

Bank restructuring in South-East Asia

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Introduction

Weaknesses in the financial systems of Thailand, Malaysia and Indonesia were exacerbated by very large devaluations in 1997 and early 1998. Policy responses have some similarities; all have set up agencies to manage bad assets and all have schemes to inject public money as capital into the banks. The differences between the responses reflect three main factors:

- the severity of the problems; Indonesia has had a much larger devaluation and more severe depression and consequently its banking system faces greater problems than does Malaysia or Thailand.
- political factors; Thailand and later Indonesia (like Korea) have had changes of leadership which facilitated policy changes and signed agreements with the IMF that have required some policy changes. In contrast Malaysia has maintained its, more market-sceptical, approach.
- the structure of the banking system; Thailand has been able to adopt more of a case-by-case approach to its treatment of banks while the much larger number of banks in Indonesia have forced them to adopt more general rules for restructuring.

This paper compares the main elements of the implementation of bank restructuring. It is not meant to be comprehensive. Moreover, these policies are being adapted over time as conditions change. It is of course too early to assess the efficacy of restructuring to date.

* This paper has benefited from discussions with officials, bankers and academics in the countries covered and comments by Elmar Koch, Robert McCauley, YK. Mo and Philip Turner. All opinions are those of the author and not necessarily those of the BIS or central banks of the countries discussed. It includes information available up to June 1999.

Background

The economic crisis

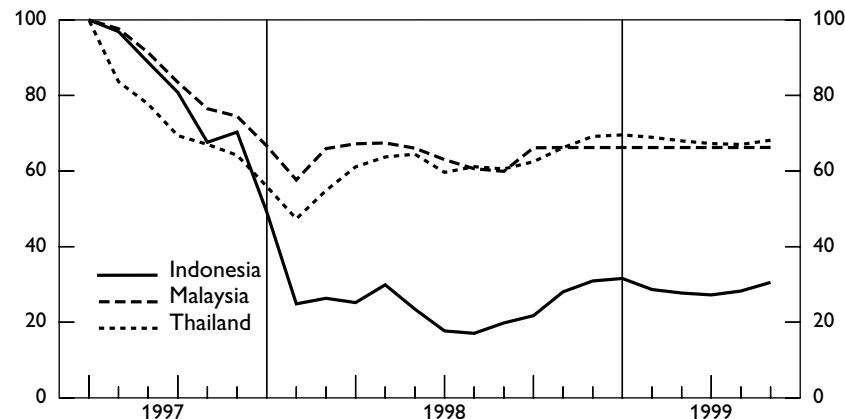
Thailand, Malaysia and Indonesia experienced from late 1997 severe and unexpected recessions after consistent and very strong growth for more than a generation. The Thai devaluation in July 1997 triggered recurrent rounds of currency depreciation affecting all three economies during the remainder of the year. The currencies all recovered somewhat from January 1998 onwards but remain much weaker than in the first half of 1997. The size of these depreciations was far greater than previous discussions of possible overvaluation had suggested was warranted.¹

Attempts to stave off devaluation, and then fears of yet further depreciation, meant that interest rates in East Asia rose to high levels in the second half of 1997 and early 1998 and credit contracted sharply. These in turn caused severe contractions in output (Table 1) and corporate profitability (as reflected in massive falls in equity prices). This unprecedented slump put the banking system under severe stress.

Graph 1

Exchange rates *

Monthly averages; June 1997 = 100



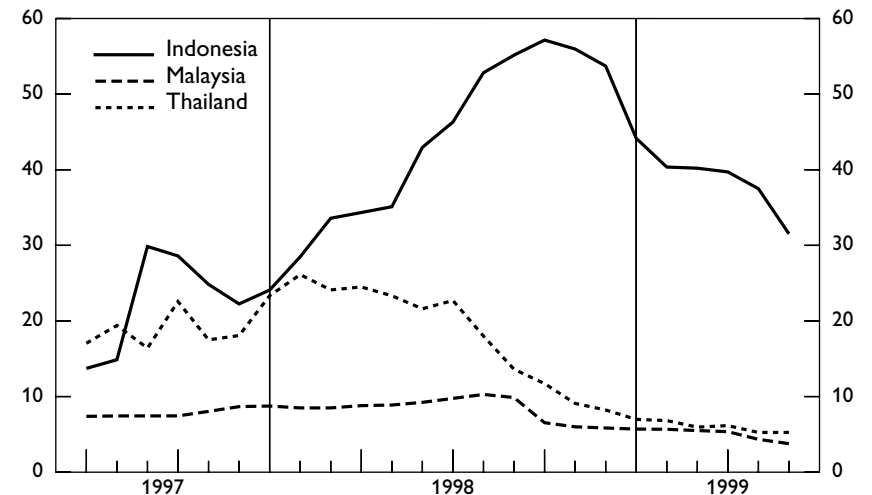
* US dollars per local currency.

¹ For a further discussion of the contours and causes of the Asian currency crisis, see Goldstein and Hawkins (1998) and Radelet and Sachs (1998).

