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The Politics of Financial and Corporate Restructuring

A defining characteristic of the Asian financial crisis has been systemic distress: the simultaneous insolvency of large numbers of banks and firms. Financial and corporate restructuring under such conditions pose a number of unresolved technical problems, but the issues are not simply technical. In the short run, the process of restructuring generates political conflicts over the recognition of losses and their allocation among interested parties—shareholders, management, workers, and taxpayers. In the long run, restructuring addresses even more fundamental issues, such as corporate governance and accountability, the transparency of business-government relations, the rule of law, and even the distribution of a society's assets.

Our knowledge of what constitutes best practice in managing systemic distress is still evolving, and the choices facing governments are typically bad. Nonetheless, government responses to such crises can be distinguished along two dimensions that are of particular importance to the success of the adjustment process: the *speed and decisiveness* of government and its *responsiveness to private interests*, particularly weak banks and firms. These two dimensions are clearly related. Banks and firms experiencing severe distress have strong interests in postponing the recognition of losses. Governments may have their own political reasons for delay as well. However, delay can also compound losses and increase uncertainty.

Government responsiveness to private interests is linked to the much-debated problem of moral hazard and the extent to which governments effectively guaranteed (ex ante) and "bailed out" (ex post) financial institutions and their corporate clients. Of course, there is no virtue in bankrupting potentially viable banks and firms. Moreover, it is misguided and even costly to think that governments can altogether avoid shouldering some of the costs of such crises.

But in periods of distress, all companies, regardless of their long-term viability, have an interest in making claims against the government, particularly the large ones that have political influence. To limit the public costs of such crises, governments require the political as well as administrative capability to distinguish among competing claims and to impose regulatory conditions on banks and firms that will limit future risks.

That capacity will clearly be influenced by the political factors outlined in chapter 2: the *security* of government, and the electoral and non-electoral challenges it faces; the *cohesiveness* of government decision-making; and the *degree of institutional and political access for private actors*. Governments facing electoral or non-electoral challenges, such as demonstrations and strikes, are more likely to delay and make concessions to stakeholders than those that are politically secure. The formal structure of decision-making also matters; policymaking processes with multiple veto gates are typically less decisive and more open to particularistic influences than are governments whose authority is more concentrated. But choices about financial and corporate restructuring will depend most on the nature of government-business relations. Moral hazard, bailouts, favoritism, and limited reform are more likely when top political leaders develop close, nontransparent political relationships with the private sector.

This chapter compares the politics of financial and corporate reform in the seven administrations that are the focus of this book—the Kim Young Sam and Kim Dae Jung administrations in South Korea, the Chavalit and Chuan governments in Thailand, the Mahathir government in Malaysia, and the Suharto and Habibie governments in Indonesia. Although we have seen how democratic politics in Korea and Thailand contributed to the initial mismanagement of the financial crisis, they also permitted new reformist governments to come into office. Under Habibie, democratic pressures also provided incentives for reform. In Indonesia under Suharto, more profound political uncertainties over succession made meaningful financial and corporate reform virtually impossible.

Yet all democracies are not created equal. Both the nature of decision-making structures and business access to government resulted in a more decisive, but also more interventionist, adjustment strategy in Korea than in Thailand. By contrast, close business-government relations weakened the ability of both the Suharto and Habibie governments to make decisions and undermined the credibility of the government when it did; we see these same problems operating in Malaysia as well, although to a lesser extent. These findings suggest that meaningful financial and corporate reform depend heavily on the broader institutional context, including the integrity of the legal and judicial process, independence of regulatory agencies, and the transparency of business-government relations.

Table 4.1 The politics of corporate and financial restructuring

Issue area	Political issues and conflicts
Limiting support to insolvent banks	Decisiveness of government in limiting liquidity support and guarantees to failing banks; allocation of losses among government, shareholders, depositors, and bank workers
Bank recapitalization	Decisiveness of government and provision of adequate resources; imposing conditions on banks; limiting costs to government of recapitalization by encouraging private recapitalization
Disposition of nonperforming loans (NPLs)	Decisiveness of government in identifying and financing ''carve out'' of NPLs; market pricing of asset purchases; timely rehabilitation or disposition of assets; maximizing value
Corporate debt restructuring	Facilitating timely restructuring; imposing conditions on corporates; limiting the cost to government
Encouraging foreign entry	Overcoming nationalist and protectionist pressures
Reform of corporate governance	Overcoming resistance from insiders to greater transparency, corporate accountability, and external monitoring

Five issues are central to the restructuring process in the short run: the management of illiquid and insolvent banks; bank recapitalization; the disposition of nonperforming loans (NPLs); the restructuring of corporate debt; and the operation, and reform, of bankruptcy procedures. Governments also took advantage of the crisis to pass reforms in an area of tremendous long-run significance—rules on corporate governance. A final issue that is also of great importance over the long run is the liberalization of rules governing foreign investment, which allow foreign banks and firms to play a greater role in the restructuring process; this issue is addressed in the conclusion. As table 4.1 suggests, each of these policy areas involves potential political conflicts.

The Political Economy of Financial Reform

The first task facing governments was to decide which banks and other nonbank financial institutions (NBFIs) were insolvent and nonviable and to stop the flow of public credit to them. It is extraordinarily difficult for any government to impose the costs of bank failures on small depositors, even if a formal insurance mechanism is not in place. The political challenge, rather, is dealing with shareholders, large creditors, managers, and bank workers. Once a bank is insolvent, managers have few incentives to run it on a commercial basis, and looting can set in. Moreover, insolvent banks will pressure the central bank to provide liquidity support, with adverse implications for monetary and fiscal policy. Stopping the flow of credit to insolvent institutions does not necessarily mean banks should be suspended or closed immediately, but delay in recognizing and accepting bank insolvency can be extremely costly.

The next task is triage: To develop a rehabilitation plan for those institutions that are viable but require support and to deal with those that are nonviable and will ultimately need to be closed. These decisions crystallize around two related policy issues—recapitalizing the banks and disposing of nonperforming loans. In severe financial crises such as those in Asia, the extent of distress and risk to the overall financial system is so great that injections of public money to recapitalize the banks is unavoidable. The key political question is the nature of the conditions attached to any support. Governments can limit the costs to taxpayers as well as future moral hazard by insisting that share prices be diluted or written down completely, by requiring banks and shareholders to raise matching capital, by limiting deposit insurance extended to large creditors, and by displacing management. Governments can also reduce the risks of future crises by improving the quality of regulation with respect to crucial variables such as capital adequacy requirements, loan classification and provisioning, disclosure, and exposure to different sorts of risk.

The disposition of nonperforming loans constitutes a third policy area in which there are potential conflicts of interest between the government and banks and debtors. Governments have typically intervened either through a liquidation agency or through more ambitious rehabilitation agencies that seek to manage and restructure the assets before sale (Klingebiel 1999). The purchase price of the assets, and the extent to which they approximate fair market value, is a good indicator of the cost to taxpayers and the extent of the bailout.

But even if assets are purchased at a steep discount, their management is equally if not more critical to the final resolution process. If the assets are transferred to a weak asset management company and simply "warehoused," bank balance sheets are cleaned up and borrowers can reestablish relations with their creditor banks, but neither may have incentives to meet their obligations. By contrast, the government can manage acquired assets aggressively to maximize value: by swapping debt for equity, taking an active managerial role in turning the company around, or foreclosing on collateral. Undertaking such actions requires not only an unusual degree of technical capacity, but also substantial political independence. The restructuring agency must have an unambiguous mandate to maximize returns to the government—even when it involves conflicts with powerful debtors.

The performance of asset management companies has led a number of analysts to favor more market-based solutions, in which the assets are sold to private agents, including foreign ones, who can manage or foreclose on them (Klingebiel 1999). But this strategy also requires substantial political capabilities. Selling assets, particularly to foreigners, and guaranteeing that foreclosure and bankruptcy processes are functioning can involve the same conflicts with debtors as do more active strategies of asset management.

Comparisons of national strategies for managing bank failure, recapitalization, and disposal of assets across countries are of necessity difficult because initial conditions and the magnitude of problems varied. Nonetheless, the indicators in table 4.2 and the case studies that follow suggest that political factors played a crucial role in the restructuring process. National differences emerge quite clearly in paired comparisons between South Korea and Thailand, the two democracies, and between Malaysia and Indonesia. Not surprisingly, business-government relations played a particularly crucial role in the pace of reform. All governments faced the problems associated with the high concentration of private assets noted in chapter 1: the difficulty of imposing reforms on powerful private actors. But governments did differ in their political connections with business. The closer the political relationship between political leaders and the banks and debtors undergoing restructuring, the more the government deferred to private interests, and the more limited and costly the private restructuring process proved to be.

The Kim Young Sam government supported the banking system following several major corporate failures in 1997 and nationalized two major banks before leaving office, but (as we have seen in chapter 2) political circumstances precluded a coherent strategy. Following Kim Dae Jung's election, however, the government moved quickly to address financial sector distress through a new regulatory agency that gave the government a powerful position in the financial sector. All banks were subject to thorough review, on the basis of which five were shut down and merged with others under government direction. A large number of nonbank financial institutions were also shut down, although many weak ones were left open. Korea's record in disposing of acquired assets seems weak, but it moved more aggressively than Indonesia, Malaysia, or Thailand.

The Thai government under Chavalit initially supported weak finance companies. The Chuan government, by contrast, moved quickly to close a number of them and dispose of their assets. But it did not recapitalize the banks or purchase NPLs from them directly. Rather, it sought to induce banks to recapitalize on their own by enforcing capital adequacy and loan loss provisions. This strategy failed, and the government finally committed itself to bank recapitalization. But few banks participated in the voluntary program because of its tough conditions and the government's lack of capacity to enforce them. As a result, the government was forced to manage the crisis through regulatory forbearance and an extraordinarily high level of NPLs (still above 40 percent in mid 2000).

Table 4.2 Managing bank failure and recapitalization

	South Korea	Thailand	Malaysia	Indonesia
Managing bank insolvency				
Institutional framework	Financial Supervisory Authority, 4/1998; Korea Deposit Insurance Corporation	Financial Restructuring Agency, 10/1997 (Finance companies only); Financial Restructuring Advisory Committee	Danamodal, 7/1998	Indonesian Bank Restructuring Authority. 1/1998, authority expanded 2/1999
Banks closed and/or merged (percentage of financial sector assets)	5 closed and merged	1 of 15 closed (2 percent)	None closed, 9 banks and 2 merchant banks merged to create 4 new commercial banks	64 of 237 closed (18 percent); 4 of 7 state-owned banks to be merged into 1 bank (54 percent)
Other financial institutions closed or merged (percentage of financial sector assets)	17 merchant banks and over 100 nonbank financial institutions (with bank closures, 15 percent)	57 of 91 finance companies closed (11 percent)	6 mergers of finance companies and banks (2 percent)	
Nationalizations (percentage of financial sector assets)	4 commercial banks (25 percent)	7 commercial banks (13-15 percent) and 12 finance companies (2.2 percent)	1 bank, 1 merchant bank, and 3 finance companies (12 percent)	12 commercial banks (20 percent)
Bank recapitalization strategies				
Initial plan and timing	$8 billion injected into 9 commercial banks, 1/98.	$8.9 billion for private banks and $11.7 billion for state banks, plan announced, 8/1998	$1.6 billion injected into 10 financial institutions, 7/1998	$41 billion plan announced 3/1999 for 9 private banks; all state-owned banks to be recapitalized.

