Corporate Restructuring and Governance in East Asia

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Corporate restructuring and improved corporate governance are essential parts of economic reform programs under way in many countries. How can corporations be restructured to promote growth and reduce excessive debt without placing undue burdens on taxpayers? What framework is needed to promote better corporate governance?

CORPORATE restructuring involves restructuring the assets and liabilities of corporations, including their debt-to-equity structures, in line with their cash-flow needs to promote efficiency, restore growth, and minimize the cost to taxpayers. Corporate governance refers to the framework of rules and regulations that enable the stakeholders to exercise appropriate oversight of a company to maximize its value and to obtain a return on their holdings. Both corporate and financial sector restructuring are central to ongoing reform programs in East Asia. This article focuses on reform efforts in Indonesia and Korea, as well as Malaysia and Thailand.

Corporations, government, and banks have close relationships in many East Asian countries. Many sectors of their economies are dominated by conglomerates controlled by a small group, nontransparent accounting, interlocking ownership between the corporate and financial sectors, and weak minority shareholder rights. It is estimated that the top 10 families in Indonesia in 1997 controlled corporations worth more than half the country's market capitalization. Comparable figures are one-half in Thailand, one-fourth in Korea and Malaysia, but only 2–3 percent in Japan. Fundamental cultural and institutional changes are required if a new corporate governance structure is to be established with arm's-length, transparent relations between corporations, government, and banks. Changing corporate governance, however, is a long-term process. In East Asia, the immediate task is to deal with the present crisis by undertaking integrated restructuring of the assets and liabilities of highly indebted firms, external debt restructuring, and financial sector reform. Integrated restructuring of both corporate assets and liabilities is required if competitive enterprise and financial sectors are to be developed, the risk of crises recurring is to be reduced, and the cost to taxpayers of accomplishing these goals is to be minimized.

Buildup of vulnerabilities in the corporate sector. Before the crisis hit, many East Asian corporations expanded into sprawling conglomerates making extensive use of debt, because equity markets were undeveloped and, in many cases, owners preferred to retain control of firms with concentrated holdings. There were also structural weaknesses in these countries' banking supervision systems and internal bank management. Much of the debt owed to banks and corporations was unhedged and short term, which led to extreme overindebtedness following the devaluations and high interest rates of 1997 and 1998. Two factors that make financial crises in East Asia difficult to manage are the large, short-term internal and external debts and openness of many East Asian economies, both of which constrain their monetary and exchange rate policies.

Need for a comprehensive approach. Resolving corporate sector, financial sector, and external debt problems requires a comprehensive and integrated approach. Since good firms are necessary if an economy is to have good banks, corporate restructuring must be linked to bank restructuring, which, in turn, must be linked to the settlement of external debt problems. Perverse incentives and inequitable burden sharing can result if obligations to short-term external creditors are met and losses are concentrated on the government, labor, and, ultimately, the taxpayers. The costs to the government of bank recapitalization are high—we estimate that they range between 15 and 35 percent of GDP for the four countries discussed in this article. Financing these costs domestically is likely to increase government borrowing, thus increasing interest rates and further slowing recovery of the corporate sector.

In the short term, there is an urgent need to restructure the corporate and financial sectors. It is important to manage the crisis in such a way as to start the process of satisfying longer-term reform goals in each country, including making the fundamental changes necessary to create arm's-length relations between the government, corporations, and banks. Necessary steps include broadening the ownership of corporations by liberalizing foreign entry and expanding the role of capital markets. Protecting shareholder rights and developing improved accounting standards and bank regulations are essential. Just as the Great Depression led to legislation and reforms in the United States that diminished "relation-based" finance and laid the foundation for a modern financial structure, so the crisis in East Asia offers a rare opportunity for countries in that region to lay the foundation for a new, arm's-length system that is likely to be more efficient and sustainable.

"The present crisis provides an opportunity to lay the foundation for a new system of improved corporate governance."

The challenge for policymakers is to undertake comprehensive reform that maintains pressure on all parties in a way that promotes equitable burden sharing among borrowers, equity holders, the government, and external creditors; restores credit to viable enterprises and confidence in the financial system; and leads to a competitive corporate and financial system that minimizes the chances of recurrence of a crisis.

Sustainable reform and the resumption of growth require a fair sharing of the burdens of economic restructuring among external participants (short-term creditors, equity holders, and bondholders) and internal participants (shareholders, workers, and taxpayers). This burden sharing needs to be seen within the context of creating a future structure in which arm's-length relations prevail between new private sector owners, the government, sound financial institutions, and the broader capital market. The present constraints of meeting external debt payments and tight capital-adequacy ratios effectively determine the extent, pace, and costs (and, to a large extent, who bears these) of corporate and bank restructuring.