Graph 2

Interest rates *

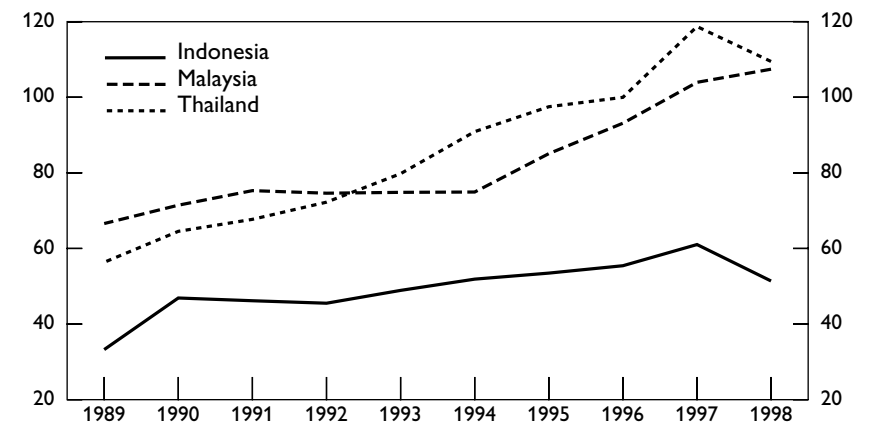
Monthly averages, in percent per annum



* Three-month rates.

Graph 3

Domestic credit *



* To the private sector, as a percentage of GDP.

Table 1
Comparative data

	Number of banks ¹	Real GDP ²	Estimated cost of restructuring ³	
		1997–99	\$US bn	% to GDP
Thailand	20	– 7	43	32
Malaysia	24	– 5	13	18
Indonesia	178	–15	40	29

¹ Pre-crisis; private domestic commercial banks and state banks. Source: World Bank (1998).

² Cumulative percentage change. Source: Consensus Economics *Asia-Pacific Consensus Forecasts*, July 1999. ³ IMF estimates as at 30 November 1998. Source: IMF (1998).

Scale of the problem in the banking system

The banking systems in the three economies now face a crisis more severe than experienced in any of the high profile banking crises in the advanced economies.² Official figures now put non-performing loans (NPLs) at almost 50% of loans in Thailand and considerably higher in Indonesia. In Malaysia, the official estimate is 8%³ but some private sector estimates are much higher. The cost of repairing the banking systems will obviously be very high; some IMF estimates are given in Table 1.⁴

The problems are extraordinarily widespread; most surviving banks are incurring losses and there are scarcely any which have not had to seek official assistance, mergers or large amounts of new capital.

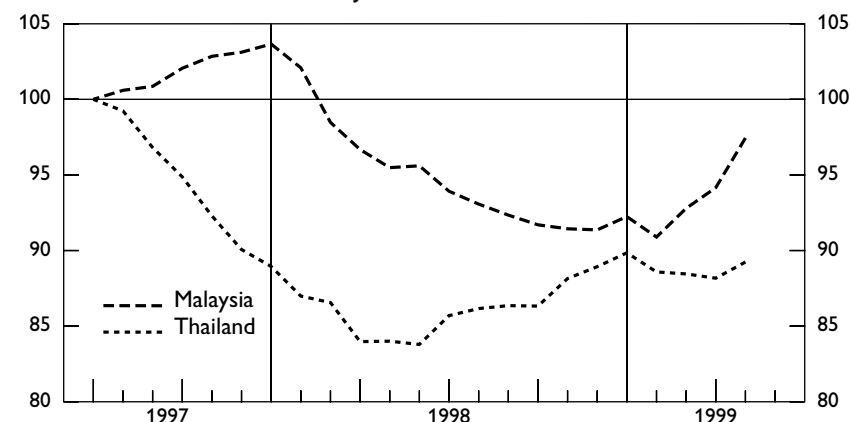
The proportion of NPLs has risen rapidly. This reflects both more realistic assessments and an increase in the number of borrowers falling behind in payments. Interest rates have eased back in all three countries. In Malaysia and Thailand they are now below pre-crisis levels (Graph 2). This has been associated with output recovering in Malaysia and Thailand (Graph 4). Equity prices have come off their lows, in some cases markedly so.

² See Tables 6 and 7 and the associated discussion in the overview paper.

³ Note that in Malaysia loans are only required to be classified as non-performing when repayments are over 6 months overdue. If the more usual 3 months classification were used NPLs would be around 13%.

⁴ Some similar private sector estimates are given in Keenan et al (1998) and Shirazi (1999). More recently, much higher estimates for Indonesia and Thailand have been made by Armstrong and Spencer (1999). Many commentators now expect the cost of restructuring Indonesia's banks to exceed 60% of GDP; Standard and Poor's think it could exceed 80%.

Graph 4
Industrial production *
June 1997 = 100



* Three-month moving averages.

Along with some successful restructuring of corporate debt, these features give some hope that NPLs may now be near a peak in Thailand and Malaysia.⁵ This is supported by a levelling off in NPLs reported by some individual banks there.

Coordinating bank restructuring

The *Financial Restructuring Advisory Committee* was formed in **Thailand** to advise on the overall process and issue guidelines. It is chaired by a former deputy minister of finance and includes representatives from the Bank of Thailand (BoT), finance ministry and the private sector. The BoT, the central bank, provides its secretariat.

Bank Negara Malaysia (BNM) itself plays the coordinating role in **Malaysia**. It has also provided some key personnel for the specialised bodies charged with resolving the problems.

In **Indonesia** the lead has been taken by the Indonesian Bank Restructuring Agency. IBRA held discussions with the five main political

⁵ Goldman Sachs (1999a) report calculations based on published corporate balance sheets supporting this view. However, they warn that a significant proportion of companies are making losses even before interest payments.

parties prior to the recent election and secured general agreement from them on its approach.