Total amount disbursed for recapitalization, 10/1999 plus estimated remaining fiscal costs (as share of GDP)	13 percent + 4 percent	16 percent + 8 percent	4 percent + 6 percent	11 percent + 48 percent
Share of financial assets held by state-owned and nationalized banks, 8/1999	58 percent	45 percent	18 percent	78 percent
Financial assets held by state-owned and nationalized banks as share of GDP (8/1999)	124 percent	127 percent	62 percent	79 percent
Asset resolution				
Asset management company and assets, 8/1999	Korean Asset Management Company, $37 billion	No asset management unit for banks. Financial Restructuring Agency for finance companies	Danaharta. $2.13 billion	Indonesian Bank Restructuring Authority. $28 billion
Assets transferred, mid-1999	26 percent of NPLs, 10 percent of GDP	All assets of closed finance company assets, 2 percent of GDP	50 percent of NPLs, 14 percent of GDP	66 percent of NPLs, 35 percent of GDP
Assets sold as share of those transferred, mid-1999	4.7 percent	100 percent of core assets of finance companies, but some to government Asset Management Unit	0.1 percent	0.7 percent

NPLs = non-performing loans

Sources: Claessans, Djankov, and Klingebiel (1999); World Bank (2000b); author's calculations and assessments.

Comparing Malaysia to the other three poses some difficulties because the extent of its banking problems were substantially less than those in the other countries. The government moved swiftly to undertake a bank recapitalization scheme, developed an institution for managing nonperforming assets, and proposed a massive bank consolidation that would have substantially reduced the number of players in the financial sector. However, the government also engaged in costly bailouts of several financial institutions that had played political roles in the past.

Indonesia appeared to respond decisively to its banking crisis, but (as we saw in chapter 2) the initial closing of 16 banks was badly handled, which contributed to the onset of the crisis, and this was followed by support for a number of politically connected banks. Although the Suharto government established a bank restructuring authority, its efforts were undermined by deepening political uncertainty. The Habibie government initiated a strategy for recapitalizing the banking sector, but implementation was subject to delay and political interference, and the state-owned banking sector remained largely unreformed. By the end of 1999 when a new government came into office, Indonesia's problems were clearly greater than those of the other countries. But it had also made the least progress in addressing them.

The Political Economy of Corporate Restructuring

Closely related to these issues of financial restructuring are questions of corporate restructuring. As with the banks, corporations may have an interest in delaying financial and operational restructuring, and can collude with banks to do so at public expense. The government can solve this problem in one of two ways. First, it can enforce capital adequacy and loan loss provisions rigorously, while providing incentives for banks to engage in out-of-court settlements; this is the so-called London Rules approach. This approach, however, depends heavily on the structuring of incentives, and in particular the capacity of the government to credibly commit to its hands-off stance.

An alternative strategy is for the government to play a more active role in the corporate restructuring process. This role may range from coordinating intra-creditor and creditor-debtor relations and monitoring and enforcing agreements, to using various instruments to enforce financial and operational restructuring objectives, such as the extent of leveraging, the nature of business portfolios, and corporate governance.

The incentives for corporate restructuring are powerfully affected by foreclosure and bankruptcy laws, the final area of potential conflict among the government, banks, and corporations. If implementation of foreclosure and bankruptcy laws are overly favorable to debtors, firms have incentives to delay debt and operational restructuring and even repayment. Reform of the bankruptcy process and clear enforcement of bankruptcy and foreclosure laws are not only important for managing actual firm failures, but also for providing incentives for creditors and debtors to reach out-of-court settlements.

Table 4.3 outlines some indicators that are relevant to understanding the corporate restructuring process in the four countries. Bankruptcy laws were stronger in South Korea and Malaysia when the crisis hit. Bankruptcy reform was delayed in Thailand. Despite legal reforms, Indonesia's bankruptcy processes in fact remain weak. In all cases, governments established agencies to facilitate out-of-court settlements.

However, Korea's approach differs somewhat from the other cases. We have seen how firms in Korea manipulated bankruptcy procedures in 1997, but under Kim Dae Jung these loopholes were shut down. Despite the nominal embrace of a market-oriented, London Rules, process, the government in fact played a strong role in pushing corporate debt restructuring and linking it to operational restructuring and reforms of corporate governance. Indeed, the question in Korea was whether the government had become *too* activist and directive in leading the corporate restructuring process.

In Thailand and Indonesia, for the political reasons already outlined, debt and corporate restructuring have been much slower and have had much weaker links, if any, to the reform of corporate governance. In Malaysia, the government designed an asset management company with a mandate to engage in active corporate restructuring. But the government simultaneously engaged in several controversial bailouts of private firms.

South Korea

The key reform of the early Kim Dae Jung presidency was the passage of the financial reform legislation stalled under Kim Young Sam and the creation of the Financial Supervisory Commission (FSC) out of other regulatory agencies.[1] With strong support from the IMF and the United States, Kim Dae Jung intervened to shift control over the agency away from MOFE and the bureaucracy to the Prime Minister, and thus effectively to the Blue House. The FSC consolidated financial supervision across all financial entities and markets and played a role in developing a new regulatory and supervisory framework. However, the power of the FSC

1. The agency was formed through the consolidation of the office of the financial inspector of the Ministry of Finance and Economy (MOFE), Office of Bank Supervision under the Bank of Korea (BOK), Securities Supervisory Board, Insurance Supervisory Board, and Credit Management Fund Agency.

Table 4.3 Corporate restructuring

	South Korea	Thailand	Malaysia	Indonesia
Corporate restructuring				
Agency and mandate	Financial Supervisory Commission, 4/1998; nominally London Rules, but through control of financial system, linked to reforms of corporate governance	Corporate Debt Restructuring Advisory Committee, 6/1998. Initially strict London Rules, some increase in coordinating function in 1999; no link to corporate governance	Corporate Debt Restructuring Committee, 8/1998; largest debtors only	Jakarta Initiative Task Force, 9/1998, supported by Indonesian Debt Restructuring Agency, 4/1998; no link to corporate governance
Ratio of out-of-court debt restructured to total debt, 8/1999	40 percent	22 percent	32 percent	13 percent
Bankruptcy				
Bankruptcy law	In place at time of crisis, reformed, 4/1998	Reformed, 4/1998 and 4/1999	Satisfactory British legacy of common law	Reformed, 4/1998
Efficiency of judicial system index (from 1 = worst to 10 = best)	5.3	5.2	9.0	2.2
Foreclosure	Possible	Difficult, reformed, 4/1998	Possible	Difficult
Ratio of in-court debt restructured to total debt, mid-1999	8 percent	7 percent	—	4 percent

Sources: Claessans, Djankov, and Klingebiel (1999); World Bank (2000b); author's calculations and assessments.

arose not only from its routine supervisory functions,[2] but also from the central role it was to play in restructuring the financial sector in the wake of the crisis. This role involved a range of highly contentious responsibilities, from making judgments about which banking institutions were viable to closing or merging those that were not and disposing of their assets. The FSC oversaw the recapitalization and restructuring plans of the banks and assisted in the disposition of nonperforming loans.

The creation of the FSC both reflected and permitted a strategy for the financial sector that emphasized speed, even if at some substantial short-run cost. The government quickly set aside W64 trillion ($49.2 billion, or roughly 15 percent of GDP) to resolve the financial crisis, with half allocated to the Korean Deposit Insurance Company (KDIC) for recapitalization and coverage of losses, and half to finance the Korean Asset Management Corporation (KAMCO), which was assigned the task of purchasing and disposing of nonperforming loans.[3]

Operating through the FSC, the government moved swiftly and in a highly directive fashion to address the problems of the banking sector.[4] At the end of 1997, only 12 Korean banks out of 26 satisfied the international capital adequacy standard of 8 percent. In early December, the Kim Young Sam government nationalized the two banks in the worst condition, Korea First Bank and Seoul Bank.[5] The next task was to make decisions about the remaining undercapitalized banks; these were made after the elections. The FSC acted quickly to order the 12 unsound banks to submit rehabilitation plans by late April 1998. No bank plans were approved outright; 5 of the 12 plans were disapproved, and immediately following local elections in June, the FSC shut down these banks down and ordered the transfer of their assets into 5 healthy banks. To compensate the solvent banks, the KDIC undertook a series of injections that totaled W8.04 trillion ($6.7 billion) by the middle of 1999; that total rose to around 10 trillion by the end of the year. To solve the problem of the NPLs, the FSC devised a purchase and assumption (P&A) method: the viable assets were transferred to the acquiring banks, with promises of compensation against further losses for one year, while the NPLs were purchased by

2. Some of these powers, such as strengthened Prompt Corrective Action (PCA) to ensure that banks met capital adequacy requirements, were substantial.

3. KAMCO quickly acquired W12 trillion of assets in 1998, but at relatively high prices (62.6 percent of book value) *Newsreview*, 3 July 1999, 30.

4. The government also acted swiftly in dealing with the merchant banks; 16 of 30 were closed outright. However, the nonbank financial institutions (NBFIs) continued to pose challenges to the government through mid-2000; this issue is addressed in more detail below.

5. After the election, the plans for these banks were toughened to include the write-down of shareholder capital to below a 10 percent ownership stake and recapitalization in preparation for sale to international bidders.

the Korean Asset Management Corporation (KAMCO), to be sold later through auctions.

Assessments of Korea's achievements in the banking sector are generally positive. The government exploited the powers enjoyed by the FSC to move swiftly, albeit at some substantial cost to the government. The FSC also used its powers to impose international standards with respect to capital adequacy, as well as high standards of transparency and disclosure and increasingly stringent loan classification and provisioning requirements (OECD 1999, 84-87). The question of foreign entry did pose political dilemmas for the government. The sale of the two nationalized banks, Korea First and Seoul Bank, stalled because of differences over valuation but also faced criticisms over the cost to the public of rehabilitating the banks and from self-interested borrowers who feared that foreign banks would take a more strict stance with borrowers.

The heavy leveraging of Korean corporations and the government's effective control over the banking system gave it a powerful instrument in seeking corporate restructuring, but the very meaning of that term was the subject of quite substantial controversy (Woo-Cumings 1999; Yoo 1999). One position, associated with some economists and the *chaebol* themselves, was that the *chaebol* form per se was not at fault. What was required in the short run was an orderly process of debt rescheduling, to be negotiated between the banks and the corporations, and some reforms of corporate governance to make firms more transparent and accountable to shareholders.

However, Kim Dae Jung, who lacked close personal connections to the *chaebol*, brought with him a number of close political advisors who had a much more hostile attitude toward them. Believing that the *chaebol* would never willingly reform themselves, and that the moment was tactically auspicious given the *chaebol*'s financial weakness, these advisors advocated a more command-and-control style of corporate restructuring, and even an effort to break up the *chaebol* groups. In the first 2 years of his presidency, these two lines coexisted in an uneasy mix.

The program of corporate reform was first outlined when Kim Dae Jung used ad hoc meetings with top *chaebol* leaders to present an "agreement" on five principles of corporate restructuring (see table 3.4). Some elements of the agreement were amenable to legislation, including in the areas of corporate governance and competition policy.[6] Changes in the listing requirements to the Korean Stock Exchange strengthened minority shareholders' rights and required listed firms to have at least one outside director. These legal changes, in turn, encouraged the formation of public interest groups that pressed the rights of minority shareholders. Revisions

6. For example, to increase transparency, revisions of the External Audit Law required that the financial statements of companies in business groups be prepared on a consolidated basis and toughened penalties against both external auditors and corporate accounting officers.

of the Securities Investment and Trust Law relieved financial intermediaries of the obligation to vote with management and facilitated the exercise of shareholder rights on the part of institutional investors. Removing barriers to mergers and acquisitions served as a check on management, as did liberalization of rules governing foreign direct investment (FDI) that opened the way for 100 percent foreign ownership of publicly traded companies, including through hostile takeovers.

Under noncrisis circumstances, the implications of these legal changes would be felt over time as they worked through corporate organization and strategy. However, the government had to contend with a more fundamental threat of large-scale corporate failure and extraordinarily high corporate leverage. During the course of 1998 and 1999, the government used the FSC and ultimately its de facto control over the banking system to achieve objectives that were not specifically legislated, and even of questionable legality.