Framework for corporate restructuring. Corporate and financial restructuring takes time. In order to avoid an unnecessarily long period of uncertainty and slow growth, however, a country's government needs to enhance efforts to resolve these systemic problems. A comprehensive approach requires an active government that will eliminate obstacles to restructuring; facilitate both formal and informal debt workouts; and establish an effective new legal, regulatory, accounting, and institutional framework.

Obstacles to restructuring that need to be eliminated include tax policies that impede corporate reorganizations, mergers, debt-for-equity swaps, or debt forgiveness; restrictions on foreigners' participation as holders of domestic equity and investors in domestic banks; labor laws and other existing laws and regulations that could hinder debt restructuring; and ineffective bankruptcy procedures.

Effective bankruptcy procedures, which can be legally enforced and serve as part of a country's debt-restructuring process, are a very important means of ensuring that unviable firms do not continue to absorb credit. An effective bankruptcy system also serves to maximize the value of the assets to be distributed to creditors. Moreover, the presence of an effective bankruptcy system will create the appropriate incentives for creditors and debtors to reach out-of-court settlements. Given the costs and risks associated with even the most developed bankruptcy systems, a policy framework that facilitates out-of-court settlements that are fast, fair, and acceptable is essential.

Experience in several countries demonstrates that the government can play a constructive, yet informal role in facilitating an orderly workout of debts (sometimes referred to as the "London approach"). This approach, used in the United Kingdom since 1989, has been designed to help bring together debtors and creditors and facilitate negotiations. Many East Asian countries have adopted, or are adopting, a similar framework to facilitate and encourage corporate restructuring that includes using new bankruptcy provisions as an incentive for creditors and debtors to negotiate.

The government's policy framework should minimize costs to taxpayers. Because its primary focus is likely to be on large and medium-sized corporations, neither direct nor indirect subsidies should be provided to them. Small and medium-sized businesses require a different approach than large ones. Because many of the former have only restricted access to banks and capital markets, it is important to have policies in place that allow for rolling over their working capital and trade credit.

Policies are also needed to improve the competitiveness of the private sector. Competition policies that reduce anticompetitive practices and stop large firms' abuses of market power need to be implemented in parallel with corporate restructuring.

Improving corporate governance. Based on experience in other countries, corporate governance improves when the

Box 1

Corporate restructuring in Indonesia

The rapid depreciation of Indonesia's currency, the rupiah, has meant that most Indonesian companies are finding it almost impossible to meet their external debt-service obligations and are also defaulting on their domestic loans. The Indonesian government has adopted a corporate restructuring strategy that contains three interrelated elements: a framework to facilitate corporate restructuring, a new bankruptcy system, and a mechanism that enables debtors and creditors to obtain protection against exchange rate risk.

Frankfurt agreement. In June 1998, Indonesia reached agreement, at a meeting held in Frankfurt, with its principal creditor banks on three elements: a framework to reduce real exchange risk on payments following restructuring of external debts, a scheme to restructure interbank debts, and an arrangement to maintain trade finance facilities.

The Jakarta Initiative. Launched in September 1998, this initiative is designed to provide a framework for out-of-court negotiations and will apply to domestic and foreign creditors in a nondiscriminatory manner. Guidelines encourage creditors to subordinate their existing claims to those of other creditors that are willing to provide interim financing to debtors making adequate information available to their creditors. The Jakarta Initiative Task Force is an independent government agency staffed with experienced corporate workout professionals (specialists in formulating plans for the settlement of overdue corporate debts) whose mandate is to facilitate active corporate restructuring and accelerate the approvals required for restructuring plans. If necessary, the task force will be able to recommend to the public prosecutor that it exercise its legal authority to initiate bankruptcy proceedings against debtor companies in the public interest.

Bankruptcy reform. A substantially revised bankruptcy law, together with the Special Commercial Court, became effective on August 20, 1998. The revisions to Indonesia's bankruptcy law include the following: procedural rules designed to ensure that bankruptcy proceedings will be efficient and transparent; provisions that allow for the appointment of receivers and administrators from the private sector to administer the estates of debtors; greater protection of debtors' assets, including protection against insider and fraudulent transactions; and limitations on the ability of secured creditors to foreclose on collateral during the proceedings, thus making reorganizations more likely. The potential initiation of bankruptcy proceedings by creditors provides an important incentive for out-of-court restructurings of debt. Moreover, the law provides a useful means by which a debtor can bind dissenting creditors to a restructuring plan that has already received support from the requisite majority of creditors. Some initial bankruptcy decisions have been controversial, and there are ongoing efforts to further enhance the capacity of the judiciary.

extent of disclosure is increased, the power of large inside shareholders is curbed, sizable outside shareholders are present, and the financial system is private and competitive. Legislative changes are necessary to encourage these reforms. In addition, the governments of East Asian crisis countries are becoming owners of substantial assets (through asset-management companies or takeovers of insolvent banks). Policymakers need to dispose of these assets in a way that encourages longer-term improvements in governance and obtains fair value so as to minimize the costs to taxpayers (thus offsetting some of the costs of bank restructuring).