Challenges for supervisors

Bank runs and depositor protection

General guarantees covering all bank deposits have been announced in the three countries; in August 1997 by Thailand, in late 1997 by Malaysia and in January 1998 by Indonesia. Explicit deposit insurance schemes are now being developed.

The need for this, notwithstanding concerns about moral hazard, was demonstrated by the reaction to bank closures in Indonesia. Under the terms of an IMF programme, Indonesia closed sixteen commercial banks in November 1997. It was explicitly stated that deposits over 20 million rupiah (about US\$ 5,000 at the time) were not guaranteed. A major run on private domestic banks in Indonesia followed. Some funds were transferred to foreign or state-owned banks but some funds appeared to be kept out of the banking system entirely, being held as cash or sent abroad.

Not only domestic depositors lost confidence. Foreign banks cut back lending (Table 2) and became reluctant to roll over credit facilities or to accept letters of credit written by banks in the region. This led to a lack of trade finance preventing exporters from taking full advantage of the apparent increase in competitiveness from the devaluations. For this reason the Indonesian authorities' guarantees apply not just to domestic depositors but all creditors both in rupiah and foreign currencies and including off-balance sheet liabilities. In January 1999, Bank Indonesia

Table 2
Liabilities to BIS reporting banks
\$US billion; December 1998 (June 1997)

	Banks	Non-banks
Thailand	46 (86)	11 (13)
Malaysia	18 (25)	5 (7)
Indonesia	18 (23)	33 (37)

Source: BIS International Banking and Financial Market Developments, June 1999 (and February 1998).

announced it had repaid almost all the local banks' trade-related debt to foreign banks. Notwithstanding references to informal understandings with the foreign banks, it is unclear whether foreign banks will now be more willing to undertake new lending to Indonesian entities.

Changes to regulations

Changes to regulations and supervisory practices take two forms. One is temporary concessions, aimed at helping banks out of current problems. The other is tightening requirements to avoid banks getting into more problems in the future. Malaysia has done more of the former, while Thailand and Indonesia have concentrated on the latter. Property development has been a particular area where regulations in Asia have been tightened.⁶

The authorities in **Malaysia** announced that banks were expected to expand their loan portfolio by 8 per cent during the course of 1998. In the event, this was not achieved. Indeed, overall outstanding loans were virtually unchanged during 1998. Despite the subsequent lack of compliance, the announcement of the loan target raised concerns about further deterioration in the quality of banks' loan books. The authorities have set a similar target for loan growth in 1999. Performance in meeting this target may be one aspect of the recently announced reviews of bank CEOs by BNM.

The percentage of eligible liabilities banks must maintain as non-interest-bearing deposits with BNM was cut in stages from 13.5 to 4%. Although the definition of NPLs was made more lenient (i.e. six months overdue), Malaysia has tightened some prudential guidelines. Banks' required general loan loss provisions were raised from 1 to 1.5% of loans. Capital requirements were to be met quarterly rather than annually. In April 1999 changes were foreshadowed to the capital adequacy requirement, relating capital to internal controls and the industrial composition of loans. The maximum exposure to a single borrower has been reduced from 30 to 25% of capital and loans to

⁶ ADB (1999) comments "In Malaysia, the Central Bank limited the banking sector's exposure to the broad property sector to 20% of outstanding loans, and set limits on the institutional and individual purchases of shares and stocks. The financing of second houses has been reduced to 60% of property value. In Indonesia, banks are no longer allowed to extend new loans for land purchase or property development, except in the case of low-cost housing."

controlling shareholders are being prohibited. Banks are required to disclose ratings, sectoral exposures, capital adequacy and NPLs six weeks after the close of the quarter. BNM permission will be required before opening new branches.

Thailand announced a mild easing of capital requirements. While the overall required ratio remains slightly above the Basle standard at 8.5%, the tier 1 component of this need only be 4.25 rather than the previous 6%. Restructured bad loans can now be classified as performing. At a meeting with BoT in January 1999, the local banks agreed to plan for 7% loan growth this year.

But so far the Thai authorities have been more concerned with removing laxity in supervision. A comprehensive review of the legal and regulatory framework is expected to lead to new legislation around the middle of 1999. Tighter provisioning requirements are being phased in and take full effect by end-2000. However, banks wanting to use the tier 1 scheme discussed below must meet these requirements immediately. BoT has also announced measures to ensure the quality of any capital raised (e.g. by limits on equity issues with attached bonds).

Amendments to the Banking Act in **Indonesia** gave the central bank responsibility for licensing, regulating and supervising banks. Bank Indonesia (BI) has issued new regulations on loan classification and provisioning, reduced the maximum allowable net open foreign exchange position and reduced the maximum size of loans to associated companies. A new central bank law was passed in April 1999 giving BI more independence but limiting BI's ability to lend to banks. From 2000 bank supervision will be handed over to a new body.

Managing bad assets

Asset management corporations (AMCs) have been established in all three economies, although they appear to be adopting different strategies. Thailand's AMC seems keenest to sell off the loans or underlying assets quickly while Malaysia's AMC seems to prefer managing them for some time and selling off more gradually.

The first AMC in the region was that in **Thailand** charged with disposing of the assets of the insolvent finance companies. The *Financial Sector Restructuring Agency* (FRA) was established in October 1997. The

FRA has its own board, including a deputy governor from BoT, a former secretary of commerce, a former finance company CEO, a public prosecutor and an accountant. It had early success in auctioning off the more homogenous assets that are easiest to value. Physical assets (office furniture, cars etc) were sold in March 1998, car loans in July and residential mortgages in August. These sold on average for around half the book value.