The government's approach was a three-tiered one. The first tier consisted of the Big Five—Samsung, Daewoo, Hyundai, and the LG and SK groups. These *chaebols* were both economically and politically important, and the government sought to deal with them through the negotiation of informal, "voluntary" agreements. The three most contentious issues with the Big Five were the elimination of mutual payment guarantees, the reduction of excessive indebtedness, and the operational restructuring of business portfolios. The first issue centered on the common *chaebol* practice of subsidizing loss-making units, contributing to weak overall performance and low productivity growth. A revision of the Fair Trade Law during the transition period prohibited the issue of new guarantees from 1 April 1998, and required all *chaebol* to phase out existing ones by March 2000.

The government's efforts to reduce the level of overall debt were particularly controversial. Early in 1998, the FSC urged the top 30 *chaebol* to lower their debt-equity ratios from an average of 519 percent at the end of 1997 to 200 percent by the end of 1999. For the Big Five, this commitment was embodied in Capital Structure Improvement Plans (CSIP), agreements with their banks on a variety of restructuring measures—asset sales, including to foreigners; issuance of new equity; debt-equity swaps; and operational restructuring.

Although these plans were to be formulated by the firms themselves, one important element of operational restructuring came directly out of the Blue House: the so-called Big Deals. Under the program, the Big Five would swap major lines of business among themselves to consolidate excessive and duplicative investments while simultaneously achieving greater economies of scale (see table 4.4). A number of premises behind the Big Deal concept were dubious, including the assumption that they would necessarily realize efficiencies or reduce surplus capacity. The

Table 4.4 Status of the Big Deal plan (as of January 2000)

Sector	Before restructuring	After restructuring	Status
Semiconductors	Samsung Electronics Hyundai Electronics LG Semiconductor	Samsung Electronics; Hyundai + LG to merge	Hyundai Electronics acquired LG Semi for won 2.6 trillion
Petrochemicals	Samsung Chemical Hyundai Petrochemical	Merger, with foreign capital	No agreement
Aircraft components	Samsung Aerospace Daewoo Heavy Industry Hyundai Space & Aircraft	Joint venture, including a foreign partner	Subject to commercial arrangements with a foreign strategic partner
Automobiles	Hyundai Motor Daewoo Motor Samsung Motor	Hyundai acquired Kia	Swap of Samsung Motors for Daewoo Electronics canceled. Samsung Motors in receivership
Rolling stock	Hyundai Precision Daewoo Heavy Industry	Joint venture	Commercial terms, with some bank assistance
Ship engines	Korea Heavy Industry Samsung Heavy Industry	Korea Heavy Industry to acquire Samsung Heavy Industry	Acquisition, no financing
Power generation	Samsung Heavy Industry Hyundai Heavy Industry Korea Heavy Industry	Korea Heavy Industry to be privatized	Acquisition by Korea Heavy Industry

Source: Mako and Jung (2000), table 3.

negotiations over them were plagued by sharp differences about the valuation of assets, a variety of questions about how quite different operations would in fact be integrated, and uncertainty about the final corporate form the new entities would take. Politics also entered into the process; both the government and the *chaebol* managers appeared to believe that the Big Deals could be consummated without closing facilities and shedding labor, which seemed to undercut one central rationale for the program. Nonetheless, the Big Deals became a litmus test of corporate commitment to the restructuring process, and were indicative of the government's directive approach to corporate restructuring.

Throughout 1998 and the first half of 1999, the government engaged in an ongoing public relations battle with the Big Five, in which it repeatedly claimed that the large *chaebol* were not being aggressive enough in introducing restructuring plans and reducing their indebtedness. The call for explicit CSIPs was the first step in this process; it continued with the government decision to halt credit to a number of small Big Five subsidiaries in June and a revision of the companies' initial Big Deal proposal, and it culminated in the public signing of financial pacts between the Big Five and their banks in December 1998.

Coming almost a full year after the corporate restructuring principles were first announced, the pacts included four elements: Specific commitments to reduce the number of affiliates by target dates, including through the Big Deal mechanism; specific targets for the reduction of debt-equity ratios; an acceleration of the elimination of cross-guarantees between affiliates; and a reiteration of the commitment to reforms in corporate governance. The groups also submitted to a quarterly review process, under the threat that failure to comply would be met by higher interest charges or even a suspension of credit (*Korea Money*, December-January 1999, 25-27).

The new agreements differed from the principles of a year earlier in their specificity and the monitoring that went along with them. The reduction of debt-equity ratios by a particular date had the most far-reaching implications, since it appeared to necessitate dramatic asset sales. Yet by April, the president was again publicly chiding the *chaebol* for reneging on their promises to sell assets, raise capital, and cut their debt (*Korea Insight*, May 1999). Data released in April 1999 showed that much of the improvement in the financial positions of the Big Five had been achieved through asset revaluations as well as new rights issues.

Moreover, both Hyundai and Daewoo had openly defied the government by taking on more debt in 1998, primarily by circumventing the banks and placing high-yield bonds with nonbank financial institutions.[7]

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7. My thanks to Sandra Eccles for this analysis.

This practice was explicitly aimed at confounding the government's efforts to limit *chaebol* control of financial institutions and the extent of corporate leveraging. Between March 1997 and March 1999, the combined market share of the 33 nonbank financial institutions owned by the Big Five increased from 18.6 percent to just over 30 percent (*Korea Herald*, 6 December 1999). The growth in the investment trust sector was even more spectacular (from 5 percent of the market to over 30 percent), and generated a whole new round of moral hazard problems in late 1999 and the first half of 2000.

In Daewoo's case, the gambling was particularly flagrant, amounting to a strategy of "invest recklessly on an international scale and use borrowed money to do it"(Graham 2000, 93). During the spring, it became increasingly clear that the government was headed toward a showdown with one or both of the two firms.

Daewoo proved the test case. In mid-July 1999, Daewoo Motors admitted to liquidity problems. The firm had been involved in prolonged negotiations over one of the most controversial of the big deals: the swap that would transfer Samsung's ailing automobile operations for Daewoo's increasingly profitable electronics business. However, Daewoo's global auto operations were also weighed down with debt. On 17 July, the chairman was forced to pledge personal properties to secure rollovers of short-term debt. In a "final" effort to secure support, the firm offered a restructuring plan on 20 July that would sell off all but nine affiliated firms, and even those would be largely divested to foreign partners in order to focus the core of the new group on Daewoo Corporation and Daewoo Motors.

The creditor group, and behind them the FSC, responded by rolling over W10 trillion in short-term debt and extending W4 trillion more in new credits. But the market reaction to both the restructuring plan and the government's decision to support Daewoo was strongly negative and gradually pushed the government toward the position that Daewoo should be dismantled. When due diligence was finally done on the group, it was revealed that its net worth was negative W17 trillion (more than $14 billion). The final reorganization plan agreed to with creditors in mid-August allowed for six units to be kept, but only on the condition that a number of profitable ones would be sold. By early 2000, the precise details of Daewoo's complex workout plan were still being negotiated and finalized.

The fall of Daewoo will undoubtedly be seen as an important event in Korea's postwar economic history. The government did not altogether avoid a bailout of the firm, because debt was rolled over and ultimately converted to equity and the core firms were not liquidated. Moreover, in September and October, the government was forced to establish massive funds to bail out the investment trust companies, which were big purchasers of Daewoo bonds. But the conditions were tough, and in his Liberation Day speech on 15 August, Kim Dae Jung even signaled an interest in breaking up other *chaebol* into independent units. Although the president retreated from this position (*Korea Herald*, 16-17 August 1999), he took advantage of Daewoo's crisis to press a restructuring of the Federation of Korean Industries itself, the peak organization that had long represented *chaebol* interests and which under the leadership of Daewoo's Kim Woo-Chang had actively opposed the government's corporate restructuring plans. The Daewoo action, the Liberation Day speech, the attack on FKI, and yet another round of public agreements with the Big Five sent strong signals that brinkmanship would have high cost.

The second tier of the corporate restructuring effort centered on the so-called "6-64" *chaebol*, and gained momentum after the June 1998 elections (Lieberman 1999; Mako and Jung 2000). On 18 June 1998, the FSC declared that 55 companies, including 20 subsidiaries of the Big Five, would no longer have access to bank credit (*Far Eastern Economic Review*, 2 July 1998). On 24 June, 236 financial institutions signed and entered into the Corporate Restructuring Accord, which defined the informal workout procedure for troubled firms. Eight major creditor banks, identified as lead banks, would take responsibility for negotiating workouts of problem debts with the 6-64 corporate groups. These workouts were nominally organized around so-called London Rules, but the process was closely overseen by the FSC through its Corporate Debt Restructuring Committee (CDRC).[8]

Although the speed of the process is noteworthy when compared to other countries, it is also the case that a degree of forbearance is visible in the fact that the principal restructuring method has been interest rate reductions, and that the contribution of new equity, whether local or foreign, has been minimal. This suggests that another round of restructuring might be required in the future, and in September 1999 the administration moved to reach more expansive operational restructuring agreements with the firms in this second group as well (*Newsreview*, 11 September 1999, 26).

The restructuring of small and medium-sized enterprises (SMEs) had particular political significance in Korea. Kim Dae Jung came to office with a longstanding belief that SMEs had been slighted by government policy, and employment, equity, and political considerations thus pushed the administration to address their problems aggressively. The administration's approach resembled a kind of corrective industrial policy. Initially, SME debts to the banks were rolled over for 6 months and for a

8. The CDRC is empowered to act as an arbitration committee in the case that the banks cannot agree on a workout strategy among themselves or the lead bank and the debtor fail to come to an agreement. If a CRA signatory fails to comply with an approved workout agreement or arbitration decision, the CDRC can impose penalties (Lieberman 1999).

subsequent 6 months, and in 1999, the banks began to restructure SME debts. But the government has also shown a concern for restoring liquidity to the sector, and has done so through a variety of means, including credit insurance funds, a central bank credit line, funding for trade finance, and four SME restructuring funds. To date, Korea is the only one of the crisis countries to aggressively address small business restructuring.

The Kim Dae Jung government initiated a broad financial and corporate reform process, facilitated by his status as an outsider with fewer connections with, or dependence on, the *chaebol*. The government was able to legislate quickly because of the unique political position enjoyed by the president in the period immediately following the election. In other areas where legislation proved more contentious or impossible, the president used direct negotiations with *chaebol* leaders and public pressure to secure business concessions. The creation of a powerful new statutory body with a clear mandate for reform expedited implementation.

However, the strongly directive elements of the Korean restructuring process also raise important questions about policy tradeoffs among speed, accountability, and the extent of government intervention. The speed with which the Korean government moved was bought by an exercise of directive powers that rested on a dubious legal foundation and lacked democratic safeguards (Mo and Moon 1999). For example, the Big Deals and the setting of quantitative targets and deadlines for achieving arbitrary debt-equity ratios are both of questionable legality as well as merit, as was the suggestion that *chaebol* should be broken up into individual business units. Moreover, these measures carried an important irony: They involved the Korean government even more deeply and directly in the economy than it had been before the crisis. Formulating an exit strategy now looms as a crucial task; I return to this question in the conclusion.

Thailand

The initial financial sector strategy of the Chuan government was two-pronged. The Financial Restructuring Authority (FRA) would evaluate the rehabilitation plans of the suspended finance companies and make judgments about whether they should be left open, while simultaneously devising a strategy for liquidating failed ones built around the "good bank-bad bank" model. In early December, the FRA recommended that all but 2 of the 58 finance companies be closed permanently, quickly resolving a problem that had been lingering for months (*Bangkok Post*, 19 December 1997). In June, 5 additional finance companies were shut down, bringing the total to 63.

