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Non-performing Loans in East Asia

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Introduction

Three years have passed since the financial crisis hit Asian economies in July 1997. As a result, East Asian countries in 1998 recorded negative growth ranging from 5 to 12 percent. In 1999, however, economies improved in several countries; South Korea in particular recorded a "V" type of recovery. Although the growth process has slowed somewhat in 2000, progress continues and on the basis of the recent rapid recovery, there is optimism that the East Asian financial crisis has ended. On the other hand, there is also the opinion that the situation does not warrant optimism, as structural reforms, including non-performing loan (NPLs) problems in the financial and corporate sectors, have not progressed sufficiently. This paper looks into the issues that beset East Asian economies, based on the assessment of the current status of NPL restructuring in Malaysia, South Korea, Thailand, and Indonesia.

Immediately preceding the Asian financial crisis, Japan was tackling a NPL problem that resulted from the bursting of the so-called bubble economy in 1990. Economic depression has continued for nearly ten years since then, and the Japanese economy has yet to get back to the track of sustainable growth. The chief cause of this crisis, in a nutshell, was that the government did not take measures to deal with NPLs in a timely manner. Cooperative

Credit Purchasing Company was launched in 1993 to buy NPLs, and the Housing Loans Management Company was set up in 1996 to deal with the problem of housing-related NPLs. These efforts were inadequate and the real solution had to wait for large-scale public funds that were made available to financial institutions in March 1998, eight years after the bursting of the bubble economy. The process of resolving NPLs in Japan was indeed too little, too late. Japan adopted the policy of waiting for the economic environment to take a favorable turn, instead of taking swift, decisive action.

On the other hand, many East Asian countries addressed the problem of NPLs rather swiftly. South Korea, for example, immediately injected large amounts of public funds into financial institutions. Three years after the financial crisis, the solution to NPLs is progressing relatively well in South Korea and Malaysia, while Thailand and Indonesia are lagging behind. To solve the issue of NPLs, it is necessary to make structural improvements, especially in the financial system and corporate governance that actually caused the NPL problems.

The economic growth rate in each of these countries is projected to register a downward trend in 2000, compared to the previous year, and the current account surplus is diminishing. Since East Asian economies depend heavily upon the US economy, its current slowdown will be a damper to these countries' recovery. It is therefore necessary to analyze the current status of NPL problems, financial restructuring and corporate governance to make sure they can cope with adversely changing economic environments.

Private Debt as Main Cause

The main characteristic of the external debt of East Asian economies was the large amount of private sector debt. As opposed to this, the main characteristic of the external debt issue in Latin America, beginning with Mexico in 1982, was the huge amount of public debt owed by governments to foreign banks. Many South American governments could not raise funds from the market, as the economic fundamentals of public finance, current account balance and inflation deteriorated, leading to their failure to repay their debt. In comparison, the fundamentals of East Asian economies were rather strong compared to Latin American nations in the 80s.

Many of the East Asian governments closed down unhealthy financial institutions soon after the crisis occurred, while public funds were made available to those that were allowed to continue. The South Korean and Indonesian governments provided guarantees on deferred external bank debts in agreements with foreign banks. The Thai government declared that it would not close down banks, in order to maintain credit lines from foreign banks. All the governments with the support of the IMF maintained a policy of not bailing out corporate debt. The Miyazawa Plan of US$30 billion also did not cover facilities to private companies.

Status of Bad-loan Measures

The policies adopted by South Korea, Malaysia, Indonesia and Thailand to deal with the problem of NPLs were as follows:

- Establishment of assets management companies to gather NPLs
- Allocation of public funds to banks and other financial institutions
- Creation of a framework for the promotion of autonomous, non-courtroom negotiations between creditors and debtors

These governments either revamped existing organizations, or created new ones to implement the above policies in 1998. Further, in Thailand and Indonesia, it was necessary to revise bankruptcy laws, since they were not functioning properly. For this reason, negotiations between creditors and debtors were delayed. For both countries it was only in 1999 that revised bankruptcy laws were enacted, contributing towards smoother negotiations between creditors and debtors on NPLs.

Three years after the crisis, differences in their growth chart are beginning to emerge. The quarter in which the NPL problem was adequately treated and restructuring of NPLs started to make significant progress, and the trend in their bad loan ratio (bank credit in arrears for over three months) are indicated below.

	Malaysia	**South Korea**	**Thailand**	**Indonesia**
Assets Management Co.	1998/3q	1998/1q	None	1999/2q
Funds infusion	1998/3q	1998/1q	1999/1q	1999/3q
Promotion of NPL negotiations	1998/4q	1998/2q	1999/2q	2000/1q
Bad Loans Ratio (%)				
1999 (Mo.)	18.1 (6)	8.4 (6)	47.7 (5)	58.7 (3)
2000 (Mo.)	11.2 (2)	8.4 (1999/12)	31.3(7)	NA

As seen from the above Malaysia and South Korea have taken the lead, whereas Thailand and Indonesia have lagged behind, especially, Indonesia which began to address this problem only in 1999.