However, the much heralded 'world's biggest asset sale' of corporate loans (many property related), with a face value of over US\$ 10 billion, in December 1998 was a disappointment. It attracted only twelve bidders, mostly US investment banks. The highest bids received were in most cases below what the authorities regarded as the minimum acceptable (reported as 25–30% of book value). While about a third of the assets were later sold for 21% of face value plus a profit-sharing deal, the aim of completing the asset sale by the end of 1998 was not achieved. Under the auction rules, purchasers are forbidden to sell loans to the original debtors for six months.

Most of the remaining assets were resubmitted to a new auction in March 1999, at which some packages of loans were offered on a profit-sharing basis, under which the FRA receives 20% of the cashflow after deduction of expenses. Bids were accepted in either cash or bonds. This flexibility was hoped to attract more bidders, but complicates the choice of the 'best' bid. Profit-sharing arrangements mean the FRA does not yet know how much revenue it will eventually have available to distribute and require it to stay in operation longer. The results of this auction were also disappointing, with few bidders and sales at an average price of only 18% of face value. A small auction of construction loans in May 1999 was cancelled when it only attracted a very small number of low bids. A final auction is to be held in August 1999.

The *Asset Management Corporation*, established in October 1997, has capital of THB 15 billion and plans to issue up to THB 180 billion of 3–7 year bonds (a portion of which will be explicitly government-guaranteed). It can act as a bidder of last resort at FRA auctions and manage assets thus acquired for up to five years. It made no purchases at the December auction but was the largest purchaser at the March auction, buying almost three-quarters of the assets on offer.

The *Radhansin Bank* was established in March 1998, with initial capital from the World Bank and the Asian Development Bank, with a

mandate to bid for 'high quality' assets (its name means 'good assets') being sold by FRA. In practice there have been few good assets so it has not been very active in its initial role. Instead it has been used to take over the failing Laem Thong Bank. The combined bank is being sold in August 1999 with the government subsidising up to 85% of losses for the first five years.

A specialised AMC, the *Property Loan Management Organisation*, was established to purchase loans collateralised against partly developed property projects from financial institutions with the aim of enhancing their value by careful management. It is owned by the government, chaired by the permanent secretary of the finance ministry and can raise up to THB 100 billion in working capital through issue of government-guaranteed bonds. It makes purchases at a market price appraised by three independent valuers. Operating expenses are funded from charges on the financial institutions and borrowers.

A 'bad bank' has been established to manage the NPLs of Bangkok Bank of Commerce. It is mostly staffed by former employees of the bank and housed in some of their former branches. The intention is to wind it up by the end of 1999. The performing assets are being taken over by the state-owned Krung Thai Bank. The government has established a legal framework to encourage private banks to establish their own 'bad banks'.

Malaysia established a public company owned by the Ministry of Finance, *Danaharta* (in full, *Pengurusan Danaharta Nasional Burhad*) in June 1998 whose objectives are to "acquire, manage, finance and dispose of assets and liabilities" of financial institutions to "allow them to focus on their core business of lending". It bought its first loan from a bank in August 1998 and is expected to operate for up to ten years. It outsources some of the management of properties it acquires.

Danaharta has a board of nine directors appointed by the finance minister. Most come from the private sector (including two from the international community) but two represent the government. The managing director, a former investment banker, is a non-voting member of the board.

The legislation establishing Danaharta gave it two special powers. Firstly, it can acquire assets through statutory vesting to give it certainty of title. If Danaharta wants to acquire a NPL from a bank, it first agrees the terms and conditions (including price) with the bank. It then issues a

vesting certificate which the Registrar of Land will accept as giving the same charge over land as held by the selling bank. Danaharta may later sell the loan, also using statutory vesting. None of this requires the consent of the borrower.

Secondly, it has the ability to appoint Special Administrators to manage the affairs of distressed companies, unable to meet their debts, subject to the approval of an Oversight Committee. The Committee comprises representatives from the finance ministry, central bank and the securities commission. While the Special Administrator is controlling the company's assets, a 12-month moratorium takes effect during which no action can be taken against the company. The Special Administrator prepares a workout proposal, which along with a report on it by an independent advisor approved by the Oversight Committee, is passed to Danaharta. If Danaharta and a majority (by value) of secured creditors approve it, the proposal is implemented.

Five subsidiaries manage property, infrastructure, industrial, construction and general investment respectively. Some of these will be taking projects through to completion before sale. This more active approach to managing assets has been compared to Sweden's AMC (*Securum*), which was able to restructure, package and sell assets within five years.

Danaharta initially estimated it needed to raise MYR 25 billion for its operations but this has been revised down to MYR 15 billion. The government contributed MYR 1.5 billion in capital and further contributions are possible. Almost MYR 5 billion has been raised from issue of zero-coupon bonds. Private equity participation is also contemplated.

As at 30 June 1999 Danaharta had purchased 2,000 NPLs, worth MYR 30 billion from the banks, swapping them for 5-year zero-coupon government-guaranteed bonds with an option to rollover for another five years, discountable at BNM. About a third of the loans purchased were property loans. In general, Danaharta is meant to give priority to supporting lending for strategically important sectors such as exporters. Danaharta is also managing MYR 13.7 billion of NPLs for two banks. In some cases, banks have rejected offers from Danaharta to buy NPLs off them.