For the 33 finance companies that initially remained open and the 15 banks, the government's strategy was to limit access to liquidity credit through the FIDF while substantially tightening loan classification and provisioning rules and capital adequacy requirements. These regulatory measures would force recapitalization, and serve the additional purpose of diluting the control exercised by a small number of families that effectively controlled the Thai banking system. At the same time, the Bank of Thailand relaxed rules governing foreign ownership, sending the message that domestic banks should consider taking on partners. The government also agreed to a tight timetable for the passage of other legislation that would facilitate the financial and corporate reform process.[9]

A number of banks responded to these new incentives (*Asiamoney*, September 1998, 15). The Thai Farmers Bank and Bangkok raised new equity through share issues, and Thai Danu Bank, Thai Farmers Bank, and the Bank of Asia took on foreign partners. However, a number of banks stood little chance of meeting the recapitalization requirements and were effectively insolvent.[10] The size of these banks—which collectively accounted for 20 percent of banking-sector assets—made them difficult to close outright, and the problems of negotiating sales in a timely fashion as well as the absence of buyers seemed to foreclose the option of selling them quickly. Through its recapitalization efforts, the FIDF became the effective owner of all four, although without clear plans for their disposition. With the combination of its equity injections, recapitalization, and earlier liquidity support, the losses of the FIDF in the early part of the year reached 20 percent of GDP.

In sum, the initial stance of the new government toward the resolution of the financial sector's difficulties appeared quite decisive in some respects. The government closed down a number of ailing finance companies. In a series of 11 auctions ending in August 1999, the FRA sold off their assets, although some ended up in the hands of the government's Asset Management Company. The government faced substantial political criticism from interested parties over the low sales prices, but it rode out the resistance and realized nearly $4 billion on them, equal to 25 percent of face value.

With respect to insolvent banks, the government took a tough stance with their shareholders, although it backed away from closing the banks outright and absorbed very large losses as a result. But this pattern is not

9. These include new standards for disclosure and auditing, a revision of the bankruptcy and foreclosure laws, liberalization of rules governing foreign direct investment, and the privatization of a number of state-owned enterprises, designed in part to help finance the costs of bank restructuring (*Bangkok Post*, 26 November 1997).

10. The Bangkok Bank of Commerce (BBC) came under public control in December 1997, and the capital of the bank was dramatically written down. In February 1998, the government took over three more ailing banks: Siam City Bank (SCIB), First Bangkok City Bank (FBCB), and Bangkok Metropolitan Bank. In the case of the last two banks, capital was written down to practically nothing, again sending a strong signal to shareholders.

untypical in crises of this magnitude. With respect to viable banks, the government's strategy sought to limit public expense by forcing private recapitalization, and thus implicitly breaking the hold that a small number of banks and families had on the financial system.

However, the government's restructuring plans quickly faced political as well as economic obstacles. The political problems, as we have seen, centered on the splits within the cabinet and the growing chorus of complaints from the Thai private sector against the government's macroeconomic policy. The economic problems centered on the gradual deepening of the crisis, which cast further doubt on the balance sheets of the banks and their ability to recapitalize on their own.

Moreover, the government's initial strategy did not directly address the underlying question of corporate debt restructuring, which had important implications for how losses were distributed. When the government did finally address the issue in June 1998, through the creation of a Corporate Debt Restructuring Advisory Committee (CDRAC), the approach was modeled on the London Framework. The government did provide an important incentive to restructure in May by allowing banks to maintain nonperforming loans off their books if debts were being restructured. But because the reform of bankruptcy and foreclosure laws and laws governing foreign direct investment were delayed, banks and particularly corporate debtors had only weak incentives to engage in serious restructuring efforts. To the contrary, the regulatory forbearance extended in May and the absence of a strong foreclosure law encouraged "shallow" restructurings that later proved of questionable value (*Thailand Economic Monitor*, 2nd quarter 1999, 15).

The fourth letter of intent formulated a new reform timetable to speed up the pace of reform of the financial and corporate sectors. Among the key elements of the new timetable were that the banks and finance companies sign memoranda of understanding (MOUs) outlining their plans to meet the new provisioning and loan-loss standards. As the mid-August deadline for these MOUs approached, it became apparent that the government's effort to handle the banking crisis by relaxing liquidity and inducing private recapitalization was failing. Large banks that were unwilling or unable to recapitalize early, including Krung Thai and Siam Commercial, faced severe distress.

On 14 August 1998, the government unveiled a new initiative for the banking sector. The first element of the new plan was to deal with problem institutions more forcefully.[11] The second element of the program was

11. Two more banks and five finance companies were effectively nationalized pending resolution strategies, while the government also clarified its strategy to deal with the previously nationalized banks. BBC was to be closed, First Bangkok City Bank to merge with Krung Thai Bank, and Siam City and Bangkok Metropolitan to be privatized, with the government guaranteeing buyers' potential losses.

regulatory forbearance; to reduce Tier 1 capital requirements from 6 to 4.5 percent. The centerpiece of the new strategy, however, was a complex, and voluntary, recapitalization scheme, backed by only implicit threats if recapitalization targets were not met.[12] But the conditions for financial support were onerous. Not only would the government have to approve the banks' restructuring plans, but banks would have to adopt end-2000 provisioning requirements immediately; given NPLs of 30-40 percent of total portfolios, this would imply an immediate write-off of shareholder capital. Moreover, the government retained the right to displace existing management.

Not surprisingly, banks showed little interest in the program, turning rather to a number of innovative, but high-cost, short-term instruments to meet capitalization targets.[13] By relying on these instruments, bank owners effectively sidestepped the need to raise "real" capital and bought time. Although the government set aside Bt300 billion for the program, it had to be modified in June 1999, and by September only 13 percent of the funds set aside for the program had been used (*Thailand Economic Monitor*, 2nd quarter 1999, 15). In effect, the policy of the government toward the financial sector had become one of forbearance: In August 1999, nonperforming loans stood at 47 percent of total outstanding loans, only marginally below their peak in May, and they didn't drop below 40 percent until mid 2000 (*Thailand Economic Monitor*, June 2000, 24).

The second component of the August scheme was to support Tier 2 capital and to provide incentives for the banks to begin debt restructuring. The problem with this second pillar of the program is that, while attractive to banks, the scheme was not necessarily attractive to debtors, who continued to delay payment; this in turn had to do with the absence of a legal framework that would support the corporate workout process under CDRAC.

In late 1998, the politics of reform came to center on a group of 11 reform bills that were conditions of the fifth Letter of Intent with the IMF.[14] Failure to pass these laws, and particularly those governing the bankruptcy and foreclosure process, were adversely affecting the financial and corporate restructuring process. But the existence of multiple veto gates and the influence of interested parties served to further delay the reforms.

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12. For Tier 1 capital, the government would recapitalize up to 2.5 percent by swapping tradable bonds for preferred shares, and match any private capital up to 4.25 percent on a one-to-one basis, also granting the banks buy-back options.

13. In particular, Stapled Limited Issuance Preferred Stocks (SLIPS) and Capital Augmented Preferred Shares (CAPS).

14. The bills included bankruptcy, bankruptcy court, and foreclosure; state enterprise capital; real estate property leasing, land and condominiums; civil justice procedures; and foreign investment.

Reform of the bankruptcy process had been a condition of the second Letter of Intent with the IMF in November 1997, but legislation proposed by the government immediately ran into strong objections from senators who would be adversely affected by the legislation, including particularly the heads of two heavily indebted groups, Thai Petrochemical and NTS Steel.[15] When bankruptcy reform was first vetted in early 1998, objections centered on the relative powers granted to creditors and debtors in the new process, including the ability to appoint administrators who would influence the restructuring plan, and the absence of provisions that would allow debtors to remain in possession. Opponents feared that the lack of Thai insolvency experts would lead foreign creditors to appoint foreign insolvency professionals, who would have less of an interest in reviving the company.

The changes introduced by the Senate contributed to a bill that discouraged its use; moreover, critical accompanying legislation governing foreclosure was not passed. Between May, when the bill was passed, and August only five business rehabilitation plans had been filed with the courts (*Bangkok Post*, 25 August 1998). As the chairman of the Senate blue-ribbon committee argued when reviewing the amended legislation, "the introduction of the business rehabilitation plan, intending to minimize judicial reviews on bankruptcy cases, has now been associated with the refinancing of the business community rather than debt-restructuring as commonly understood before the passage of this new law" (*Bangkok Post*, 27 November 1998).

When the amended bills were reintroduced in the fall, the criticism in the Senate widened to include a range of new issues and changes that would have dramatically weakened the legislation.[16] The Senate also sought similar dilutions of the bankruptcy court law.[17] In the end, the bankruptcy and foreclosure law reform had taken the Chuan government more than 15 months to complete, and even then concerns remained that procedural concessions with respect to the appeals process made the

15. The Senate has the power to review and amend legislation; if the House objects to the Senate's changes, they are mediated through a joint committee. If the joint committee fails to reach agreement, the House can nonetheless pass its version. But the review process and the publicity surrounding it provided an opportunity for senators opposed to the bill to secure concessions favorable to debtors.

16. These included raising the minimum debt limits, a prohibition on filing bankruptcy against holders of personal guarantees, a common way to "secure" lending, and even a provision that would have prohibited bankruptcy suits in cases where the value of the collateral matched the amount of debt outstanding *on the day the loan was made* (*Bangkok Post*, 12 March 1999)!

17. These included reducing the power of the court to declare a firm bankrupt if its rehabilitation plan were not approved, stripping the new courts of their powers to handle criminal aspects of bankruptcy, and keeping a cumbersome appeals process that had been a major factor in slowing the bankruptcy process.

bankruptcy process unwieldy. Creditors and debtors proved unwilling to settle disputes in court. In 1999, only 37 business reorganization petitions were filed with the Central Bankruptcy Court, although the pace increased in the first half of 2000 (*Thailand Economic Monitor*, June 2000, 33). Rather, private innovations through CDRAC provided the basis for an increase in the number of debt restructuring agreements.[18]

To summarize, politics in Thailand exerted a powerful influence over policymaking with respect to the financial sector and corporate restructuring. Under Chavalit, there are clear signs of moral hazard related to the way the FIDF interpreted its mandate (Nukul Commission Report 1998, para. 329-40), but the problems ran deeper. Politicians with direct interests in regulated financial institutions were able to influence the government's decision-making, delaying an effective response to the problem. Both intracoalitional and intraparty conflict frustrated the efforts of reformers. These political failings directly contributed to the onset of the crisis by weakening confidence in the Thai financial sector, and deepened it once the devaluation occurred by further delaying adjustment until the change of government.

As with the Kim Dae Jung government in South Korea, the Chuan government demonstrates how a new democratic government can exploit a crisis to extend the reach of the technocrats over policy. The decisiveness of the government was particularly visible in the handling of the finance companies, the establishment of the FRA, the disposition of assets, and the intervention of the four insolvent banks.

However, the government's action toward the finance companies proved the exception rather than the rule, and the government ended up being much less decisive in other areas. In recapitalizing the banks, the government made a large sum of money available and devised a scheme that would have imposed strong conditions on the banks. But the scheme was voluntary, not used extensively, and in the end rested on substantial forbearance toward bank owners. The government was slow to move on the issue of corporate debt restructuring and in passing bankruptcy and foreclosure laws. These delays had a powerful influence on the distribution of losses among groups. The burden of financial restructuring was borne largely by taxpayers and bank shareholders, although their losses were limited by government forbearance. However, the weak legal and administrative regime for bankruptcy benefited debtors and even created

18. Of particular importance were the development of debtor-creditor agreements and intercreditor agreements that defined an expedited process that allowed for information sharing and negotiations; 75 percent majority voting approval; and a mechanism for enforcement, including an expanded role for the Bank of Thailand in the process. As of April 2000, 2,682 "target debtors" had been identified, but full restructuring agreements had been completed in only 266 cases, although accounting for over 20 percent of total debt. (*Thailand Economic Monitor*, June 2000, 34).

perverse incentives for them to continue to avoid repayment. It was ultimately left to the private sector to devise a more coherent strategy.

Why does the Thai recovery strategy look very different than Korea's—less decisive and more prone to forbearance toward the private sector? The answers can be found in the political constraints outlined in chapter 3. The combination of parliamentary rule and the dependence on coalition partners meant that legislative support for reform was always fragile. As the case of the bankruptcy reform shows, Thailand also had legislative processes that substantially slowed decision making, certainly when compared with the early days of the Kim Dae Jung administration. Although such deliberation is a legitimate function of democratic government, many of the objections to the reform process reflected the interests of large debtors, some of whom actually sat in the Senate.

