive incentives for the institutions which have more aggressively restructured their operations, NPLs and balance sheets. Moreover, the medium
term transition has as much to do with implementation and changing mindsets as new policy or enactment of law, but the latter continue to be delayed. The Financial Institutions Act, the Central Bank Act, the Secured Lending Act, the Credit Bureau Act, The Derivatives Act and further amendments to the Bankruptcy Act, the Public Companies Act and foreclosure codes all remain in the queue.

An important question is to what degree and at what speed will the authorities allow competitive forces back into the banking sector. Ensuring competitive forces goes beyond simply having price competition on lending to a smaller pool of viable firms, but include entry and exit under international standards of provisioning and capitalization and under market discipline driven by high standards of disclosure. Without supervisory pressure, weaker banks will not take advantage of these relatively favorable markets to raise capital and take the restructuring charges necessary to clear their books and position themselves to lend again. And the regulatory forbearance obfuscates balance sheets, which is a disincentive to prospective providers of fresh capital. This leaves them vulnerable to three future trends. First, the measured transition from a blanket government guarantee to a limited guarantee on deposits will increase market discipline on weak banks. Second, market opening under WTO will increase competition in financial markets. Third, disintermediation through increased issuance of corporate bonds will increase over time.

**Corporate sector developments in the crisis-affected countries**

**Overview**

**Corporate performance**

While sizable progress has been made in reducing debt to equity ratios, the corporate sector remains highly leveraged by OECD standards in most countries in the region. The debt to equity ratio in Indonesia is now the highest among the crisis-hit countries, at 7.6 in 2001. Debt to equity ratios in Thailand remain high: the average debt to equity ratio of 230 listed non-financial firms surged to over 4 at the time of the crisis and was still at just over 3 at the end of 2001. Even in Korea, where the average debt to equity ratio of companies has fallen significantly from the very high levels prior to the crisis, it remains above international standards (Figure 2). The average debt to equity ratio in the US, for example, was 1.1 in 2001 while in the UK was 0.4.

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13 This is a simple average of all listed corporations with positive equity (source JITF). In December 2000 the debt equity ratio was 5.2.
14 Data on the first half of 2002, however, indicate that Korean firms have made further progress in deleveraging: the KSE reported that the aggregate debt to equity ratio of manufacturing firms was down to 1.13 in the first half of 2002 from 1.82 at the end of 2001. The average interest coverage ratio also improved in the first half of 2002—with the percentage of companies with interest coverage less than 1 having dropped from 19.5 percent at end 2001 to 14 percent in the first half of 2002.
15 Ratios for the US and UK are based on a sample of listed non-financial firms from Worldscope.
The still relatively high debt burdens are constraining corporate profitability. Compared to the peak of the crisis, the ratio of operating income to sales—i.e. the profit margin—has improved in almost all the crisis affected countries, except Indonesia (Table 3). However, in most countries, profitability performance is much poorer when non-operating expenses are deducted—due to interest expenses that cut heavily into profits (even though interest rates have been relatively low during the period).

Table 3. Indicators of corporate profitability

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<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>12.9</td>
<td>15.1</td>
<td>10.2(^1)</td>
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<tr>
<td>Operating income to sales</td>
<td>11.05</td>
<td>-11.85</td>
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</tr>
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<td>Ordinary income to sales</td>
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<td>5.6(^1)</td>
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<td>of which interest expenses to sales</td>
<td>6.0</td>
<td>5.7</td>
<td>3.7</td>
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<td>Korea</td>
<td>1.5</td>
<td>0.71</td>
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<tr>
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<td>9.16</td>
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<tr>
<td>Ordinary income to sales</td>
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<td>5.7</td>
<td>3.7</td>
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<tr>
<td>of which interest expense to sales</td>
<td>1.5</td>
<td>0.71</td>
<td>2.5</td>
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<tr>
<td>Malaysia</td>
<td>11.8</td>
<td>5.19</td>
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<tr>
<td>Operating income to sales</td>
<td>10.5</td>
<td>2.34</td>
<td>5.9</td>
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<tr>
<td>Ordinary income to sales</td>
<td>2.8</td>
<td>5.29</td>
<td>2.5</td>
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<tr>
<td>of which interest expense to sales</td>
<td>6.9</td>
<td>9.16</td>
<td>3.7</td>
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<tr>
<td>Philippines</td>
<td>11.3</td>
<td>6.2</td>
<td>6.6</td>
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<tr>
<td>Operating income to sales</td>
<td>14.82</td>
<td>0.01</td>
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<td>5.83</td>
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<tr>
<td>of which interest expense to sales</td>
<td>7.6</td>
<td>4.4</td>
<td>4.0</td>
</tr>
<tr>
<td>Thailand</td>
<td>7.7</td>
<td>4.4</td>
<td>6.6</td>
</tr>
<tr>
<td>Operating income to sales</td>
<td>6.6</td>
<td>6.9</td>
<td>5.7</td>
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<tr>
<td>Ordinary income to sales</td>
<td>5.2</td>
<td>9.5</td>
<td>4.0</td>
</tr>
<tr>
<td>of which interest expense to sales</td>
<td>1.29</td>
<td>1.46</td>
<td>1.73</td>
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</table>

Note. Operating income is the difference between revenue and related costs and expenses, excluding income derived from sources outside the company’s regular activities. Ordinary income is operating income after losses/gains from interest expenses/income, foreign currency transactions and disposal of investments and tangible assets.

Source: Worldscope.

\(^1\) Figure for 2000 only
The average numbers do however mask significant differences among firms. In particular, an analysis of listed Thai firms shows that not all firms are still highly leveraged. Indeed, more than half the firms (mostly smaller) have reduced their debt ratios to pre-crisis levels. At the same time, the difference between the aggregate and median debt to equity ratios has persisted since 1997, showing that a substantial subset of larger firms in particular is still highly leveraged. In Korea too, some 30 percent of manufacturing companies had debt to equity ratios above 200 percent at the end of 2001—again with large enterprises having significantly higher debt to equity ratios than small and medium sized firms.