The price Danaharta offers banks for NPLs is calculated using either a market value for collateral or a discounted present value approach based on that employed by the RTC in the United States and *Securum*

in Sweden. This has so far meant paying an average of 61% of book value (excluding one exceptional case). Danaharta only caters for the 2,000–3,000 NPLs made by banks of more than MYR 5 million. Lack of involvement with consumer or housing loans makes its operations less politically sensitive: it is not evicting people from their homes. (A special purpose vehicle is being established to purchase and manage small NPLs from finance companies.) In some cases Danaharta takes over performing loans to a firm if other loans to that firm are in arrears. In 1998 it concentrated on secured loans; in 1999 it may purchase unsecured and foreign currency loans.

There are two specific incentives for banks to sell NPLs to Danaharta. Firstly, if the loan or underlying collateral is subsequently sold for more than Danaharta pays, 80% of the surplus is returned to the bank. Secondly, banks will be able to amortise the loss on any loans sold to Danaharta over up to five years. Danaharta has started to dispose of some assets. A tender has been held for foreign currency loans, with bids due in August.

In **Indonesia**, the *Assets Management Unit* is a component of the *Indonesia Bank Restructuring Agency* (IBRA – sometimes called BPPN after its Indonesian initials). IBRA takes over the management of unsound banks. It was established in January 1998 and has 500 staff. Initially its staff were mostly seconded from the central bank, finance ministry and other public and financial institutions and supplemented by external consultants. Now most of the staff have a private sector background. Separate parts of IBRA handle financial assets and non-core assets.

It has just started the process of selling the IDR 158 trillion of financial assets it has acquired so far (it may eventually have over IDR 250 billion in assets to sell). A package of credit card receivables was sold in June 1999, following the sale of some cars and computers. Up to IDR 1 trillion of retail loans will be sold in July. It plans to contract out recovery of loans below IDR 25 billion.

Mergers and takeovers

Domestic private bank mergers have not been able to play a large role in resolving banking problems as almost all banks have suffered in the crisis. In September 1998 the authorities in **Indonesia** announced that

four state-owned banks would be merged into the new Bank Mandiri. Their bad assets will be transferred to IBRA. The new bank, whose name means “self-reliant bank”, will have almost a third of total bank assets and may later be sold. Treasury operations have been centralised and a centralised credit unit has been formed. Substantial staff cuts are likely in order to reduce costs; a voluntary severance plan has already resulted in over 9,000 applications. Most NPLs will stay with Mandiri. The bank is being advised by an array of international companies. According to *The Economist* (1999), Deutsche Bank is overseeing the restructure and overhauling credit procedures, McKinsey is developing a retail banking strategy, Andersen Consulting is revamping information systems, Hay Management looking at staffing and Ogilvy & Mather designing a new image. Preliminary merger talks have been held between five other Indonesian banks.

The **Malaysian** authorities have announced plans for the country's banks and finance companies to be merged into six large groups by September 1999.

Takeovers by foreign banks have become much more favourably regarded in Indonesia and Thailand since the crisis broke out. Legislative amendments in Indonesia now permit majority foreign ownership. A British bank has taken control of one large Indonesian bank. However, while foreign banks are now allowed to take a majority stake in domestic banks in Thailand, it can only be held for ten years. This appears to have deterred foreign banks from buying. However, in contrast, Malaysia is retaining its 30% limit on foreign ownership of banks.

Recapitalisation schemes

All three economies have schemes in place to assist the recapitalisation of the banking system. Recapitalisation in **Thailand** is taking place under the aegis of the *Financial Institutions Development Fund* (FIDF). FIDF was established in 1985 to provide financial assistance to troubled banks, accepting a broader range of collateral than allowed under the BoT's lender-of-last-resort facility. It is staffed by the Bank of Thailand (BoT), who provided its initial capital, and is partly funded by a levy on financial institutions of 0.4% of deposits. (In time it will be replaced by a new deposit insurance agency.) The government issued THB 500 billion in

bonds to cover the FIDF's liabilities. The interest on the bonds is met from the budget with amortisation from future BoT profits. The FIDF has taken over some undercapitalised banks by converting its loans to them into equity. Initially it had hoped to sell these banks by end-1998 by providing guarantees covering future losses. It now hopes to sell them by end-1999. Foreign purchasers will be offered a loss-sharing agreement, where the cost of bad loans will be partially shared by the central bank for several years. Bids are expected from HSBC and Citibank among others.

Krung Thai Bank, now 94% state-owned, is being used to consolidate some failing banks and its subsidiary KTT is taking over some finance companies. The government has recapitalised it and intends to sell 20% of it by June 2000 and a further 30% by end-2000.

The government announced two general recapitalisation schemes in August 1998, which are operated by the FRAC. They involve the issue of up to THB 300 billion in government bonds. Under the 'tier 1 scheme', the government will inject capital to bring a bank's tier 1 capital up to 2.5% of assets with further government funding to bring capital up to 4% being contingent on private shareholders contributing matching amounts. The funds are provided in the form of tradable 10-year government bonds carrying market-related interest rates.

The tier 1 scheme is conditional on banks presenting viable restructuring plans to BoT. They must also meet strict requirements for loan classification and provisioning, which would often mean existing shareholders losing most of their stakes in the banks. Furthermore, the new capital will have preferred status to the existing shareholders. The BoT is also able to require replacement of top management as a condition of assistance and the ministry of finance can nominate at least one board member. For all these reasons, banks have been slow to take up the offer. The Siam Commercial Bank, part owned by the royal family, is the only bank to have had an application approved under the scheme so far, although at least one other bank has applied.