Finally, the political circumstances just described fed into a third factor; the government's political relationship with the private sector. From the outset, the Chuan cabinet and the Democrat Party were divided over a range of policies between those around Tarrin, who defended the IMF line and sought to limit government commitments to private actors, and those around Supachai and in the Senate, who sought a macroeconomic stimulus, greater government intervention in support of business, and a cautious approach to reform. The very existence of this split provided an important entry point for the private sector.

Malaysia

Malaysia was somewhat slower than the other countries in devising an institutional structure to handle the financial and corporate restructuring process, in part because the depth of the problems in its banking sector was substantially less. It was not until mid-1998, following the issue of the National Economic Action Council (NEAC) report, that the government established three new institutions to deal with the problems of nonperforming assets in the financial system, bank recapitalization, and corporate debt restructuring. In general, the design of these institutions mirrored best practice and they subsequently moved with great speed, even if the government ran some risks in adopting an active asset management strategy.

But the operation of the formal institutions did not constitute the full scope of the government's approach to financial and corporate distress; the government also engaged in a small number of controversial bank and corporate bailouts. The extent of these bailouts should not be exaggerated, and some were modified and partly reversed in response to political pressures. Nonetheless, they shed light on continuities in the nature of business-government relations in Malaysia.

The first to be established, Pengurusan Danaharta Nasional Bhd, or Danaharta, was set up on 20 June 1998 under the Ministry of Finance to acquire nonperforming loans from banks.[19] Unlike the asset management companies in South Korea and Thailand, Danaharta (1999, 3) is neither a rapid disposition agency nor a warehouse agency. Rather, it was granted a wider range of restructuring options, with the only stipulation being that recovery value was maximized. Danaharta could take legal action to recover security through the bankruptcy process and could sell the loans to a third party, but it could also take a more active role in rehabilitating companies. Given the risks associated with such a strategy, Danaharta outlined strict loan restructuring guidelines to avoid problems of moral hazard.[20]

As of 30 June 1999, Danaharta had a portfolio of RM39.3 billion of nonperforming loans, 17.7 billion acquired at an average discount of 57 percent and another RM21.5 billion in assets from two failed banks—the Sime Bank Group and Bank Bumiputra—that fell under Danaharta management (Danaharta 1999, 1).[21] Sixty-six financial institutions sold loans to Danaharta, but the majority of acquired NPLs were concentrated in fewer than 10 financial institutions, with the Sime Group and Bank Bumiputra the largest offenders.[22] This suggests that, although the banking system was generally sound, there were pockets of serious regulatory and institutional weakness (*Business Times*, 17 March 1999); as we will see, these weaknesses had political roots.

The most important test for an asset management company is its ability to maximize value, either by turning assets around or disposing of them judiciously. By the end of 1999, Danaharta had initiated recovery with 88 percent of borrowers in terms of value and over one-third of debt had undergone loan restructuring, asset restructuring or outright disposal (Thillainathan 2000, 13). Given Danaharta's ambition of restructuring companies, its performance should not necessarily be measured by asset sales.

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19. With paid-up capital of RM250 million (approximately $59 million), Danaharta raised RM25 billion in working capital in zero-coupon government-guaranteed bonds.

20. These included the ability to displace management and appoint "special administrators" to manage distressed companies, insistence that shareholders take disproportionate "haircuts" in any loan rescheduling, and the provision that borrowers are provided only one opportunity to implement a restructuring plan (Thillainathan 2000, 12).

21. The largest sectors in Danaharta's portfolio (as of June 1999) were the property sector (31.9 percent); purchase of securities (18.6 percent); finance, insurance, and business services, particularly investment holding companies (15.2 percent); and manufacturing (12.7 percent). These numbers underline that risk was concentrated in the nontradable goods sector. The variation around the mean discount of acquired assets was wide. Danaharta acquired unsecured nonperforming loans for a flat 10 percent of the principal outstanding, while construction and real estate loans, which constituted more than half the portfolio, had an average discount of approximately 30 percent.

22. Those banks that chose not to sell nonperforming loans to Danaharta were required to write down their values immediately to Danaharta's valuation (20 percent discount to market value).

Nonetheless, it is noteworthy that its first sale of physical property did not take place until November 1999, and the sale was extremely modest.[23] It is even more difficult to judge the success of Danaharta's operational restructuring efforts, but as of early 2000, the agency had appointed administrators for 53 companies. But the risk with Danaharta is that its relatively long life span may result in the effective warehousing of assets, with high costs for the government and taxpayers (Thillainathan 2000).

The second institution for managing the crisis was the bank recapitalization agency, Danamodal Nasional Bhd, incorporated on 10 August 1998 with an anticipated life span of 5 to 7 years.[24] With assistance from two foreign investment banks, Salomon Smith Barney and Goldman Sachs, Danamodal moved very quickly to identify 14 institutions in need of recapitalization. By October, it had recapitalized 9, in March 1999 a 10th (for a total of RM6.2 billion), and had worked out arrangements with the remaining 4 to recapitalize privately. To address problems of moral hazard that are inherent in such an exercise, Danamodal operated on the first-loss principle, under which losses arising from past credit decisions are born by shareholders. Danamodal also appointed nominees to the banks' boards and a monitoring process to assure the operational restructuring that constituted the quid pro quo of the restructuring.

Danamodal's recapitalization efforts were only part of a wider restructuring of the financial sector. In contrast to other countries in the region, the government did not move to close financial institutions directly; rather, it sought to consolidate the sector through a merger plan. Mergers would cut the number of domestic banks from 22 to 16, and merchant banks from 12 to 9, increasing the degree of concentration. The plan also envisioned a substantial reduction in the number of finance companies (*Straits Times*, 9 March 1999). But somewhat contradictory factors resulted in a number of institutions resisting the pressure for merger. On the one hand, the recession made merger partners less attractive; on the other hand, the recapitalization effort and purchase of NPLs allowed a number of smaller institutions to survive without assistance. The merger plan stalled.

In July 1999, a central bank (Bank Nasional Malaysia, or BNM) decree outlined an even more radical restructuring plan designed to increase the size and competitiveness of the financial sector: To cut the number of commercial banks from 21 to 6, finance companies from 25 to 6, and merchant banks from 12 to 6, with each class of institution built around a small number of "anchor" institutions. (*Straits Times*, 31 July 1999; *Asian*

23. Of 44 properties with a face value of RM122.6 million (0.3 percent of Danaharta's total assets), 24 were sold to successful bidders at an average 8 percent over their indicative value.

24. Danamodal fell under the central bank (Bank Nasional Malaysia, or BNM), and was to be funded by capital raised in the form of equity, hybrid instruments, or debt, in both the domestic and international markets, to minimize the use of public funds. The central bank provided the initial seed capital of RM3 billion, and another RM2 billion on a standby basis.

Wall Street Journal, 2 August 1999). The plan was highly directive: The BNM itself identified the likely anchor institutions, how they would be built, and the generous incentives they would receive. Also noteworthy is the fact that as many as 4 of the 6 new banks would continue to have significant government equity, maintaining the government's presence in the financial sector, and even increasing it in relative terms.[25]

The merger plan naturally set off a political scramble, as banks lobbied to be designated one of the anchor banks (*Straits Times*, 11 October 1999). But the most contentious political issue was the effect the consolidation would have on Chinese banks. Under the New Economic Policy, the Malay presence in the banking sector had grown dramatically, primarily at the expense of foreign and to a lesser extent Malaysian-Chinese banking institutions.[26] Because they have been smaller and weaker institutions, the proposed consolidation would have had an important effect on the Chinese presence in the sector. The number of Chinese-controlled banks would have been reduced to two. Hong Leong and Phileo Allied, two institutions affiliated with Anwar and his supporters, also emerged as losers out of the plan as well. The political significance of the bank consolidation plan was made apparent in early October when Mahathir himself signaled that the number of anchor banks was arbitrary and the plan might be modified; protests from the Chinese community and electoral calculations clearly had a bearing on this decision. The minister of finance and the central bank quickly fell in line, and the plan was modified to allow for a larger number of anchor institutions (*Asian Wall Street Journal*, 21-23 October 1999; *Straits Times*, 15 February 2000).

In the final piece of its restructuring efforts, the government moved to address the underlying problems in the corporate sector through the formation of a Corporate Debt Restructuring Committee in October 1998 under BNM. The purpose of the committee, like its counterparts in Indonesia, South Korea, and Thailand, is to minimize losses to creditors, shareholders, and other stakeholders through voluntary coordinated workouts that sidestep the formal bankruptcy procedure, particularly for larger debtors. Existing insolvency legislation in Malaysia was clearly more institutionalized than in either Indonesia or Thailand. Nonetheless, it was unpopular with creditors and did not provide the range of solutions to preserve value for other stakeholders in complex corporate groups with multiple creditors. The purpose of the committee was thus to persuade

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25. Rules for bank valuations would be set by BNM, and shareholders of acquired banks in the scheme would have the option of being paid either in cash or in shares of the merged entity *(Straits Times*, 11 August 1999).

26. Foreign banks have had a significant presence in the Malaysian banking system—accounting for roughly 30 percent of assets and lending. But unlike in other countries in the region, the crisis in Malaysia has not spurred efforts to further open the system, and the current cap of 30 percent on the foreign stake in local banks has remained in place.

financial institutions not to precipitate insolvency, while simultaneously keeping companies from running for the cover of court protection (Section 176).[27] As of the end of 1999, the CDRC had managed to oversee only 16 restructurings, but they were very large, with a total value of RM13 billion (Thillainathan 2000, 15).

Although the Malaysian government did move to establish strong institutions for managing bank and corporate restructuring, not all interventions took place through these institutions. In contrast to other countries in the region, a distinguishing feature of the Malaysian response to the crisis has been to extend support directly to a number of firms. These interventions do not exhibit a single pattern. Not all were straightforward bailouts; some involved indirect forms of support. In others, a proposed bailout was either rejected or modified, suggesting some of the checks that operate on the government. Others, however, suggest the socialization of private risk and the presence of moral hazard, including forbearance toward shareholders and management of ailing firms. Some actions could have been predicted by government efforts to use companies to fulfil social and foreign policy objectives. But others appear to stem from political and even family connections to recently privatized companies.

Projects initiated directly by the government and state-owned enterprises always pose dilemmas for governments; the temptation to use budgetary resources to support them during times of distress is high. The Proton national car project provides an example. As we saw in chapter 1, the Proton project was initially undertaken by a state-owned enterprise, Heavy Industries Corporation of Malaysia Holdings Bhd (HICOM), but by late 1995, the government had divested itself of majority control of Hicom by selling its remaining 32 percent interest to Yahya Ahmad's publicly held Diversified Resources Bhd, a holding company involved in assembling motor vehicles among other things (*Far Eastern Economic Review*, 2 May 1996).[28] Proton was badly affected by the crisis, but the firm also faced longer-term challenges, including the elimination of tariffs by 2002 under the ASEAN Free Trade Area (AFTA) agreement. The firm informed the government in early 1998 of the need for substantial capital investments to compete internationally.

Although the government had relinquished ownership, the prime minister remained closely involved with, and committed to, the national car project. Petronas, the state-owned oil company that falls directly under the control of the prime minister, was tapped to assist the ailing project,

27. A CDRC workout includes initial meetings of debtors and creditors, appointment of consultants, an initial review of the viability of the business, a formal standstill among creditors if the restructuring exercise proceeds, and oversight of restructuring plans. For details, see Thillainathan 2000, 13-18).

28. Hicom Holdings owned 32 percent of Perusahan Otomobil Nasional Bhd (Proton) and 27.2 percent of its distributor Edaran Otomobil Nasional Bhd (EON).

while Chinese-owned private companies with prior experience in the auto industry were excluded from participation in the restructuring of Proton-EON.[29] Petronas has vigorously denied that its involvement constitutes a bailout and insists that it would pay "fair market value" for its stake based on "due diligence." However, the prima facie evidence is strong that the transaction constitutes a "reverse privatization" of an ailing company and had the indirect effect of assisting Diversified Resources as well. (*Far Eastern Economic Review*, 12 August 1999, 13).