A good measure of the short-term viability of a corporate is the interest coverage ratio, defined as earnings before interest tax, depreciation and amortization (EBITDA) divided by interest expenses. A firm with interest coverage of less than 1 is unable to meet its interest payments—let alone its principal obligations—from its current earnings. Analysis of a sample of listed non-financial firms (Table 4) shows that:

- With the exception of Indonesia, the median interest coverage ratio is now around 2.
- However, at the end of 2001 there were still a significant proportion of firms—27-28 percent in Korea, 28 percent in the Philippines, 25 percent in Malaysia and almost 10 percent in Thailand—with interest coverage less than 1. In terms of amount of debt held by weak firms, the proportion was particularly high in Indonesia, but also in Korea and Malaysia. In Indonesia, firms with interest coverage of less than 1 held 77 percent of the total debt. In Korea and Malaysia the percentage of debt held by corporates with interest coverage less than 1 was 28 percent and 33 percent respectively.
- Moreover, in most countries the percentage of firms with interest coverage of at least 2, is still a lot lower than, say, in the US. Thus, firms in the region are still potentially vulnerable to shocks.

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16 EBIT (earnings before interest and taxes), which excludes depreciation and therefore usually shows a lower value for earnings (and therefore a lower ICR) than does EBITDA, is also often used in analyses. However, EBITDA, which includes depreciation, is regarded as a more accurate measure of a firm’s cash flow position and short-term ability to finance its loan obligations. EBIT is used more often because of the ease in collecting the data and in drawing comparisons with other countries.

17 Source: Worldscope

18 In Korea, where the data are available, there seems to be a widening of differences in corporate performance: while interest coverage of manufacturing firms improved significantly in 2001 for the first and second quartiles of corporates, that of the third quartile deteriorated. Regarding differentiation by size of firms: large firms have higher operating income, but also higher debt burden and interest expenses. Their interest coverage thus tends to be much lower.
### Table 4. Interest coverage ratios in listed non-financial companies

<table>
<thead>
<tr>
<th></th>
<th>Percentage of firms with interest coverage of less than 1</th>
<th>Percentage of firms with interest coverage of at least 2</th>
<th>Percentage of debt held by firms with interest coverage of less than 1</th>
<th>Percentage of debt held by firms with interest coverage of at least 2</th>
<th>Median ICR</th>
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<td>Indonesia</td>
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<tr>
<td></td>
<td>5.4</td>
<td>47.7</td>
<td>87.5</td>
<td>42.0</td>
<td>4.5</td>
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<tr>
<td>Korea</td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>sample 1</td>
<td>9.5</td>
<td>27.7</td>
<td>41.0</td>
<td>60.0</td>
<td>7.7</td>
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<tr>
<td>sample 2</td>
<td></td>
<td>28.6</td>
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<td>55.5</td>
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<tr>
<td>Malaysia</td>
<td>8.2</td>
<td>25.1</td>
<td>85.7</td>
<td>68.0</td>
<td>5.1</td>
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<tr>
<td>Philippines</td>
<td>15.6</td>
<td>28.3</td>
<td>77.7</td>
<td>60.0</td>
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<td>Thailand</td>
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<tr>
<td>sample 1</td>
<td>11.0</td>
<td>9.1</td>
<td>75.7</td>
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<td>sample 2</td>
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<td>Memo:</td>
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<tr>
<td>US</td>
<td>3.2</td>
<td>7.0</td>
<td>95.8</td>
<td>90.0</td>
<td>1.2</td>
</tr>
</tbody>
</table>

Source: Worldscope. Interest coverage: EBITDA/interest payments

1/ Figures for 2000. 2/ Figure for 1997. 3/ This sample is based on manufacturing companies only, where the interest coverage ratio is defined as operating income/interest payments. 4/ Sample based on 230 listed non-financial firms.

### Progress in corporate restructuring.

Against this backdrop, the pace and depth or quality of restructuring remains a concern, especially in Indonesia and Thailand.

- In Indonesia, as noted, corporate debt to equity ratios are very high, the median interest coverage ratio is barely over 1 and a very large proportion of corporates have interest coverage ratios less than 1. And, according to the most recent survey 57.5 percent of total corporate debt is distressed. As of May 2002, however, IBRA had only completed the restructuring (defined as restructuring in their final commercial term or legal agreement stages) of 51 percent of its total distressed debt of $37.4 billion. As of May 2002, JITF had also completed only 51.5 percent of its total distressed debt of $30.1 billion. In addition it is estimated that another $10 billion of distressed debt remains outside the IBRA and JITF process, of which only $2.4 billion has been restructured. Moreover, although more recently JITF restructurings have involved debt to equity conversions and cash payment, the bulk of the restructuring that has taken place has been in the form of debt rescheduling.

- In Thailand—where the debt-to-equity ratios are also high, especially in larger firms—the concern is especially on the quality of the restructuring that has taken place. The restructuring led by private banks appears weak—over 90 percent of the
Restructurings by private banks during 1999-2001 was through debt rescheduling. Only large banks have converted debt to equity and this only happens at the margin. There is, moreover, a high level re-entry NPLs and new NPLs have continued to enter the system. Decomposing the change in cumulative NPLs since the third quarter of 1999 to the second quarter of 2002 shows that debt restructuring, others, and transfers to AMCs and write-offs have contributed to a reduction in cumulative NPLs by about 24 percentage points, 14 percentage points and 13 percentage points respectively, while new and re-entry or reversion NPLs have added to the cumulative NPLs by 13 percentage points and 12 percentage points respectively.

In Korea and Malaysia the issue is more one of ensuring that the restructuring of the remaining distressed firms and the exit of non-viable firms, is expedited. It also remains to be seen whether the restructuring that has already taken place is adequate to ensure that the loans of such corporates remain performing.

- In Korea, while a great deal of progress has been made in reducing average debt to equity ratios, as noted these are still above international norms (especially for the larger firms), and there is still a significant proportion of firms whose interest coverage is less than 1 (although the proportion has fallen further in the first half of 2002). Moreover, as noted, firms with interest coverage of less than 1 hold a sizable proportion of total corporate debt (28 percent). The potential for creditor-led restructuring as a vehicle for promoting the restructuring of the remaining non-viable firms has diminished. Holdout creditors and shareholders delay workout resolutions by holding back support for an agreement. To expedite exit of nonviable firms, attention needs to shift towards greater reliance on court-supervised insolvency and further insolvency reform.

- In Malaysia too, although debt equity ratios are much lower, there is also a sizable proportion of firms that have interest coverage ratios of less than 1. And, as in the case of Korea, weak firms hold a significant proportion of total corporate debt (33 percent). Until recently, corporate restructuring efforts had been relatively successful with respect to small and mid sized, and even some larger indebted enterprises but progress on the largest and politically best connected had been elusive. This appears to be changing more recently.