Thailand is yet to set up an assets management company. Further, the NPL ratio of banks is comparatively low in South Korea and Malaysia, but in Thailand it is currently around 30 percent, despite a small decline, and in Indonesia it is said to be as high as before. Let us briefly look at the steps taken by individual countries against NPLs.

Malaysia:

The measures taken by the Malaysian government against NPLs were swift and strong. Originally, the external debt of companies was not large, and the debt capital adequacy ratio was relatively low. Further, since the Company Act of 1965 was relatively well structured in comparison to Thailand, out-of-court settlement progressed relatively smoothly under the Bankruptcy Act. Danaharta, the assets management company, completed purchase of NPLs by December 1999, and the NPL ratio fell to 11.2 percent by February 2000. Danamodal, the organization for the infusion of public funds, has pumped 6.4 billion ringgit (equivalent to US$2 billion) into 10 banks so far, and already six of them have repaid their debt amounting to US$600 million. Therefore, the capital adequacy ratio of banks had improved to 12.8 percent in March 2000. The Corporate Debt Restructuring Committee, an organization promoting out-of-court restructuring, entered the field somewhat late, but by March 2000 there were 68 applications totaling US$9.5 billion. All debt restructurings are scheduled to be settled by September 2000, including transfer to Danaharta.

The Malaysian Central Bank has taken the initiative to settle NPL problems by year-end. The authorities will also restructure financial institutions, consolidating them into around 10 groups that will be completed within this year. Since it is necessary to open up the domestic market by 2003, per the arrangement with the WTO, the government needs to strengthen the competitive edge of banks. Since Malaysia has not resorted to IMF loans, its financial reforms may not be as forceful as other countries and there is concern that it may have undergone only partial structural changes in the financial system and corporate governance.

South Korea:

Like Malaysia, the South Korean government took immediate steps against NPLs. The Korea Asset Management Corporation, which was set up in December 1997, has settled NPLs worth 35 trillion won (US$32.1 billion) and recovered 18 trillion won (US$16.2 billion). Further, the government initially decided to provide 64 trillion won (US$57.6 billion) in public funds, but made fresh allocations, so far pumping 89.6 trillion won (US$107.7 billion) in public funds into the banks and non-banking financial institutions. As a result, bank lending started increasing in May 1999.

The process of out-of-court negotiations between creditors and debtors began somewhat late; it was in June 1998 that a framework targeting 73 medium and small businesses, was agreed upon. With regard to five large business conglomerates, the government has carried out reforms based on five Principles: enhanced transparency, withdrawal of financial guarantees, improvement of financial structures, business restructuring, and strengthening of managerial responsibility. The cross financial guarantee within a business group (equivalent to US$20 billion as of December 1997) was resolved to a great extent by March 2000, but the debt capital adequacy ratio (target below 200%) is yet to be improved. (As of December 1999, it stood at 349 percent for four business conglomerates, on a consolidated basis). In July 1999, Daewoo went bankrupt, and the Hyundai group is currently in the process of dismantling due to the inadequate liquidity of Hyundai Construction. The pace of improvement varies from group to group, but on the whole, reforms of large businesses by the government are behind original schedules.

Thailand:

The process of settlement of NPLs is delayed in Thailand, primarily because the government's response has been rather weak. It did not adopt a centralized solution to NPLs, but rather encouraged each bank to set up and transfer NPLs to its assets management company. By this method, where valuation is depreciated at the time of transfer, there is the risk of not doing enough or delaying the transfer, since it is left to the discretion of individual banks. In addition, the actual amount of public funds made available was less than banks needed. As a result, the solution to the problem of NPLs has been delayed and bank lending has not yet picked up.

A framework for corporate debt negotiations outside court was set up in September 1998, but revision of the Bankruptcy Act was left pending before the upper house for as long as one year. Bankruptcy courts began to function in the third quarter of 1999 and by June 2000, 553 large cases worth US$23 billion, were reorganized. Nevertheless, the whole process has been lagging behind.

In Thailand, it is not usual to settle matters before a court of law. There is strong public resistance to pumping public funds into a particular financial institution, and dislike of official interference in management when a public fund infusion is made. Unless the government overcomes these obstacles, a quick solution to Thailand's NPL problems will be elusive. According to an announcement by the Bank of Thailand, between October 1999 and February 2000 NPLs worth 334.3 billion baht were reduced, based on the agreement for restructuring of NPLs, but fresh NPLs worth 201.3 billion baht were also generated. Further, as a result of reorganization, loans that were regarded as healthy became bad; such loans totaled 55.8 billion baht. Bad loans that were settled once, but turned bad again imply that the restructuring process has not been carried out properly.