The management of Bank Bumiputra's financial problems provides a second example of the dilemmas governments face in dealing with loss-making state-owned enterprises. "Bank Bumi" started in 1965 to help ethnic Malays and was bailed out in 1984 and again in 1989. After injecting fresh capital in 1998, the government arranged a merger with another state-owned institution, Commerce Asset-Holding Bhd (CAHB) (*Asian Wall Street Journal* and *Straits Times*, 9 February 1999).[30] With assets of some RM65 billion, BCB will be Malaysia's largest banking group after Malayan Banking. To ensure the new bank is free of encumbrances, it was granted an option to sell some RM5 billion of Bank Bumiputra's nonperforming loans to Danaharta at face value; as the opposition was quick to point out, this favorable but costly arrangement was not made available to other banks.[31] CAHB will get a clean bank at a good price, while the government will avoid the problem of retrenchment of bank workers by spinning off a new Islamic bank that will continue to pursue the objectives previously pursued by Bank Bumiputra. During periods of systemic distress, it is typical for banks to get relief through recapitalization and purchase of nonperforming loans, but the terms on which CAHB and BCB were managed clearly differed from those of other private or state-owned banks.

The most visible and controversial case of government support for private companies is the complex saga of Renong and its affiliates, which shows—at a variety of points—how close business-government connections can generate high social costs. Fleet Holdings was UMNO's holding

29. The two-stage transaction, involving RM1 billion, has Proton first acquiring Hicom's other auto businesses, including a 32 percent stake in EON and several automotive-component manufacturing companies. Second, Hicom would sell its equity interest in Proton to Petronas, netting enough through the two transactions to settle its debts (*Asian Wall Street Journal*, 7 July 1999).

30. The share-swap deal reduced the government's 100 percent stake in CAHB to 30 percent, and gave CAHB 99 percent of the new Bumiputra Commerce Bank Bhd (BCB). Swapping RM334.2 million in new shares for the government's entire RM1.4 billion shares in Bank Bumiputra, CAHB will also pay up to RM560 million in cash or other instruments pending final valuations, for a total of approximately RM1.6 billion.

31. See the statement by Lim Kit Siang on Danaharta's purchase of Bank Bumiputra's NPLs at http://www.malaysia.net/dap/sg1680.htm.

company in the 1970s and in 1991, ''through a complicated series of share swaps, takeovers and mergers'' (Gomez and Jomo 1997, 52), Renong became its main corporate instrument. Renong was one of the success stories of the Mahathir strategy of privatization. By the early 1990s, its well-connected *bumiputra* management had benefited from privatization and established an extensive network of holdings in media, construction, and finance.

The controversy surrounding Renong involves several different transactions. The first dates to 1996, when the company's chief executive officer, Halim Saad, rescued the debt-laden National Steel Corp of the Philippines from Wing Tiek Holdings, which in turn was controlled by a Malaysian member of Parliament.[32] Wing Tiek's holding in the troubled company was sold to a shell subsidiary of Renong, Hong Kong-based Hottick Investment Ltd. The transaction was financed by a consortium of Malaysian banks. Danaharta took over the RM3.09 billion loan to Hottick Investments Ltd., albeit at a deep discount, thereby limiting losses to parent Renong. This single loan, not initially included in Danaharta's balance sheet, was equal to more than 15 percent of all of its purchased loans (*Asian Wall Street Journal*, 17 March 1999).

The next controversy was the government's decision to allow United Engineers Malaysia Bhd (UEM), a subsidiary of Renong, to undertake a reverse takeover of its ailing parent. Three issues were involved in the UEM-Renong case, the first being the waiver of the requirement to make a mandatory general offer. This waiver was opposed by Anwar, who attempted to revoke it in Parliament on 25 November 1997, but with Daim's support the waiver was reinstated on 12 January 1998. The reinstatement of the waiver raised questions of who held ultimate decision-making authority within the government. The second related issue was whether the reverse takeover of Renong was at the expense of minority shareholders, a long-standing criticism of Malaysia's weak rules on corporate governance (Gomez 1990).[33]

The third issue was whether the government would come to Renong's assistance more directly. As a major beneficiary of Mahathir's privatization program, Renong had gained interests in building and operating toll

32. Wing Tiek was controlled by a Malaysian member of Parliament, Joseph Chong, and had initially acquired National Steel at government urging as a gesture of support to the Ramos government. Wing Tiek faced financial problems in 1995, and Fidel Ramos personally sounded out Mahathir on whether other Malaysian investors could take over Wing Tiek's stake; Wing Tiek held 87.5 percent of the firm. Renong stepped in at that point.

33. On 17 November 1997, UEM bought 32.6 percent of Renong from eight different shareholders. The question was raised whether Halim was the actual purchaser of the eight tranches. With an existing personal stake of 23.3 percent in Renong, he would then come to own 55.9 percent of the company, exceeding the 33 percent trigger at which point it becomes mandatory to make general offers to minority shareholders.

roads, including the North-South Highway. The company had also gained exclusive rights to build a new telecommunications systems along the highway, as well as a variety of other concessions (motels, rest areas, restaurants, petrol stations, and toll collection itself). However, the company sustained a loss for the financial year ending 30 June 1998 of RM818 million, and its debts as a group amounted to 5 percent of total outstanding loans in the entire banking system! Initially, the government contemplated an outright bailout for the firm through the issue of RM10.5 billion in zero-coupon bonds (*Straits Times*, 28 October 1998). In the face of criticism from the opposition, subsequent plans moved to tap the group's subsidiary, Projek Lebuhraya Utara-Selatan (PLUS), which holds the toll concession on the North-South Highway.[34] Beyond the question of whether Renong should be directly or indirectly bailed out was the further question of whether Renong should be allowed to retain ownership of PLUS at all (Jomo 1998b).

The state-owned enterprise Bakun Hydro-Electric Corporation (BHEC) in Sarawak also demonstrates a number of the political and contractual complexities surrounding Malaysia's privatization program. BHEC was co-owned by a consortium of private and government entities, and was involved in a project that would transmit electricity to Peninsular Malaysia via a submarine cable (*Straits Times*, 10 July 1996).[35] The revival of the project was controversial because it involved Malaysia's largest build-operate-own (BOO) contract—RM15 billion—but was awarded without tender to Ekran's Chinese executive chairman Ting Pek Khiing, who was closely connected with Sarawak Chief Minister Abdul Taib Mahmud, Daim, and Mahathir (Gomez and Jomo 1997, 110-16).

As the crisis began, Ekran threatened to break a RM13.6 billion contract with Asea Brown Boveri (ABB), Ekran's main subcontractor. ABB refused to absorb cost overruns associated with the project, and announced in April 1997 that all subcontract work would be awarded competitively (*Straits Times*, 1 August 1997). ABB's announcement ran counter to the intentions of Ting Pek Khiing to give four of his listed companies some RM9 billion in subcontract work. ABB was not willing to concede control over subcontracting. The government took over BHEC from Ekran at a cost of RM290.2 million (*Straits Times*, 21 November 1997),[36] not only

34. PLUS, rather than the government, would issue the bonds in exchange for the sale of undisclosed assets by Renong. But the government would extend PLUS's toll concession and still forgo future tax payments by PLUS as a way of providing indirect support to Renong.

35. BHEC's owners: Ekran (32 percent), the Sarawak government (19 percent), Tenaga Nasional (25 percent), Malaysian Mining Corporation (5 percent), EPF (10 percent), and Sarawak Electricity Supply Corporation (9 percent).

36. The government also compensated Ting RM390 million for work done, but stopped short of his request to be compensated for ''foregone profits'' and other expenses (*Far Eastern Economic Review*, 23 April 1998, 75-6; *Straits Times*, 6 May 1999).

compensating Ting for a contract secured through less-than-transparent means, but effectively saving the firm from a dispute generated by its desire to channel business to related firms.

Finally, although nepotism has not been anywhere near as pronounced in Malaysia as in Indonesia, there are several troubling examples. A visible bailout involved the prime minister's eldest son, Mirzan Mahathir, and his Konsortium Perkapalan, a transportation conglomerate with debt of RM1.6 billion ($412 million) (*Far Eastern Economic Review*, 19 March 1998). The bailout again involved the government using Petronas to purchase Perkapalan's shipping assets. Both father and son have denied charges of nepotism, and Mirzan Mahathir subsequently sued Dow Jones Publishing for what he believed was a defamatory article about his growing business empire (*Asian Wall Street Journal*, 13 February 1999). But Mirzan is not the only son of Mahathir to be the beneficiary of government largesse.[37]

A common pattern in these cases is for the government to initiate projects, either directly through state-owned enterprises or through policy decisions, and then to privatize those efforts in whole or in part to favored private partners. It is impossible to say whether these partners were selected on the basis of political criteria alone; all had some prior experience in business. But it is possible to say that the discretionary and nontransparent means of allocating assets and contracts, as well as the personal connections to government officials, created risks. Because the projects in question served some broader political and policy purposes—diversification of the economy (Proton); supplying credit to *bumiputra* borrowers (Bank Bumiputra); advancing foreign policy goals (Hottick); and supplying infrastructure (Renong, Ekran)—the government had strong incentives to intervene to keep the projects afloat when they experienced distress. In some of the cases, this occurred by tapping various resources over which the executive had discretionary control, including the reserves of the Employees' Provident Fund and Petronas (*Far Eastern Economic Review*, 12 August 1999, 11). In others, such as the Bakun project, direct fiscal outlays were involved. In yet others (UEM-Renong), regulatory forbearance appears key. Yet, in all cases, the government's private partners or their creditors have been shielded to some extent from losses they might have otherwise incurred.[38]

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37. The privatization of hospital support services for the southern region was awarded to Tongkah Medivest Sdn Bhd, in which the prime minister's second son, Mokhzani Mahathir, had a 13.19 percent stake; Mokhzani was also UMNO Youth treasurer (*Straits Times*, 22 June 1999).

38. It should be underlined that the group of politically favored private actors is by no means limited to *bumiputras*, but includes a number of Chinese (Gomez 1999). It is also interesting to note that firms with ties to Anwar also realized advantages before the crisis, but were not recipients of similar government largesse once it struck; indeed, their failure marks a reduction of that faction's economic as well as political capabilities. Multi-Purpose Holdings faced its problems unaided (*Asian Wall Street Journal*, 12-13 March and 9 April

The Malaysian government's strategy toward financial and corporate restructuring appears to have two faces. On the one hand, the government established institutions with clear mandates and professional staff to address the problems of bank recapitalization, nonperforming loans, and corporate debt restructuring, and launched an aggressive plan of mergers in the banking sector. On the other hand, the government's strategy has relied heavily on an interventionist approach to asset restructuring that runs the risk of shifting losses onto Danaharta and the government. Moreover, the government also intervened directly in support of a number of public and private firms. Although Daim has publicly deemed it "politically unacceptable to use public funds to bail out businessmen who have made mistakes in judgement" (*Far Eastern Economic Review*, 30 April 1998, 62), in fact such government involvement remains a central theme of the opposition.

Indonesia

Of the four countries discussed here, the challenges of financial and corporate restructuring are clearly the most daunting in Indonesia. The government's program for the rehabilitation of the banking sector was unveiled under Suharto on 27 January 1998, and while it contained a number of important reform initiatives, we saw in chapter 2 how its implementation was affected by a variety of political constraints. The Indonesian Bank Restructuring Authority (IBRA), charged with overseeing the financial restructuring process, had little room for independent maneuver, and was in fact subjected early to turnover of high-level personnel.