**Country details**

**Indonesia**

Corporate debt restructuring in Indonesia has been occurring through three main avenues. First, through IBRA, the holder of the bulk of distressed debt\(^{19}\), second, through JITF which mediates restructuring negotiations between corporate debtors and creditors (often foreign creditors) and expedites needed regulatory approvals and regulatory relief, and third through spontaneous private sector agreements with no government involvement.

As of May 2002, IBRA’s AMC had completed debt restructuring of about $24.9 billion out of a total $37.4 billion. Of the completed amount, about $12.4 billion had reached legal closure.

\(^{19}\) According to the most recent survey of JITF, total corporate debt at end-May 2002 amounted to $127.6 billion or Rp 1,121 trillion, not much different from December 2001 level. Of this, 57.5 percent was distressed debt (onshore and offshore). IBRA holds 90 percent of the onshore distressed debt, of which the debt of large private companies account for 88 percent.

\(^{20}\) Restructuring defined by IBRA data as falling in the last stage of the restructuring process.
IBRA was also working toward a resolution of $18.3 billion in aggregate distressed debt (defined by IBRA as falling in the early and middle stage of its restructuring process). IBRA reports that, as of end-June 2002, it had completed 77.5 percent of its “top 21 obligors”, 37.8 percent of its “top 22-200 obligors” and 27.5 percent of its “over top 200 obligors”.

Even where IBRA has reached agreement with its corporate debtors however, the quality of the restructuring has been questionable. To address concerns about the sustainability or moral hazard associated with the recent restructuring, the Government adopted new corporate restructuring principles in July 2001 with a view to ensuring more transparent restructuring agreements consistent with international best practice, and to share the financial burden more equally between debtors, creditors and taxpayers. In accordance with these principles, IBRA’s Oversight Committee has finished its review of a total of 55 MOUs between IBRA and its large obligors, thereby completing the list of all companies to be reviewed. Many of these restructurings were found to have departed in important respects from agreed corporate debt restructuring principles and in some cases the Financial Sector Policy Committee (FSPC) has asked IBRA to reconsider the restructuring in light of the OC’s findings. The process has served an important function of increasing the transparency of IBRA’s activities and providing an appropriate benchmark against which to assess its restructurings.

The JITF was created to facilitate and mediate between debtors and creditors to help reach agreement in out-of-court debt restructuring negotiations. It has also helped eliminate tax, legal or regulatory impediments to corporate restructuring transactions on a case-by-case basis. More recently, it has been authorized to provide incentives (for example through tax or regulatory relief) to motivate quick resolution and to impose sanctions to penalize non-cooperation.

After a slow start, the pace of restructurings accelerated in the second half of 2000 after steps were taken to enhance the framework—including new time bound incentives for participation and the FSPC referrals of strategically important cases to JITF. Progress has since slowed, however. This was due initially to the political uncertainties in 2000/2001. But despite a relatively stable political and macroeconomic environment in Indonesia since then, corporate debt restructuring has yet to regain its former momentum, due to external weaknesses in the world economy and continued uncertainties in the Indonesian investment climate. The slower pace is likely to continue since most of the easier corporate restructuring deals have now been completed and the ones remaining are the more difficult cases. Nonetheless, JITF was able to meet its targets: by end May 2002 total restructurings of $16 billion had reached the MOU stage. Of this amount, $10.7 billion had reached legal closure, and $5.3 billion was still awaiting final closure following a MOU (term sheet) signing. As of end-May 2002, JITF was mediating active cases in an aggregate amount of $14.6 billion, involving 56 companies in a wide range of industries. The prevalent method of restructuring has been debt rescheduling. Since mid-2001 however debt/equity swaps and debt repurchases at a discount have become more prevalent (while debt rescheduling accounted for about 53 percent of total debt restructured in 2001, during the first half of 2002 cash payment and debt equity conversions together account for 93 percent of the total debt restructured). Creditor fatigue is said to be the main reason for this change.

With respect to debt restructuring outside IBRA and JITF, the JITF recorded the restructuring of 14 companies in 2001, involving an aggregate distressed debt of about $2.4 billion. Based on JITF estimates, at end-May 2002, about $10 billion in corporate distressed debt was still outside of the JITF and IBRA frameworks. Again, debt rescheduling has been the predominant means of restructuring, accounting for around half of total observed debt restructured.
One of the reasons for the relatively poor quality of corporate debt restructuring deals is the absence of a credible threat of bankruptcy. Creditors have found that they can rarely expect to prevail in court proceedings to enforce claims in cases of insolvency. Enforcement of unsecured or secured debt is subject to successive appeals by debtors to the District Court, the Court of Appeals and through cessation procedures to the Supreme Court. There is also the possibility of a civil review before a different chamber of the Supreme Court. All this results in a lengthy and expensive judicial process.

Efforts have been directed at both strengthening the legal framework and addressing pervasive governance problems in the courts. Regarding the former, a key step was the creation of a specialized commercial court to hear bankruptcy cases and strengthened rules to allow more expeditious and transparent bankruptcy proceedings. An important initiative to address court governance concerns was the appointment of ad hoc judges to the commercial court. However, many observers believe that it will take many years before these reforms begin to deliver tangible results.

Korea

Progress in corporate restructuring continued in 2001. As a result of rehabilitation, sell-offs and liquidations, the number of companies in formal out-of-court workout programs fell to 22 at end-2001 from 38 at end-2000. To ensure that the credit risk posed by corporate borrowers is continuously monitored, to encourage out-of-court workouts by creditor banks, the Government had introduced the “Continuous Credit Risk Assessment System” in March 2001. Following the first round of assessments in September 2001, 141 companies were picked to be exited. In the second round of assessments that were completed in January 2002, 28 companies were picked to be exited. Out of these companies, procedures for exit have been completed for 89 companies.

Priority has been given to the resolution of distress in large corporations. To speed up the process, the “Corporate Restructuring Promotion Law” was enacted in September 2001. This law formalizes some aspects of the “out-of-court” workout framework and the authorities hope that it will shift the balance of workouts away from continued provision of new financing towards more operational restructuring. During the last 8 months it has been successfully applied to 6 large workout cases including Hyundai Engineering & Construction and Hynix Semiconductor, inducing agreements on the MOUs of their restructuring plans.

One of the most important pending issues in corporate restructuring is the sale of Hynix. The sale to Micron Technology promoted in the creditors’ rescue plan of October 2001 failed in April 2002 due to objections by the board of shareholders. The creditors are now looking into ways to set up a new restructuring plan leading to its sale with Deutsche bank as its adviser. The main contract for the sale of Daewoo Motors was made at end-April, and at the end of September a $12 billion debt-restructuring plan was approved for Daewoo Motors, paving the way for General Motors to take control. The new joint venture firm, GM Daewoo Auto and Technology was launched in October.