Approaches to corporate restructuring

Indonesia, Korea, Malaysia, and Thailand have all adopted an approach that facilitates and encourages corporate restructuring and have moved to eliminate obstacles to restructuring. The extent of progress and the degree of government involvement differ among countries, however, and are influenced by the share of corporate debt held by domestic banks versus foreign banks, whether domestic banks are institutionally strong enough to engage in active restructuring, and which sector the bad loans are concentrated in (real estate, commodity production, or manufacturing). In Indonesia, foreign private banks hold two-thirds, and domestic private banks hold about one-third, of corporate debt. In Thailand, foreign private banks hold about one-half the corporate debt. In Korea, most corporate debt is owed to domestic banks; similarly, in Malaysia, domestic banks hold about 90 percent of corporate debt.

In Indonesia, most corporate debt is owed directly by the borrowing firms to foreign banks. The weak domestic banks and their small share of total corporate debt imply that foreign banks will be an important player in the process. The authorities have adopted a three-pronged restructuring approach that consists of a framework to facilitate workouts on a voluntary basis, an improved bankruptcy system, and provision of foreign exchange risk protection once a restructuring agreement is reached (Box 1). To support this process, the authorities are also eliminating regulatory obstacles to corporate restructuring.

In Korea, more foreign banks made loans to domestic banks, which, in turn, lent the proceeds to the corporate sector, particularly to the *chaebols* (large corporate manufacturing conglomerates) whose debt-to-equity ratios increased to 500 percent or higher in 1998. Solutions will require a coordinated approach to reducing corporate indebtedness and restructuring domestic banks and their external debts (Box 2). Domestic banks are institutionally weak and thus find it difficult to actively restructure the large and powerful *chaebols,* so the government will play an important role in accomplishing this objective.

In Malaysia, corporate debt is owed almost exclusively to the domestic banks, and many bad loans are in real estate and infrastructure. The debt problem is less severe, and the legal system, more conducive to restructuring than in other Asian countries. The banks, with strong support from the government, may become the prime agents of change in achieving restructuring.

In Thailand, the share of foreign debt is smaller than in Indonesia, and many of the bad loans are concentrated in real estate. Banks may be able to be the prime agents of change in achieving the needed restructuring. A committee overseen by the Bank of Thailand plays a coordinating role. Current efforts to revise the bankruptcy system have been controversial, but progress is being made on eliminating tax and other disincentives to restructuring.

Conclusion

Many corporations in East Asian crisis countries are overindebted and frequently are part of conglomerates that are controlled by small groups and have nontransparent accounting and close links to government and banks. Integrated restructuring of both corporate assets and liabilities is required if competitive enterprise and financial sectors are to be developed, recurrence of crises is to be reduced, and the costs to taxpayers of accomplishing these goals are to be minimized. Indonesia, Korea, Malaysia, and Thailand are putting in place frameworks for corporate restructuring in which government can play a constructive, yet informal role to facilitate and encourage necessary changes. The present crisis provides an opportunity to lay the foundation for a new system of improved corporate governance that brings in sizable outside shareholders and encourages transparency, strengthened minority shareholder rights, broader capital markets, and sound financial systems.

Box 2

Corporate restructuring in Korea

Key elements of the Korean government's approach to corporate restructuring include implementation of legal and regulatory reforms. The Financial Supervisory Commission was created as an independent agency mandated to restructure both the corporate sector and financial institutions. The strategy is to focus on the restructuring of the top five *chaebols,* voluntary workouts for the other *chaebols,* and special relief for small and medium-sized enterprises.

Soon after the current government took office, the national legislature passed a series of acts to make the legal and regulatory environment more conducive to corporate restructuring, including improvements in accounting and reporting standards.

The government, under the auspices of the Financial Supervisory Commission, is encouraging the lead banks of lending syndicates to focus first on workouts of those *chaebols* ranked between the sixth and the sixty-forth largest. Dealing with these is urgent because they are the ones in deepest distress; they lack the financial resources and clout to restructure on their own; and large-scale insolvencies in this group would sharply increase unemployment. The Corporate Restructuring Coordination Committee has been formed to act as an arbitrator. The government is trying to build the workout capacity of the banks and has entered into an extensive and difficult dialogue with the five largest *chaebols* about their own restructuring programs.

Suggestions for further reading:

Stijn Claessens, 1998, Systemic Bank and Corporate Restructuring *(Washington: World Bank).*

Mark Stone, 1998, "Corporate Debt Restructuring in East Asia: Some Lessons from International Experience," IMF Paper on Policy Analysis and Assessment 98/13 (Washington).

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