The political pressures on Habibie would appear nearly as daunting as those that operated in the first half of 1998, but these pressures were not all counterproductive. In his 16 August Independence Day speech, Habibie announced that his four economic priorities would be cleaning up the banking sector, resolving the debt problem, eliminating monopolies, and increasing transparency. Given the further deterioration that occurred as a direct result of the political crisis, addressing the problems in the banking sector was primary among these four objectives; and in August, the government outlined a major package of banking legislation.

The package included a number of measures, but its central feature was a program that combined recapitalization with more aggressive action against weak banks and their clients. The audits ordered by Bank Indonesia—to be completed by October—were used to divide the banks into three categories: Category A banks, with a capital adequacy ratio above

1999) and other Chinese groups associated with Anwar, including Malaysian Resources Corp. Bhd (newspapers and a television station, once owned by UMNO), Hong Leong Bhd (from construction to finance), Phileo Allied Bhd (financial group), and Promet (a diversified conglomerate) also received no assistance (*Asian Wall Street Journal*, 7 April 1999).

4 percent (62 mostly small banks); B, for those below 4 percent and above −25 percent (66 banks); and C, for those under −25 percent (38 banks). Banks in group A were deemed temporarily sound, but called upon to raise capital to 8 percent in 3 years. B banks were eligible to participate in the recapitalization program.[39] But the government also exercised some conditionality; banks seeking recapitalization were required to submit a business plan showing that the owners were capable of meeting their share of the initial recapitalization and a schedule for higher capital-adequacy ratios. The plan also required that the banks' owners fully absorb the losses arising from loans extended to affiliated parties and that all bank obligations obtained from central bank liquidity support be transferred to IBRA, which would convert them to equity or subordinated loans.

The presumption was that some of the category B banks and most of those in category C faced closure, and thus many private banks had very strong interests in seeing the implementation of the program delayed.[40] The big exception to the rule, however, was the government's continuing commitment to 6 state and 15 provincial banks. Although all fell into category C, all were to be recapitalized. The key political issue with respect to the state banks was not only whether they would be retained or privatized, but whether the government and IBRA could collect on nonperforming loans or seize assets in compensation for them. The state banks had become a central means for channeling resources to politically favored parties and projects under Suharto, and the rate of nonperforming loans in them was extraordinarily high.

The recapitalization program would incur high costs for the government in the form of bond issues of Rp350 trillion, approximately 90 percent of GNP, and that figure excluded liquidity credits and in any case had to be revised upward to accommodate the tremendous cost of recapitalizing the state-owned banks. On the other hand, the plan did require owners to demonstrate their capacity to raise capital and contained the implicit threat that if they failed to do so, the banks would be taken over and sold or liquidated.

The key question was whether IBRA had the political as well as administrative capacity to design and execute the recapitalization program. With losses mounting, the negotiation of a new letter of intent with the IMF in November 1998 committed the government to announce the result of the audits on the banks and to move forward with the recapitalization program by the end of January.

39. The government would inject up to 80 percent of the capital required to reach the stipulated capital adequacy requirement of 4 percent in the form of government bonds.

40. C banks were required to raise their capital adequacy ratio (CAR) above −25 percent within a month of completion of due diligence and would be required to produce a business

The program immediately ran into a series of delays, reversals, and irregularities—all of which centered on the question of whether the marginal group B and C banks would gain access to government money. It was later revealed that at least one of the banks that had been categorized as Category B had a capital-asset ratio of minus 210 percent with 99 percent of its loans questionable (*Far Eastern Economic Review*, 19 August 1999, 12). In January, Habibie also signed a presidential directive authorizing government participation in the recapitalization of 12 banks before the scheduled release of the full list. This interim directive covered 10 regional development banks, which played an important political role for the government, but also two private ones, including Lippo Bank owned by the Riady family, which was close to Habibie.[41]

On March 13, the government finally announced that it was closing down 38 domestic private commercial banks (21 Category B, 17 Category C), nationalizing 7, and recapitalizing 9, subject to their ability to raise adequate capital by 21 April; 8 of the 9 made the deadline. The plan was hailed by the international financial institutions as a breakthrough. Some cronies and Suharto family members lost their banks, and the government initiated a process of investigation into whether the bank failures were the result of irregularities. However, questions were raised not only about those banks that the government chose to recapitalize, but about the closed and nationalized banks as well.[42]

The fate of the 7 larger banks that came under IBRA management proved even more complex.[43] The owners of 4 of the larger banks, which accounted for the overwhelming share of all liquidity assistance—BCA, Danamon, BDNI, and Bank Umum Nasional—expressed a willingness to strike deals with the government by providing funds and other assets and stretching out the deadline for repayment of liquidity credits. Given that much of the banks' bad lending was to affiliated companies,[44] the

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plan bringing their share of intergroup lending to less than 20 percent of capital and their CARs to 8 percent by the end 1999.

41. Lippo had raised the required 20 percent share through a rights issue and brought its CAR up to 4 percent, but it was scheduled to receive almost all of the allocated funds (3.75 trillion of 4.2 trillion) under the special directive.

42. The government had not proved effective in resolving the banks that it had previously closed. The assets of the 10 banks that had been "frozen" in April 1998 and the 7 smaller banks suspended in April 1999 were to be transferred to the Asset Management Unit for liquidation, but well into 1998 the licenses of the first 10 had not been revoked nor had all assets been successfully transferred due to conflicts over pricing and taxes.

43. Of the 7, 3 were suspended (BDNI, Bank Umum Nasional, and Bank Modern) while the other 4 (Bank Danamon, Bank PDFCI, Bank Tiara, and Bank BCA) were to be retained by the government with the intention of restructuring their capital (Economist Intelligence Unit, *Country Report: Indonesia,* 4th quarter 1998, 33).

44. Bank Dagang Nasional Indonesia, owned by the Nursalim family, was one of the worst offenders, with 91 percent of all lending to affiliated groups. But the situation was similar

government set a condition that the funds and assets provided must cover both central bank liquidity support and all credits extended to their groups. But given the limited administrative resources of IBRA, the deals held out the possibility that owners might continue to control both their banks and their pledged assets.

The nationalization list was also controversial.[45] Nationalization was justified on the grounds that closure of the banks would have adverse effects on the payments system, and it implied that owners would lose control over their assets. The boards of a number of the banks were purged. But liquidation would have arguably led to a faster unraveling of the troubled banks' loans and seizure of collateral.

However, the biggest test for IBRA was whether it could recover on the accumulating portfolio of assets it held. After the announcement of the recapitalization plan, these holdings included a bewildering variety of assets: Those pledged as a result of negotiations with seven major groups over repayment of liquidity credits; bad debts from state banks; and assets from private banks either closed, nationalized, or recapitalized. By the end of 1999, estimates of IBRA's assets (at face value) ranged as high as Rp500 trillion ($85 billion and well over half of Indonesian GDP; Hufbauer 1999).

In February, Habibie signaled his commitment to recover assets by extending the life of IBRA for 4 years and placing it on a more firm legal footing. The agency was also granted quite substantial quasi-judicial powers to seize assets and even to cancel commercial contracts that were seen to impose losses on IBRA; when the significance of these powers became fully apparent, they generated quite substantial controversy among foreign investors and banks (*Asian Wall Street Journal*, 20 May 1999; *Jakarta Post*, 12 May 1999). But the question was whether these and other powers could be exercised.

In the period before and after the June 1999 elections, the government came under increasing pressure from the opposition to aggressively pursue bad debtors (*Jakarta Post*, 2 June 1999). The process began with an effort to identify the largest 20 debtors to the state-owned banks, which accounted for more than half of those banks' NPLs, and to initiate a debt restructuring program with them. These debtors included well-connected businesspeople and some of Suharto's children. IBRA and the banks also

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at the others: e.g., 78.4 percent of Bank Umum Nasional's portfolio was intergroup, and 43.8 percent of Bank Danamon's was intergroup, according to Forum Keadilan.

45. Among those nationalized were Bakrie Group's Bank Kusa Nasional (BNN), owned by Aburizal Bakrie, head of the Indonesian Chamber of Commerce and a member of Habibie's board of advisors; and Bank Duta, majority-held by one of Suharto's foundations. Both banks had heavily exceeded related-party credit limits, and both were expected to have negative returns on equity and CARs by the end of 2001 (*Far Eastern Economic Review*, 25 March 1999, 65).

began releasing lists of the largest debtors from the nonstate banks and held a high-level meeting with the largest debtors to exploit their political vulnerability—including their identity as Chinese[46]—and to pressure them to sign ''letters of commitment'' by 22 June. These letters would include an agreement to be transparent, to allow IBRA audits, to propose a restructuring plan, and to agree to divestments when debtors lack the cash to make repayments. If such agreements were not reached by 30 August, the government threatened to take ''unpopular steps.'' By 22 June, 173 of the 200 had signed the letters, and the government was threatening litigation against the rest.

But the signed letters of commitment were only the first step in the recovery process (*Jakarta Post*, 13 and 25 June 1999). An even more challenging task was how to move from the restructuring of the banks to the task of corporate restructuring. IBRA's mandate extended only to bank restructuring and loans made by banks; most large corporations had borrowed from foreign or domestic creditors as well, and those obligations were not being serviced either. Beyond this narrow sense of debt restructuring was the larger issue of how to push forward the *operational* restructuring process.

One positive effect of the change of government from Suharto to Habibie was the establishment of a framework for the workout of corporate foreign debt. Following the successful conclusion of negotiations with foreign creditors, on 2 July 1998 the government established the Indonesian Debt Restructuring Agency (INDRA), which would allow debtors to covert their foreign-denominated obligations into rupiah ones—thus removing exchange risk—and shifting the burden of foreign exchange payments to INDRA.[47] The framework to facilitate and encourage voluntary corporate debt restructurings was announced on 9 September 1998. The so-called Jakarta Initiative was designed to provide a framework for out-of-court negotiations, overseen by a Jakarta Initiative Task Force (JITF).[48] The government tried to jump-start the process by making the Indonesian government's investment banking arm, PT Persero Danareksa, a test case by restructuring $438 million (*Asian Wall Street Journal*, 21 April 1999); but by late 1999, only three other major cases were moving through the process.

As in Thailand, the progress of the private restructuring exercise was partly influenced by the bankruptcy process. Unlike in Thailand, the

46. Interview with IBRA chairman Glenn Yusuf, *Asiaweek*, 28 May 1999, 91.

47. For an outline of the how INDRA works, see Johnson (1998, 53).

48. The JITF had the ability to obtain and develop information on companies to be restructured; help design restructuring action plans; facilitate negotiations and encourage participation of creditors and debtors; and speed regulatory approvals for restructurings in progress. The JITF could also recommend that the public prosecutor file bankruptcy proceedings against particular debtors if they were deemed to be stripping assets or showing a lack of good faith.

problems in the process did not arise in the legislation of the reform; the new law was passed quickly under the Suharto government and contained all the features that the IMF had sought when making it a condition of the third Letter of Intent (Johnson 1998). The problem, rather, was in the weakness of the courts. In the first 6 months, the bankruptcy court consistently ruled in favor of insolvent business groups in a series of decisions that were highly confusing to lawyers; fewer than a third of the 50 petitions filed with the Jakarta Commercial Court in that period actually led to bankruptcies. In a number of cases, the results appeared to rest on a weak understanding of the law, but others appeared to reflect political judgments about the undesirability of liquidation and foreign acquisitions

Despite the potential importance of both the courts and informal mechanisms over the longer run, the major vehicle for corporate restructuring would perforce be the government itself, for it had come to control approximately 80 percent of the banking sector's total assets. But therein lie a host of unresolved political problems and conflicts over precisely how IBRA should exercise its power, particularly given the diversity of the assets IBRA controls. To manage the assets pledged against unpaid liquidity credits, IBRA set up 5 holding companies "managing" 200 companies (*Asian Wall Street Journal*, 9-10 July 1999). IBRA exercises shareholders' rights until debts are repaid, but owners continue to manage the companies on a day-to-day basis. However, it is far from clear that this model can be extended to the variety of other assets that IBRA effectively owns, which are in general very inferior to the pledged assets.