Despite these elements of progress, the needed restructuring and asset sales for those firms that are still heavily indebted (including some of the more distressed workout chaebols that are still making losses) continue to be hampered by disagreements among creditors over loss-sharing, and by weak insolvency procedures. In addition, creditor banks (especially state-owned banks) have been reluctant to accept reductions in their claims, delaying the liquidation of unviable companies. Creditor-led workouts are an important tool, but their potential as a vehicle for promoting restructuring has diminished.
To expedite exit of nonviable firms, attention needs to shift towards a greater reliance on court-supervised insolvency and further insolvency reform. Reforms to insolvency laws were introduced in February 1998, to provide a better balance between creditor and debtor rights and to improve the speed and efficiency of the court system. Thus time limits were imposed to expedite the reorganization process, a specialized bankruptcy court was created in the Seoul district, and in April 2001 a form of the prepackaged bankruptcy was introduced which allowed for quicker court approval of a reorganization plan if agreed beforehand by creditors. However, these reforms did not go far enough to address the fundamental weakness in the system. In particular, without credible threat of bankruptcy, dissenting creditors have been able to block agreement on restructuring plans until their narrow demands have been met.

To this end, the government is planning to consolidate and strengthen the three separate bankruptcy codes, and to submit the consolidated revised law to the Parliament this fall. A unified insolvency regime would enhance the predictability of the system.

The problem of hold-out creditors could be addressed through the enactment of strong “cram down” provisions that authorize court approval of a restructuring plan even when some creditors have voted against the plan. To be effective, the cram down mechanism would need to differentiate between classes of creditors and provide minimum protection for dissenting creditors (such as guaranteeing at least liquidation value or introducing an “absolute priority rule” to safeguard equity treatment among creditor classes). It would also be important to ensure that the cram down rules are not extended too far so as to weaken creditor rights to the point where the availability of credit in the system is adversely affected.

The revision of the Law envisages strengthening the rights of the creditor committee and its role in insolvency procedures. Giving the creditor committee the right to recommend auditors and request an evaluation survey on firms to be restructured is one of elements that is being considered. From the debtor’s perspective, under consideration is the introduction of an automatic stay or reduction of the current time limit until the court’s preservation order that freezes creditor action against the debtor. This provision should help make insolvency procedures a less dangerous option for debtors, and prevent chaotic asset grabbing. The introduction of a debtor-in-possession system is also being considered, giving management more control to operate the business during reorganization, as is the establishment of special bankruptcy courts.

**Malaysia**

Corporate distress in Malaysia has been addressed through three main channels: Danaharta (the asset management company), out-of-court workouts by the CDRC and court-supervised workouts.

Danaharta has restructured or approved for restructuring nearly all of its holdings of NPLs under its management (total NPLs acquired and managed by Danaharta amounted to RM 47.7 billion at end 2001—of which RM 39.8 billion or 83.4 percent were NPLs from the banking system). It is now expected to focus on implementing approved recovery strategies until its targeted closure date of 2005. The bulk of Danaharta’s resolutions as of end June 2002 have been in the form of foreclosures (25 percent), plain restructuring (19 percent), scheme of arrangements (19 percent) and settlements (13 percent). Danaharta’s broad legal powers have had an important bearing on its success. First, special vesting powers insulate it, and subsequent purchasers, from undisclosed claims made after acquisition of the asset from the creditor. Second, it has the power to appoint special administrators without having to go to court. Finally, it can assume ownership of the assets and foreclose on collateral just as if it were the original creditor.
The out-of-court workouts by the CDRC—which follows the London Approach to provide a framework for creditors and debtors to reorganize firms on a voluntary basis—covers cases with outstanding debt of at least RM 50 million with more than three creditors. The Committee’s work was facilitated last year when it was allowed to consider a scheme viable provided it was approved by 75 percent of lenders by value (or 50 percent of lenders by number), rather than the unanimity that was previously required. During the first quarter of 2002 the CDRC resolved five restructuring cases. And at the end of March 2002, the committee had only 8 cases outstanding out of an original 87 received. At its closure on July 31, 2002, only four accounts (with a total debt of RM 11.1 billion) remained outstanding. Subsequently, one was withdrawn and one was discharged from CDRC. Danaharta and the Creditors Steering Committee monitored the two remaining cases as they were being resolved.

Progress through court workouts, however, is still hindered by several factors. Creditors may petition the High Court to “wind up” a corporation for failure to pay its debts under the Malaysian 1965 Companies Act (sections 212-318). Wind-up provisions of the Act have provided debtors the incentives to seek the protection of court-supervised reorganizations or to cooperate with out of court restructuring efforts. Under the Act (sections 176-181) the High Court can enforce a reorganization or debt composition plan that is supported by 75 percent (debt weighted) of the company’s creditors. Moreover, with recent amendments to section 176 of the Company Act, a distressed company cannot make an ex-parte application to a court for a restraining order against possible action by creditors. However, the Act still does not provide for the ready appointment of special administrators to manage the affairs of distressed companies except to a debenture holder. Furthermore, reorganization proceedings have been hampered on several accounts, including: the lack of detailed rules for judicial management (e.g. appointment of independent managers to design a reorganization plan, suspension of claims against the debtor company pending reorganization) and limited court experience in overseeing the development and implementation of rehabilitation plans.

Until recently, corporate restructuring efforts had been relatively successful with respect to small and mid sized, and even some larger indebted enterprises, but progress on the largest and politically best connected had been elusive. However since last year there have been clear signs of a new intensity in this regard, with the Government moving more aggressively and directly to address the restructuring problems of larger groups that weigh heavily on the banking system and overall investment. In particular, the authorities have been willing to remove some well-connected controlling shareholders from management and write down their equity stakes as a way of facilitating restructuring. In 2001, the Government took over the UEM-Renong group whose restructuring could see divestment of assets and share sales that would halve its debts from RM 30.3 million to RM 14 billion by mid-2002. In 2002, the Government took over the debt laden Malaysian Airline System (MAS) and is planning to take over a number of other firms that need restructuring. These prospective changes should improve corporate balance sheets and help companies to start investing again. The Government may be able to achieve a more orderly disposal of assets and avoid fire sale prices than might be achieved by distressed firms themselves. Against these benefits however, must be weighed the additional risks that are being taken on by state run pension funds that are playing a key role in the government’s strategy.