A third of the government funds are earmarked for the 'tier 2 scheme', which involves the government exchanging 10-year non-tradable government bonds for 10-year bank debentures. The bank debentures are to pay interest 1 percentage point above that on the bond and are convertible to preferred equity if the institution's capital ratio falls below the regulatory minimum. The amount offered to a bank will depend on

the extent of write-downs resulting from corporate debt restructuring and the amount of new lending but is limited to 2% of risk-weighted assets. So far only three banks have taken up the offer but more are expected to do so.

In **Malaysia**, *Danamodal*, (in full, *Danamodal Nasional Berhad*) was established in August 1998 as a limited liability corporation, and a subsidiary of BNM. Danamodal has raised additional funds through issuance of MYR bonds. As it achieves its objectives, Danamodal will sell its stakes in the banks. When they are all sold, any residual value will be distributed to shareholders. The current plan is for Danamodal to operate for five years; reforming banks in the first two years and then winding down shareholdings over the following three.

Danamodal is designed to operate separately from the government and take its own decisions on which banks in which to invest. The central bank has a strong involvement in establishing and overseeing Danamodal's operations. Danamodal's managing director is a former BNM assistant governor. Accompanying him on the board are two additional members from BNM, a deputy secretary of the finance ministry, the head of Danaharta and an accountant and lawyer from the private sector.

Danamodal can inject capital into domestic banks in the form of equity or hybrid instruments. It is nominating two directors, one of whom will serve as chair or deputy chair, to those banks to which it has contributed capital so far and has said if further capital is contributed it may seek further representation. As a strategic shareholder, it may seek mergers if it judges them appropriate and act to revamp management. Before receiving capital from Danamodal, existing bank shareholders have to bear all losses. Banks have to sell all eligible NPLs to Danaharta and comply with a comprehensive set of performance targets.

The BNM contributed MYR 1.5 billion as initial capital and a further MYR 1.5 billion in November 1998. 57 banking institutions also subscribed to MYR 11 billion nominal value (MYR 7.7 billion net) of zero-coupon bonds with maturity of 5–10 years, paying with funds freed up from the September 1998 reduction in required reserves with BNM.

In January 1999 BNM took control of Malaysia's largest finance company and guaranteed its deposits. In March 1999 Danamodal bought 70% of it for a token 1 ringgit and then injected MYR 1.6 billion in new equity. Danamodal will provide the chairman and five directors. By June 1999 Danamodal had injected MYR 6.2 billion into ten banks restoring

them to health, and raising the average risk-weighted capital ratio for the banking system to 12%.

In **Indonesia** it was about a year after the crisis hit before a major recapitalisation scheme was launched and not until March 1999 that the details of the package were announced. The package was initially costed at IDR 300 trillion; by June 1999 this estimate had been doubled. About IDR 230 trillion will be required for the state banks, IDR 220 trillion has been provided by BI to the private banks, a further IDR 130 trillion will be needed for recapitalising them and IDR 20 trillion will be needed to repay depositors of closed banks. These estimated costs are continuing to rise however as most banks are continuing to pay more on deposits than they are earning on loans. After audits of local banks (for the larger banks by international auditors and for smaller banks by the central bank), the banks were initially classified into three categories:

- *sound*; 74 banks with capital ratio over 4% (about a third of these banks had management regarded as “not fit” and were required to merge with other sound banks);
- *viable*; 9 banks with capital ratios between –25 and 4%, which will be eligible for recapitalisation support;
- *unsound*; 24 banks with capital ratios below –25%, and 21 banks previously classified in category B, which were not thought to be recoverable and are being closed and their depositors paid out by BI.

Under the plan eight of the nine banks classified as viable will receive equity from the government; one elected at the last stage not to join the scheme. The banks have been required to present credible business plans for bringing capital ratios up to 8% within three years to review committees that include representatives from the central bank, finance ministry, IBRA and independent observers from international agencies. Their shareholders were also required to inject at least 20% of the banks’ capital requirements; by early June 1999 four had done so. NPLs will be transferred to IBRA’s asset management unit. The government will receive preference shares with limited voting rights, which the original bank owners will have the option of purchasing at a later date. In addition, seven of the unsound banks were taken over by IBRA as their extensive branch networks mean they risk substantial disruption to the payment system. (This is in addition to the four taken over in 1998.) One bank is being taken over by a major international bank. The ultimate

Table 3
Corporate debt-equity ratio, 1998

Thailand	4.2
Malaysia	2.0
Indonesia	9.4

Source: IMF, reported in Stone (1998).

goal is a banking system comprised of 8–10 solid banks with a mix of domestic private banks, foreign-owned banks and a state-owned bank.

The government is to swap long-term rupiah bonds, tradable after six months, for the equity in the banks. There will be three types of bonds issued in June 1999: IDR 164 trillion with a real interest rate of 3% and maturity of 20 years; IDR 95 trillion with a rate tied to the three-month central bank bill rate and maturity of 3–10 years; and IDR 9 trillion with a fixed rate of 12–14% with maturity of 5–10 years. The annual coupon payments on the bonds represent about 3% of GDP in the first year. It will be funded from the sale of assets from liquidated banks and from the fiscal budget.

At the same time, Indonesia is trying to force former majority shareholders in some banks to repay the IDR 110 trillion in emergency loans they received from the central bank. It was agreed in November 1998 to extend a deadline from one year to four years, with only 27% of the total owed due in the first year. An International Review Committee is monitoring the process.