Moreover, until the change of government in November, serious disagreements continued within and outside the government over the fundamental nature of IBRA's mandate. As with Malaysia's Danaharta, an inherent contradiction existed between the objectives of getting the best price for foreclosed assets or the best settlements with debtors, and acting swiftly to dispose of assets both to reduce the short-term liquidity constraints on government and the wider uncertainty surrounding the process.

But both strategies faced fundamental political as well as economic and administrative constraints. Those emphasizing the first path argued that IBRA should follow the Malaysian model and get into the asset rehabilitation business, including through offering debtors "haircuts" (and leaving them in control of businesses) and swapping debt for equity (which implies haircuts, in any case). At the extreme, this strategy could involve more ambitious operational and even industrial restructuring efforts.[49] But this would have required that IBRA have both the political indepen-

49. One idea circulating in Jakarta in late 1999 was for IBRA to effect a major consolidation of the entire petrochemical sector through a combination of mergers, asset sales, and supporting industrial policies.

dence and administrative capacity to undertake such an ambitious strategy.

The alternative—to dispose of assets quickly—is the favored route of those critics who see problems in any form of government intervention in the rehabilitation process. They see the barrier to a swifter resolution of the crisis in the emergence of a new "iron triangle" of IBRA technocrats and corporate owners and managers aligned against a group of willing buyers, both domestic and especially foreign. The main piece of evidence for the prosecution is that by August 1999, less than 1 percent of all of the assets IBRA had acquired had been sold (*Business Times*, 2 October 1999).

But as in Thailand, the sale of assets is limited precisely by the absence of a credible resolution process. Without a process that permits buyers to get access to collateral, the problem visible in Thailand recurs: Firms do not have incentives to reach meaningful settlements. Not surprisingly, those wanting to see more rapid asset sales naturally focus on expanding, or simply using, IBRA's extrajudicial powers.

When compared with the other countries under IMF programs, it is clear that Indonesia lags the other countries in bank restructuring and recapitalization, in corporate debt restructuring, and in restructuring or disposing of acquired assets. This is in part a result of the fact that Indonesia's problems have been much more severe than in the other countries, but the depth of the country's difficulties can also be traced in part to politics. Passing and implementing reforms have been affected by elections and non-electoral challenges, and particularly by the ability of private-sector actors to exploit generalized political uncertainty to evade reform.

The Bank Bali scandal of August 1999 also demonstrated that old patterns of business-government relations died hard. The scandal revolved around the alleged illegal transfer of about $80 million from the bank to an Indonesian firm as a commission for helping the bank recoup interbank claims on banks suspended but guaranteed by IBRA. But precisely because such claims are guaranteed, there should be no rationale for such a payment, and certainly not one of this size. Rather, the transfer, which involved government officials from both the executive and IBRA, was used to help finance Golkar's election campaign.

In the wake of Bank Bali, it was abundantly clear that political change and reform was a necessary condition for effective financial and corporate restructuring. However, it was not clear that it was a sufficient condition.[50] The Wahid administration replaced the existing IBRA leadership and the new team quickly pushed through the important sale of one of Indonesia's largest groups, Astra International, over substantial political resistance. However, IBRA has not received consistent support from the courts for

50. The following draws on *Van Zorge Report*, 22 May 2000, 5-13.

its actions and the president has intervened directly in several important restructuring cases in ways that undermined IBRA's independence and even appeared to bail out dubious enterprises and projects associated with the old regime. As in all of the crisis countries, the ability to undertake effective corporate restructuring ultimately hinges on a combination of consistent political support from the executive and a legal foundation for forcing the hand of recalcitrant debtors.

Liberalizing Foreign Investment

Despite strong political resistance, all four governments have not only launched short-term restructuring programs but initiated regulatory reforms that will affect the evolution of the financial and corporate sectors for some time to come. One of the most important of these reforms centers on the rules governing foreign direct investment.

Well before the crisis, all the countries discussed here had already begun to liberalize their rules governing FDI. This was particularly true in the three Southeast Asian countries, which took advantage of the sharp appreciation of the yen in the mid-1980s to position themselves as major sites for manufacturing investment—not only from Japan, but from the other newly industrializing countries, the United States, and Europe as well. However, the rules governing FDI were often ringed with exceptions, for example, emphasizing export-oriented industries; shielding the non-tradable goods sector, and particularly finance, from foreign entry; and continuing to impose equity requirements.

In all four countries, the crisis dramatically accelerated the liberalization of foreign investment, often with the explicit objective of facilitating the restructuring process.[51] In Thailand, the Chuan government eased restrictions governing land ownership; and after an initial delay, a difficult political fight in the Senate, and some restrictive amendments, it replaced the Alien Business Law of 1972 with a new Foreign Investment Law in October 1999. The new law retains a restrictive negative-list system and still requires firms to seek approval for investment in a number of sensitive sectors. But it opened domestic transport, retail trade, and legal services to foreign ownership. In the manufacturing sector, the Board of Investment substantially liberalized the criteria required for firms to receive investment incentives, particularly with respect to equity requirements, and even set up a mergers and acquisitions unit. Foreign firms responded quickly by expanding their stake in joint ventures or buying out partners entirely. In 1999, a review of Board of Investment incentives went farther,

51. The following discussion on Indonesia, Malaysia, and Thailand draws extensively from Felker and Jomo (1999).

proposing an elimination of all equity requirements and the move toward complete national treatment.[52]

Finance Minister Tarrin was also explicit in his desire to use foreign investors to facilitate the financial restructuring process. Foreign parties were major bidders in the asset sales organized by the FRA—again over political objections—and the government encouraged Thai banks to seek foreign equity partners and approved foreign takeovers of four failed banks in 1998.

Of the middle-income Asian countries, South Korea was historically one of the most restrictive in its approach to FDI. Under Kim Young Sam, the government had already launched a comprehensive investment liberalization in anticipation of OECD membership which left only 40 of 1,148 industries either partly or completely closed. Kim Dae Jung placed particular emphasis in changing Koreans views of foreign investment (D.J. Kim 1999, chap. 9). Liberalization of portfolio investment and direct investment in banking was a part of the IMF program and in May, the new government liberalized hostile takeovers by foreigners. In November 1998, the government passed legislation that replaced the entire legal framework governing FDI with a new Foreign Investment Promotion Act. The legislation was based on the principle of national treatment, and reorganized Korea's notoriously cumbersome application and approval process.[53]

But the most innovative administrative component of the reform, no doubt growing out of Kim Dae Jung's interest in expanding investment to poorer regions of the country, was to decentralize the management of incentives governing FDI to the provincial level. Local bodies can obtain financial assistance for the formation of Foreign Investment Zones, which extend additional tax and trade privileges and facilitate the leasing of land for larger investors. Provinces are also granted some discretion over the setting of relevant tax rates, thus spawning competition among provinces to attract investors. The new law substantially extended the tax holidays previously given to "high technology" activities and expanded the number of industries eligible.

Of the Southeast Asian countries, Malaysia was the most aggressive in courting export-oriented foreign investment prior to the crisis, but a number of domestically-oriented and import-substituting industries, such as autos, were restricted. Following the crisis, the government eliminated sectoral restrictions on new manufacturing projects, allowed foreign joint-venture partners serving the domestic market to increase their sharehold-

52. With the exception of some continuing incentives to deconcentrate investment away from Bangkok and to induce technology transfer.

53. A summary of the new law can be found at http://www.kotra.or.kr/kti/issues/1999/1-2/focus.html.

ings, and permitted wholly owned foreign firms to expand their local sales (from 20 to 50 percent). The imposition of the capital controls in September 1998 explicitly guaranteed convertibility on current account transactions and "free flows of direct foreign investment and repatriation of interest, profits, and dividends and capital" (*New Straits Times*, 2 September, 1998, 23); the controls clearly sought to minimize disruption to ongoing foreign operations.

In one respect, however, Malaysia did take a more restrictive stance than the other most seriously affected countries, and one that is consistent with the adjustment strategy outlined above. Wholly foreign-owned banks licensed in the past continue to occupy an important position in the financial system, but the government has retained the 30 percent equity cap on new investment in the financial sector. Nor was foreign purchase of assets seen as a central component of the restructuring process.[54]

Like that of South Korea, Indonesia's investment regime has historically been relatively restrictive. Following the decline of oil prices in the early 1980s, the government renewed efforts to court manufacturing investment in order to diversify away from dependence on natural resource exports. The government relaxed complex sectoral, equity, and trade and sales restrictions and opened its first export-processing zone, which allowed 100 percent foreign ownership. A major liberalization in 1994 partially opened nine previously closed "strategic" sectors to foreign participation,[55] although the brokering of foreign entry into these sectors provides an example of how liberalizing measures can be captured by private actors; many became the locus of new Suharto business enterprises.

The crisis resulted in a commitment to privatize a number of state-owned enterprises and to open or further open a number of sectors to foreign investment: petroleum, infrastructure, mining, utilities, retail trade, plantation agriculture, finance, and other nontradable sectors. In October 1998, Habibie introduced and passed legislation allowing 100 percent foreign ownership in the banking sector as a component of the financial sector restructuring effort. Felker and Jomo (1999) conclude that by 1999, Indonesia's investment regime was the most liberal and neutral in the Association of Southeast Asian Nations.

Conclusion

This chapter has identified the main policy challenges associated with systemic distress and explained some of the differences that have emerged

54. The government has also not been aggressive in seeking foreign buyers for Danaharta's acquired assets, but neither has it been aggressive in seeking *any* buyers to date.

55. The new activities included ports, electricity, telecommunications, shipping, air transport, railways, and mass media, but were subject only to a minimum 5 percent Indonesian ownership.

across the four crisis countries in trying to manage it. The first set of conclusions has to do with how democracies and non-democracies fare. Delays caused by electoral and non-electoral pressures, decision-making processes, and rent-seeking are certainly not absent from democracies. Thailand demonstrates these problems most clearly. But democracy gives competing politicians incentives to monitor corrupt business-government relations and for the public to bring new reformist governments to office. The differences between the Kim Young Sam and Kim Dae Jung governments in South Korea and between the Chavalit and Chuan governments in Thailand are clear.

The experiences of Indonesia and Malaysia suggest that whatever problems democracies have in undertaking reforms of business-government relations, the problems are equal if not greater in undemocratic systems. Indeed, because of the high level of discretion and low level of transparency, these governments are particularly prone to weaknesses in financial regulation and corporate governance. Government commitments to private-sector actors have strong implications for how firms behave; without the capacity to monitor those business-government relations, the public is likely to pay the cost of rent-seeking, weak regulation, moral hazard, and forbearance.

A second set of conclusions concern the role that independent agencies can play in the reform process, and particularly the assumption that they can reduce the problems caused by multiple veto gates and private-sector resistance. However, it is important not to confuse cause and effect; the power of the FSC in South Korea was ultimately grounded in some base of political, legislative, and party support. By contrast, the relative weakness of IBRA in Indonesia or the declining regulatory efficacy of the Bank of Thailand in Indonesia is not just administrative, but also political.

A final set of conclusions center on the question of how to make an overall assessment, particularly of a target that is moving quickly. The task of financial and corporate restructuring during a crisis is a daunting one, and even relatively positive assessments recognize that there is much to be done (Claessens, Djankov, and Klingebiel 1999); more critical ones have pointed out the risk of continuity and a reversion to old ways of doing business (Mann 1999). There is certainly much in the accounts just outlined to buttress the skeptics. But in drawing up a balance sheet, it is important not to make a simple but important error: to discount the longer-term consequences of legal and regulatory changes spawned by the crisis that will take some time, perhaps a decade, to have effects at the level of the firm and particular markets. Two important examples already noted in our case studies are the development of bankruptcy and foreclosure laws and reforms of corporate governance. A third reform—born of financial constraint and pushed by the IMF but also championed by reformers—were the rules governing foreign direct investment.

The concluding chapter addresses the question of how and whether such longer-term legal and regulatory changes are affecting business-government relations. To fully address that theme, however, it is important to first understand the social dimensions of the crisis.