Philippines

As noted, the Philippines has not adopted a centralized arrangement for dealing with NPLs and repossessed assets on the books of the banks. With delays in the passage of the SPAV bill (which will allow banks to sell assets to a specially designed private sector AMC or special purpose asset vehicle), systematic efforts to accelerate corporate restructuring remain stalled.
Given the absence of a centralized AMC or workout scheme it is difficult to gauge the extent of corporate restructuring activity in the Philippines. Nonetheless, there are a few examples of companies that are moving to restructure their balance sheets.

However as noted above, there is a sizable proportion (28 percent) of firms with interest coverage of less than 1, and it is also the case that many distressed companies continue to operate, even though they are both illiquid and insolvent and with few prospects for viability, continuing to make losses until they have become decapitalized, exhausted their working capital, and been refused further credit by suppliers and banks. Where there has been some restructuring through banks, moreover, it has been mainly through the extension of the repayment period. The fact that NPLs have continued to rise is due, in no small part, to the fact that many of these restructured loans have remained non-performing.

A number of policy and institutional weaknesses continue to hamper restructuring. While steps have been taken to reform the insolvency regime—the December 1999 “Rules and Procedures on Corporate Recovery” and the December 2000 “Interim Rules of Procedure on Corporate Rehabilitation”—the formal protection of creditors under law as well as under bankruptcy protection and workout arrangements in the Philippines is still weak.

Secured creditors do not have adequate protection from stay of foreclosure and do not necessarily enjoy a priority in payment. Also, creditors do not have an adequate say in reorganization of distressed borrowers, or over management. Under the Law, creditors may submit to the court their comments on the merits of a proposed rehabilitation plan, but it is the trial court judge who decides whether to try and rehabilitate or liquidate a distressed company. (Under the Commonwealth model, creditors take this decision based on meetings and discussions among themselves). And although the law requires that a conservator be appointed, there is no obligation for the conservator to report to the creditors or the Court. There is also no provision for a “cram down” plan and the circumstances under which it could be used. At the same time, though the law imposes a number of requirements on the debtor, there are no defined consequences if the debtor does not fulfill these requirements. Finally, tedious and protracted court proceedings are major deterrents to effective rehabilitation and insolvency proceedings.

Progress has been made, though, in improving corporate governance. In order to raise investor confidence and promote the development of capital markets the SEC promulgated a Code of Corporate Governance applicable to listed corporations in April 2002. This code requires corporations to adopt corporate governance rules and principles in accordance with the code. The rules are to be submitted for approval to the SEC and be available for inspection by any stockholder of the corporation.

Thailand

In Thailand, as in the other countries, restructuring has occurred through creditor-led initiatives, voluntary out-of-court arrangements and more recently through the Thai Asset Management Company. The quality of creditor led restructuring appears weak. Over 90 percent of the restructurings by private banks during 1999-2001 was through debt rescheduling. Only large banks have converted debt to equity and this only at the margin. None of the banks have reported giving haircuts to debtors. Private banks have realized annual losses of 6 percent on debt restructuring, mostly for reductions on present value rather than forgiveness of principal.

In an important reform initiative, the Thai Asset Management Company was established to resolve distressed loans, mainly of the state banks. The TAMC intends to restructure rather than divest the assets. As of June 2002, TAMC managed about 40 percent of the distressed loans in the financial system, and the TAMC Executive Committee and the courts had made decisions
on 28 percent of the loans that had been transferred to it. These resolutions account for about 40 percent of the 2002 target. The bulk of the concluded resolution plans were for loans in finance (66 percent), real estate (40 percent) and manufacturing (24 percent). An encouraging sign is that the contribution to the increase in resolution plans during June 2002 has come mainly from decisions to foreclose assets. However, without more detailed breakdown of foreclosure (either by TAMC’s powers or court order), the extent to which TAMC has exercised its special powers cannot be quantified.

Prior to 2001 the voluntary, out-of-court CDRC process had greatly expedited the debt restructuring of large corporate cases. It has slowed down with the establishment of the TAMC, but still continues on a scaled down basis to facilitate multi-creditor cases that are not transferred to TAMC, and for NPL re-entry cases. As of June 2002, the CDRAC process covered 222 cases with total credit exposure of Bt 200 billion. BOT plans to facilitate the restructuring of these cases within 2 years—by June 2004. The sustainability of the CDRAC process remains to be demonstrated however: continued re-entry of previously restructured NPLs is a testament to this concern.

The pace of court-led restructuring has been undermined by the backlog of cases in civil courts. Filings to foreclose on collateral and sue guarantors are increasing. There are two predominant sources of filings: cases that failed the CDRAC process and loans in default for more than a year where direct negotiations with debtors and guarantors outside the CDRAC process have failed. From the beginning of the CDRAC process in June 1998 to April 2002, a total Bt 1.17 trillion involving 725 cases have failed the CDRAC process and become backlogs in the courts. It is estimated that the Civil courts could take at least five to six years to resolve the backlog, given the cumbersome civil procedures and evidentiary process, the limited number of judges with the experience to handle relatively complex disputes over secured loans and the limited administrative capacity of the judiciary. Despite this backlog, the evidentiary and enforcement process—that are most time consuming and do not have a limited time frame—have not been expedited. While the 1999 amendments to civil procedures shortened the completion time of all court processes down from 42 to 33 months (from 60 to 42 months if the case is appealed), it can still take longer than 3 years if the enforcement process is included. This implies that the legal regime still lacks an expeditious mechanism for debt collection and the enforcement of security rights outside the bankruptcy law. Debtors are still able to use the legal framework to delay restructuring negotiations.

Financial sector developments in China

Overview. The need to address the problems of state owned enterprises (SOEs) and the financial sector lies at the heart of the structural reform agenda in China. The large concentration of NPLs in state commercial banks (SCBs) as a result of lending to the poorly performing SOE sector not only hinders the sound future development of the corporate and financial sectors, but also constitutes a contingent liability which threatens medium term fiscal sustainability. Reforms of SOEs and the financial sector began before the East Asian financial crisis, but have since gained urgency with the prospect of China’s entry into the WTO.

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21 Analysis based on TAMC’s statistics on completed resolutions should also be made with care, since TAMC defines completed resolution as cases in which decisions have been reached, but restructuring transactions have not yet been concluded. This is important because closings are constrained by TAMC’s back office capacity.
Bank soundness. Recognizing that banking soundness is key to financial stability, the authorities have pushed ahead with a broad-based reform effort to strengthen the banking sector. In early 2002, PBC implemented new loan classification and provisioning requirements, consistent with international best practice. Banks are publicly reporting more accurate financial statements and the recently issued guidelines on bank disclosure should push this trend further.