Dealing with corporate debt

Corporate debt restructuring

As well as restructuring the banks themselves, helping the corporate sector cope with large debt repayments (especially when interest rates are high) from their reduced cash flows is an important element of getting the process of financial intermediation operating again. Once schemes for addressing problems in the banks had been developed, this became more of a focus of attention. As firms are not subject to ‘runs’

in the manner of banks, it was not generally thought appropriate to make public injections of equity into them. Instead the authorities tried to facilitate and encourage private sector deals to restructure corporate debt and keep firms operating rather than proceed with bankruptcy cases. These issues were particularly important in Indonesia, given that its companies tended to borrow more heavily and incur foreign debt directly rather than through the banking system (Tables 2 and 3).

Drawing on the Bank of England's 'London Approach', the 'Bangkok approach' to corporate debt restructuring was developed in **Thailand** during 1998.⁷ It calls for creditors to agree on a standstill, and perhaps provide new money senior to existing debt, while a restructuring plan is formulated by the firm and its advisors. The agreement of creditors representing 75% of the amount owed is required for a deal to progress. If creditors cannot agree, the final decision rests with the court. A *Corporate Debt Restructuring Advisory Committee*, (CDRAC) chaired by the governor of BoT with representatives from the financial and corporate sectors, acts as an intermediary facilitating such negotiations (and has compiled a list of advisers with expertise in the area). It is monitoring around 200 corporate groups with combined debts approaching THB 700 billion and by end-May 1999 THB 430 billion of debt had been restructured. This may be a reflection of Thai bankers lacking experience in corporate restructures. CDRAC is hiring more mediators in coming months and will take on more cases. To encourage a faster resolution, some tax measures favouring restructuring will only apply until end-1999. Banks are being allowed to reclassify restructured loans as performing. Some corporate restructuring has involved equity for debt swaps.

CDRAC and BoT have also been involved with the Thai Bankers' Association, the Foreign Bankers' Association and the Association of Finance Companies in the jointly developed 'Debtor-Creditor Agreement on Debt Restructuring Process' and the 'Inter-Creditor Agreement on Restructure Plan Votes and Executive Decision Panel Procedures' finalised in March 1999. The agreements are binding contracts that commit signatories to follow a set framework, including deadlines, arrangements for the debtor to negotiate with a lead institution and fair

treatment of all creditors. They become effective in a particular case when the debtor signs the debtor accession form. As part of the process a CDRAC mediator can give non-binding advice. A plan approved by over half the creditors (but less than the 75% needed for the Bangkok Approach) can be referred to a panel for a binding decision.

Along similar lines, **Malaysia** has established a *Corporate Debt Restructuring Committee* (CDRC) to help preserve viable businesses. It calls for banks to share information and voluntarily grant firms a standstill period during which consultants can assess viability and devise schemes for saving the company. (See also the discussion above of the special administrators appointed by Danaharta.) As at June 1999 it was working to resolve and restructure loans amounting to MYR 32.6 billion from 52 applicants. Ten cases, involving MYR 10 billion, have been resolved with a further 18 involving debts of MYR 6 billion expected to be resolved in the near future. This procedure supplements the existing provisions in section 176 of the *Companies Act*, whereby the borrowers can obtain a stay against involuntary bankruptcy proceedings by submitting a reorganisation plan to the appropriate court. The plan is then implemented if approved by creditors representing 75% of the value of each kind of debt. The CDRC arranged a debt restructuring for the Renong Group, one of the largest in Malaysia.

Indonesia announced the Jakarta Initiative, a set of principles to guide voluntary restructuring of corporate debt, in September 1998. Each overdebted company can approach its major lenders to form a steering committee, agree to a standstill and consider new funding with priority over existing debt. The steering committee will appoint an adviser to assess the financial rescue plan proposed by the company and may then agree to a plan. If not all lenders agree, with commercial court approval a plan can come into force subject to the approval of a minimum share of creditors. The Jakarta Initiative is supported by a task force, led by the chairman of the stock exchange and including representatives from INDRA (see below), domestic and foreign creditors, government agencies and companies. Over 125 companies employing a total of 220,000 people are seeking such assistance but by mid-March 1999 only 15 companies had reached an arrangement with their creditors.

In some cases corporate debt restructuring will be a matter for the AMCs that now own the NPLs. Some have argued they have poor

⁷ See Table 11 of the overview paper in this volume for further information.

incentives to do this but if the necessary expertise is concentrated in this one body it may operate more efficiently than if it is diffused among a number of banks.

Another important aspect of these approaches is whether arrangements can be made for new credit to be advanced for working capital to firms that may be viable in the longer term but struggling to meet repayments on current debt. The Jakarta Initiative recommends this. One important form of new lending is trade financing. Thailand and Indonesia have established programmes whereby the central banks buy notes backed by export receipts and the government supports the banks in issuing letters of credit.

A more active approach involving public money has also been adopted in **Indonesia**. The *Indonesian Debt Restructuring Agency* (INDRA) was established in July 1998 following the Frankfurt Agreement. It assists Indonesian debtors repay their foreign currency obligations to foreign creditors (including Indonesian branches of foreign banks) by intermediating between the domestic debtor and the foreign creditor in servicing renegotiated debt. A condition of INDRA's participation is that creditor and debtor agree to restructure the loan so that repayments are spread over eight years or more with only interest paid for the first three years. Debt service payments are made to it in rupiah at a set exchange rate. The set rate is derived from a nominal exchange rate calculated as the best 20-day average rate since August 1998. This is then adjusted to be stable in real terms. INDRA then pays the foreign creditor the agreed amount of dollars. By April 1999, 794 companies had contacted INDRA, mostly eager to join the scheme, but no deals had been finalised.