The state owned banks are focused on reducing NPLs and improving lending practices. Stricter prudential regulations, reduced government interference and improved corporate governance in SCBs have induced improvements in risk management and loan assessments. Some SCBs have also established specialized work-out departments to deal with NPLs. As a result, average NPL ratios of SCBs declined slightly in 2001\textsuperscript{22}, their credit growth slowed to 9 percent year on year (from an average of 15 percent per year during 1997-2000) and the composition of their new lending shifted towards lower risk loans such as consumer loans, low risk housing loans and, among corporates, to the more creditworthy corporates.

Despite the progress made, however, the financial condition of the banking sector remains weak. Even after the transfer of bad loans to the AMCs (see below), reported NPLs of SCBs remain high at 30 percent of loans. Moreover, the composition of NPLs suggests a high loss content, with over three quarter classified as doubtful or loss and 80-90 percent resulting from loans more than five years old. Thus further strengthening of prudential regulations and incentives for sound banking is needed, and banks’ adherence to prudential regulations needs to be strictly enforced. Steps should also be taken towards completing the corporatization of the SCBs and improving the banks’ credit risk management, internal controls and accounting and management information systems.

Asset disposal by AMCs. Four state-owned AMCs were established in 1999 to take over and resolve the non-performing loans of the four major state commercial banks. Some RMB 1.4 trillion of NPLs were transferred to the AMCs in 1999-2000. By end June 2002, the four AMCs had disposed NPLs with a face value of RMB 210.4 billion and collected RMB 45.4 billion in cash, yielding a recovery rate of 21.5 percent. The legal framework for AMC operations has also improved, including through new regulations for foreign investor participation—although some deficiencies remain such as difficulties in exercising creditor rights.

Capital market development. The authorities’ efforts to strengthen China’s equity and bond markets have also continued. Over the past two years, the authorities have tightened market oversight to crack down on market manipulation, strengthened listing and delisting rules and taken steps to improve corporate governance in listed companies.

Corporate sector developments in China

Overview. The focus of corporate sector restructuring in China has been on State-owned enterprises (SOEs). The aim of the recent SOE reform has been to privatize small enterprises and commercialize large ones under the principle of “seize the large and release the small”. Some progress has been made on hardening budget constraints and following the authorities’ initiative in 1998 to revitalize medium and large SOEs, enterprise profitability has improved somewhat over the past three years. The Government has also emphasized ownership transformation and

\textsuperscript{22} Reported NPLs ratios of SCBs fell to an average of 30.4 percent at end 2001, from 30.6 percent at-end 2000. The underlying improvement was somewhat larger though, taking into account the shift to a new classification system, which resulted in upward revisions in reported NPL of two SCBs by about 3-4 percentage points.
privatization of SOEs, private sector development, capital market development, corporate governance, as well as industrial organization, as the basis for sound and viable banks and companies. But many challenges remain to be addressed.

Reflecting the seriousness of reform efforts, the number of state owned enterprises fell by 16 percent in 2000 and a further 9 percent in 2001—as a result of privatization, conversion to limited liability companies, bankruptcy or mergers and acquisitions. Another major change has been the rapid move towards much greater labor market flexibility in urban industry and the large shakeout of labor from SOEs and urban collective enterprises: by 2000, employment in these sectors had fallen by some 47 million from a peak of 145 million in 1994/95, with layoffs accelerating especially after 1997. Although employment has grown in the new and expanding shareholding, limited liability, privately owned and foreign invested enterprises, this has not been enough to absorb all of the labor released from the SOEs and collectives. The growth of a large “unclassified” labor force or unemployment or informal sector workers underlines the urgency of strengthening public social insurance and safety net mechanisms.

Financial status of the enterprise sector. The evidence on the impact of reforms on enterprise performance is mixed. The absolute volume of SOE profits rose in 2000 but declined slightly in 2001, while returns on assets remained low. In the first 8 months of 2002, the profits in industrial enterprises increased by just over 10 percent from a year earlier, while those of SOEs decreased by 4.1 percent.

A recent study has looked at the financial status of mostly state-owned Chinese listed enterprises, and has found that profitability in China’s corporate sector fell over the period 1995-2000 and is now weak. The liquidity position of listed firms is also weak, with short-term liabilities typically exceeding current assets by 4 to 1. Several enterprises in the sample (accounting for 20-30 percent of the total debt of all sample firms) are unable to generate enough cash flow to pay interest on their debts. In fact, the corporate sector is susceptible to even modest interest rate and demand shocks. Sensitivity analysis suggests that a moderate rise in interest rates and drop in sales could cause 40-60 percent of the debts of all firms to become unserviceable—underscoring the fragility of the sector. The interest coverage analysis corroborates the high level of NPLs in the banking sector.

Ownership transformation, privatization, mergers and acquisitions. In June 2001, the State Council passed a regulation allowing the sale of state-owned shares in listed companies. Part of the funds raised was to be used for funding social security. A steep fall in the A share market has however unsettled China’s numerous investors and raised concerns about the health of many financial institutions with a large exposure to the stock market. The Government was thus obliged to cancel the plan in June 2002. Privatization of small SOEs has proceeded rapidly, however, mainly driven by local governments. According to recently released data, there were only 34,000 small industrial SOEs left at end-2000, 38,000 less than in 1995—the reduction being due to privatization or liquidation. Two recent deals have raised the prospect that a full-fledged Chinese market for mergers and acquisitions may be on the horizon: the US Emerson company recently bought a 100 percent of a division of Huawei, a privately run Chinese telecoms company, and Alcatel of France gained control of a joint venture with a SOE.

Reform of the insolvency system. There are several flaws in the current insolvency system. Creditors have little influence on the process, are treated inconsistently, and often suffer violation of their secured claims. Moreover, procedural and institutional shortcomings make the insolvency process vulnerable to irregularities. Under a special program that applies to large SOEs, the entitlements of labor affected by SOE bankruptcy are quite substantial as well. A new bankruptcy law, modeled on those in market economies was drafted in 1995-96. It would apply to
state and non-state enterprises. However, due Government and party concerns about the social implications of SOE bankruptcy, the draft has not yet been reviewed by parliament (NPC). Thus the widely expected NPC review of the new bankruptcy law in April did not take place, and according to the local media, it is still unclear as to when the new bankruptcy law will be passed.

**Corporate governance.** A Code of Corporate Governance for Listed Companies was jointly enacted by CSRC and SETC in January 2002. The CSRC has also published many new rules and regulations covering the stock market. For instance, a revised rule makes it easier for a loss-making company to be de-listed. In an attempt to speed up the development of the market for corporate control, a regulation on mergers and acquisitions in the stock market has been enacted, to be effective December 2002. The CSRC has also continued to implement the requirement for listed companies to have an independent board of directors. Listed companies have been busy hiring in order to meet the CRSC requirement of at least two independent directors by end-June 2002. Training of independent directors has also been intensified.
ENHANCING PRODUCTIVITY-DRIVEN GROWTH

Overview

There is a growing appreciation that sustaining economic growth in the region over the coming decades will need to rest increasingly on improving productivity and raising the returns on accumulated assets and innovation—rather than on resource mobilization as such.

How do East Asian firms currently rank in terms of their technological sophistication and capacity to innovate? According to the indices compiled by the Global Competitiveness report, while East Asia does not fare too badly on “technological sophistication”, there is nonetheless much scope for catch-up with world technology leaders (Figure 3).

At a more in-depth level, a recent World Bank financed study has developed a methodology for benchmarking the technological position of firms in terms of their readiness to assimilate and absorb new innovations from basic shop floor level to the more sophisticated research and development activities, and has applied this methodology to assess a sample of “leading edge” firms in Korea and Thailand.

Evaluating firms on the degree to which they are aware of technological issues on the one hand, and how well they are prepared and able to improve in practice on the other, the study places firms into four possible categories that range from being a) unaware/passive—the firm is unaware of technological trends and at the mercy of the environment; b) reactive—the firm recognizes the need for to keep up with technological but lacks skills and capabilities; c) strategic—the firm is highly capable with a clear view of technological priorities; to d) creative—the firm is knowledge intensive, with fully developed capabilities.

The study finds that these better-performing Korean firms are beyond the “unaware/passive” and “reactive” stages and fall largely in the “strategic” stage (Figure 4). They

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23 At the same time, the fact that these firms are not too far off from global best practice means that they should be well placed to move further up the technological ladder through mechanisms such as FDI, supplier linkages with transnationals and global networks. Firms whose technical know-how is very distant from the technological frontier or best practice find it difficult to assimilate new technologies even if they are exposed to such technologies.

24 The sample focused on high performing firms in Korea and Thailand and was therefore not randomly selected or representative. However, this sample is useful to study since it is the more innovative firms are likely to be leading the transition towards a knowledge-intensive economy and since it can help illustrate where leading firms in these countries stand in relation to the technology frontier (i.e. the creative firms capable of contributing to the world technology frontier through R&D or new generation, high value products).
are not, however, as yet in the creative stage (only two firms scored highly enough to be in the creative category). Historically Korean firms (particularly exporters) have progressed from basic assembly to technology intensive manufacturing, and their current emphasis is on process innovation rather than on upstream knowledge intensive activities (such as R&D and product design), or downstream high value-added activities (such as distribution, marketing and brand exploitation). In Thailand, there is a much wider distribution of capabilities—from passive, through to reactive and strategic (Figure 5). In large part these firms are aware of technological possibilities, but fall short of effectiveness in practice.

A key policy issue for countries in the region, therefore, is how to engender productivity-driven economic growth over the coming decades.

There is increasing evidence that international production networks can be important in providing impetus for productivity growth in firms participating in such networks. With the changing production systems of transnational corporations that has been seen globally over the past few years, firms’ relationships with transnationals can range all the way from the more traditional equity based governance (FDI) to non-equity linkages such as franchising, licensing or even stable trust based relationships. Regardless of the form of governance, firms that are linked in such networks are exposed to the rigors of competition—an important disciplinary mechanism that enhances the drive for efficiency and productivity improvements and encourages firms to make investments in innovation and undertake the efforts to adopt technologies developed elsewhere. They can also provide the means for the acquisition (and diffusion) of technical know-how.

The potential gains from FDI

FDI has long been considered an important source of technology transfer and of providing a productivity impetus to the host economy. A recent study, based on surveys of East
Asian manufacturing firms undertaken by the World Bank\textsuperscript{25} looks at the productivity of foreign-owned firms in East Asian manufacturing. Consistent with the notion that foreigners may be more familiar with technological opportunities abroad and that ownership may give greater incentives and ability to invest in improvements in technology or management—the study finds that in four out of the five countries—Indonesia, Korea, Philippines and Thailand—total factor productivity is (statistically) significantly higher in firms that are foreign-owned relative to domestic firms, even after controlling for other characteristics (such as the age of the firm, size, sector and establishment level reports of their capacity). Moreover, firms with foreign ownership of over 50 percent—i.e. with strong control—stand out especially in terms of their higher productivity. The estimated productivity differentials are the greatest in Indonesia and the Philippines where the differences are around 40 percent, as compared to 15-20 percent in Thailand and Korea.

Do domestic firms in the same sector gain from the higher productivity of foreign owned firms? In principle, knowledge spillovers across firms in a particular sector could arise through a number of mechanisms: local firms may be able to learn by simply observing and imitating multinationals; employees may leave multinationals to create or join local firms; or multinational investments could spur the entry of professional services such as international trade brokers, accountants, and consultants, from which all firms can benefit. But the empirical evidence on this has been mixed\textsuperscript{26}. It may be that the technology gap between foreign and domestic firms is too wide and local firms lack the absorptive capacity needed to recognize and adopt the new technology. Relatedly, domestic firms often produce for the local market and multinationals for foreign markets and because of differences in quality and other attributes of the products they sell, their production methods may be significantly different and therefore reduce the potential for technology transfer. It is also likely to be the case that multinationals attempt to minimize technology leakage to local competitors—so the weak empirical relationship between FDI and domestic firms in the same sector is perhaps not all that surprising.

More recent work has started to explore another channel—one which has hitherto received less attention—through which foreign direct investment may contribute to the productivity of local firms: vertical linkages or supply chains. International buyers want high quality, low-cost goods of the latest design, so the incentives for multinationals to transfer production techniques, managerial practices, design guidelines and other know how to their suppliers seems clear. Such studies find that while horizontal linkages indeed appear to have little impact on the productivity of local firms, vertical linkages between foreign direct investment and domestic firms can have significant positive effects on the productivity of the latter. This positive effect goes beyond any scale effects (because selling to multinationals may allow suppliers to increase their output and operate at a more efficient scale); in fact, a substantial amount of the growth in output experienced by domestic firms—as a result of linkages with FDI—are found to be due to gains in technology.