The process of working out corporate debt may be facilitated by the development of a secondary market in corporate loans. The *Asia Pacific Loan Market Association* (APLMA) was established by 15 banks in the region in September 1998. A key goal is to develop standardised loan documents including clauses relating to the transferability of loans. APLMA also hopes to compile data on secondary trades of syndicated loans. For better quality loans, so far the main sellers have been Japanese banks seeking to reduce their balance sheets and the main purchasers European and US banks. There has been less trading so far in distressed loans, typically selling for about a quarter of face value. US 'vulture funds' are potential buyers for these.

Bankruptcy procedures

An important factor inhibiting both corporate restructuring and banks realising on collateral in all three countries has been the weakness of bankruptcy legislation and the long delays such cases face in the courts. (In Indonesia it has been claimed that only 13 cases went to court in the four years before the crisis. In Thailand, cases could take over five years and claims in foreign currency were frozen at their baht value at the time proceedings were initiated.⁸) Many bankers in the region say this has fostered a culture of non-repayment and rendered threats of legal action ineffective. It has been suggested that about a third of NPLs in Thailand are 'strategic'; the loans are to relatively healthy companies using the economic crisis as an excuse not to repay loans.

In **Thailand** some amendments were made to the 1945 bankruptcy legislation in April 1998 but they still left many problems and this was cited as an important reason why the December auction was unsuccessful. New laws were finally passed in March 1999, just before the subsequent auction. Inter alia, they established a separate bankruptcy court which opened in June 1999 with 13 judges having a strong background in economics and experience in debt restructuring. The number of judges will be increased to 60 over time. Only 37 cases were filed during its first month of operation.

The **Indonesian** bankruptcy law had been characterised as "seldom invoked due to its drawn-out, costly and sometimes unfair procedures".⁹ An amended code adopted in August 1998 was patterned on US Chapter 11 provisions and established a new Commercial Court to facilitate realisation of collateral and bankruptcy procedures. There is a 30-day deadline for court decisions and specially trained judges. However many commentators have claimed it is not functioning efficiently and unduly favours borrowers. For example Eichengreen (1999, p. 31) comments "the courts remain unpredictable ... by the end of November (1998) only five cases (of 17 filed) had been evaluated by the commercial court ... and three of these ... had been rejected on technical grounds".

⁸ Delhaise (1998, pp. 23, 98).

⁹ ADB (1995, p. 25).

Other measures

Improvements are required, and are gradually being made, in other areas of corporate governance and transparency. Accounting and disclosure rules are being upgraded. In Thailand the central bank is helping establish a centralised credit bureau to help banks share information on debtors. Taxation codes and licensing procedures are being made clearer and fairer. Government-sanctioned monopolies are being dismantled. These moves away from what has been termed 'crony capitalism' should encourage banks to base loans on more objective financial criteria and make the financial system more efficient.

Removing regulatory and tax impediments to the development of corporate debt markets should also diversify some risks away from the banking system. The development of bond markets in the region has lagged well behind banking and equity markets. One main reason why bond markets have not developed is because governments did not run large deficits. The bank recapitalisation and asset management programmes will entail the issuance of substantial amounts of government paper which, as it is subsequently traded, will help establish benchmark yield curves.

Attachment: Chronology of bank restructuring in South-East Asia

	Thailand	Malaysia	Indonesia
July 1997	Baht depreciates sharply. 42 FCs suspended.		Rupiah band widened.
Aug 1997	IMF-led rescue package refers to bank restructuring.		Rupiah floated.
Oct 1997	Financial Sector Restructuring Authority (AMC) established for FCs. Foreigners allowed majority share in banks for 10 years. Bank and foreign exchange deposits guaranteed.		
Nov 1997	56 of 58 FCs closed.		IMF-led rescue package refers to bank restructuring. 16 banks closed.
Jan/Feb 1998	Radhansin Bank established. 4 banks nationalised.		IBRA (includes AMC) established. Bank deposits guaranteed.
April 1998	Bankruptcy Act amended.		
May 1998		Danaharta (AMC) announced.	
June 1998		Danaharta incorporated.	
Aug 1998	Bank recapitalisation schemes announced. 2 banks nationalised. Forced bank mergers.	Danamodal (BRV) incorporated.	
Sept 1998	The first bank announces participation in recapitalisation scheme.	Danaharta purchases first NPL. Ringgit pegged to \$US. Capital controls introduced.	Recapitalisation scheme announced. 4 SOBs to be merged.
Oct 1998		Danamodal agreement with 10 FIs and first bond issue.	

Attachment (cont.)

	Thailand	Malaysia	Indonesia
Dec 1998	Large auction of FC assets fails to sell most.	12 foreign banks make loan to assist in bank restructuring.	
Feb 1999		Capital controls modified.	
Mar 1999	Second large auction of FC assets, mostly sold to AMC.		Banks classified as sound, to be recapitalised, taken over or closed.
Apr 1999			Capital injected into 8 banks.
AMC: asset management corporation; BRV: bank recapitalisation vehicle; FC: finance company; FI: financial intermediary; IBRA: Indonesian Bank Restructuring Agency; NPL: non-performing loan; SOB: state-owned bank.			

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