\textsuperscript{25} The surveys were undertaken in Indonesia, Korea, Malaysia, the Philippines and Thailand. They were undertaken during the early part of 1998 and hence the data collected refer mostly to two or three years before the crisis.

\textsuperscript{26} Studies based on cross sectional data generally find a positive correlation between the presence of foreign direct investment in a sector and productivity of local firms within that sector. However, such analyses cannot distinguish whether FDI actually creates positive externalities or knowledge spillovers, or whether multinationals simply invest in inherently more productive sectors. On the other hand, studies based on panel data (i.e. ones that study particular firms over time and hence address the problem of simultaneity) have not found net benefits in terms of horizontal spillovers—that is the presence of multinational corporations has not been found to have on domestic firms in the same sector.
Box 1. Recent FDI developments in the region

The region has actually fared relatively well in FDI inflows since the crisis. China has been the largest recipient of FDI inflows to developing countries for most of the 1990s and has continued to receive large amounts. (Although inflows to China stagnated during 1997-2000, they regained momentum in 2001—and despite the period of stagnation, the annual averages since 1998 have been almost twice that received during 1990-96). FDI inflows to Korea have increased dramatically from the very low levels pre-crisis, on account of the significant liberalization of the FDI regime that has been undertaken since the crisis. While inflows to Korea in 2001 tapered off following the strong surge in 1998-2000 associated with the wave of post financial crisis M&A activity, Korea now receives almost 6 times the annual average inflows seen during 1990-96. While the increase has been less dramatic (and starting from a higher base), Thailand too has received more inflows compared to the pre-crisis period. Average inflows to the Philippines have remained about the same as during the pre-crisis period. However, Malaysia, which was an important destination of FDI inflows prior to the crisis, has received lower inflows since the crisis. And in Indonesia divestments have exceeded inflows since late 1998.

Data source: World Investment Report 2002

Greater opportunities from the changing production systems of transnational corporations

The scope for vertical spillovers from foreign to domestic companies discussed above may be increasing. During the past 15 years, falling barriers to international transactions have not only invigorated global markets through arms’-length transactions but have given rise to
elaborate corporate systems of organizing the production process. As a result, international production systems are emerging in which TNCs locate different parts of the production processes—including various service functions—across the world to take advantage of fine differences in costs, resources logistics and markets (World Investment Report 2002). One of the distinctive features of such international production systems, as compared with earlier organizational structures, is the emphasis on the efficiency of the system as a whole, rather than individual firms. This means that a given location is judged on how cost effectively it performs a given function in coordination with functions located elsewhere and not merely in isolation (World Investment Report 2002).

The form of governance of such systems range from ownership (or equity) linkages that provide direct managerial supervision, to various non-equity linkages in which formally independent intermediaries—suppliers, producers and marketers—are linked through a variety of relationships such as franchising, licensing, subcontracting, marketing contracts, common technical standards or stable trust based relationships. A recent trend in many manufacturing and service international production systems is in fact a shift towards the systematic outsourcing of a greater range of activities, including back-office operations like customer service—as the TNCs themselves focus on those activities in which they can deploy proprietary advantages, wield market power or otherwise enjoy higher returns (i.e. on their core competencies). This outsourcing trend has complex implications for global industry structures, creating entire new industries and opportunities. In particular, leading TNCs in a range of industries have begun to exit from manufacturing altogether, in response to which contract manufactures have emerged to specialize in turnkey manufacturing services. For countries that are well positioned in terms of certain key elements—including high quality infrastructure especially in transport and communications, a technical workforce and good logistics and supplier capabilities—there is thus considerable scope to benefit from the changing production systems of transnational corporations.

Exports and productivity growth

The notion that exporting—which is, of course, also an integral element of participating in international production networks—provides an impetus to productivity growth by subjecting firms to competitive pressures, is also supported by the Hallward Driemier et al (2002) study mentioned above. In particular, the study finds that in Indonesia, Philippines and Thailand, firms that were established as exporters, are systematically more productive than their domestic counterparts (In Korea and Malaysia the results were not statistically significant). And it is not simply that firms that are more productive self-select into becoming exporting firms, but that firms that explicitly target export markets make different decisions regarding investment, training, technology and the selection of inputs—precisely in order to be able to compete abroad.

The importance of services trade liberalization and its impact on productivity

Services such as transport and telecommunications are key if firms are to be able to successfully participate in international production networks. There are good conceptual reasons to expect that the liberalization of such services can give rise to productivity improvements both because there is considerable scope for learning by doing, knowledge generation, expanding product variety and upgrading product quality in these sectors, and because in many of these sectors foreign firms can only compete by making foreign direct investments in the host country, thereby enhancing the potential for spillovers of new technology and skills to the host economy.

27 Contract manufacturing differs from the earlier system of original equipment manufactures in that the brand-holding TNC does not simply draw on subcontractors for extra production capacity but rather outsources the entire manufacturing for certain individual product lines, or sometimes the entire product range.

28 Moreover, removal of barriers to entry by both foreign and new domestic competitors can enhance competition and the scale of activity in these sectors, with further gains in productivity.
And the higher productivity of the sectors themselves in turn boosts the productivity of the manufacturing sector, better positioning domestic firms to participate in international production networks.²⁹

While the degree of openness in services sector is quite difficult to measure empirically, recent work undertaken for the World Bank’s research program on trade in services, for example, (Matoo et al (2001)) has constructed indices of liberalization in telecommunications and financial services. The work finds a strong statistical relationship between greater openness in these sectors and countries’ per capita income growth performance in the 1990s. How open are the East Asian countries in these sectors? In fact, comparing the East Asian countries with others, the study finds that several countries in East Asia lag behind Latin American countries in terms of openness in both these sectors (Figures 6 and 7).

Hence the potential gains from the liberalization of such services in East Asia could be very high. As in the case of trade reform in goods, however, such liberalization initiatives need to be accompanied by the building, strengthening or reforming of supporting institutions. In the case of services such as telecommunications and transport, sectors that are prone to monopolistic structures, such institutions would include the regulatory bodies and the competition agency.

²⁹ In fact, the potential synergies go both ways: i.e. from services to manufacturing and from manufacturing to services, to raise overall productivity. A 1996 OCED study, for instance, found that across ten OECD countries, new technologies developed in the manufacturing sector were transferred to information technology intensive activities in the services sector, where they improved productivity growth significantly.
References