Indonesia:

Among the four nations cited here, Indonesia was most seriously affected by the Asian economic crisis, and many of its banks became insolvent. Despite the pumping in of large amounts of public funds—including emergency loans by the central bank—the road to recovery is still long, and a solution to the NPLs problem has been the most delayed among the four East Asian countries. The Indonesia Bank Restructuring Agency (IBRA) was established in January 1998, to pool NPLs and to infuse public funds. It presently holds NPLs worth 625 trillion rupiah. A breakdown includes: shares of corporate real estate worth 125 trillion rupiah collected from the owners of 28 banks (later nationalized) that received emergency funding from the central bank; NPLs of national/nationalized or liquidated banks worth 250 trillion rupiah, and shares of banks worth 250 trillion rupiah, taken over as a result of capital allocation. In short, a considerable amount of inferior quality loans is included. One year after its inception, IBRA continues to be bogged down by politics, and there was scarcely any progress in the resolution to NPLs in 1999.

IBRA started its activities after President Wahid's government assumed office in November 1999, and when Mr. Chachuk became its President in January 2000. A basic agreement to restructure 35 percent of IBRA's top debtors was reached with the IMF in June 2000, and it is believed that the 21 top debtors account for one-third of total NPLs of 250 trillion rupiah. All are either related to the Suharto family or their followers. The problem of NPLs in this country is complicated, since it involves political as well as economic issues.

The Jakarta Initiative, in charge of out-of-court settlements, was set up in January 1998. It began to function only in the first quarter of 1999, after it was reorganized as the Jakarta Initiative Task Force, and given legal sanction following the promulgation of the revised Bankruptcy Act. It is said to have settled 57 NPL cases worth US$3.3 billion in 1999. Foreign banks, which provided loans to relatively better quality companies, have settled in many cases through negotiations with individual debtors, without going through the Jakarta Initiative Task Force.

Future Issues

There is no other option or effective method other than to solve NPL problems through government initiatives. South Korea and Malaysia achieved positive results through powerful government intervention. On the other hand, the absence of separation between management and capital, along with aversion to government intervention in some cases (such as family-managed companies in Thailand), has delayed the process of recovery. In Indonesia, political reforms were given precedence over the resolution of NPLs. Moreover, a large number of NPLs held by local and national banks, which were transferred to IBRA, are of inferior quality. The occurrence of scandals related to NPLs has further complicated the matter, and resolution has been delayed further. It is feared that the NPL problem may delay the economic recovery in countries like Thailand and Indonesia.

To solve NPL problems and to inject capital into banks, many countries except for Malaysia had to incur a financial burden that far exceeded the cost originally estimated. In Indonesia, public funds provided to the financial sector—focusing on national banks—amounted to 650 trillion rupiah (US$87 billion). The combined external and public debt of Indonesia has jumped to US$150 billion. While the recovery rate of NPLs in Malaysia is over 60 percent, in Indonesia it is estimated to be much lower, since the loans held by IBRA are of inferior quality.

As seen in Thailand's case, the fact that once-restructured loans became bad again calls for caution. This occurs when an "easy" approach is taken towards corporate restructuring. It is often the case that financial restructuring is carried out by simply extending the loan period, and there may be a number of doubtful cases where restructuring has been carried out without strict cash flow management. Even in Malaysia, it has been said that simple extension of the loan period is the main method used, while debt equity conversion and changes in management is hardly seen. Compared to other regions such as Latin America, there are few instances of conversion of debt into equities. According to the accounting practices of some East Asian countries it is believed that once NPLs are restructured, they may be recognized as healthy loans that do not require reserves. Therefore, there may be cases where banks and creditors have entered into relatively easy restructuring plans, and it is feared that in such cases resolution to problems may simply be deferred. Though it is not easy to grasp the details of corporate restructuring, it is necessary to pay attention to the fact that the decline in NPL ratios does not necessarily mean that the real amount of NPLs has been reduced.

Five Thai banks and two South Korean banks have been sold to foreign investors. In Thailand, as a result of a build-up in capital through the stock market instead of infusion of public funds, it is said that acquisition of shares of big banks by foreigners has taken place in a significant manner. In Indonesia, as seen in the failure by a foreign bank to buy out Bank Bali, acquisition of banks by foreign capital has not succeeded. In Malaysia, there are no instances of acquisition of Malaysian banks by foreign capital. In Latin America, as a result of opening its market, acquisition of banks by foreign capital is quite common, but it is still limited in East Asia. In Thailand and South Korea, management of banks based on foreign capital will prove to have a positive impact on the local financial system.

Although the process of recovery has been delayed in Thailand and Indonesia, considerable progress is expected in the coming one to two years. It is vital to reform the structural elements that caused NPL problems. Some NPLs in Indonesia resulted from business practices based on connections, bribery, and lenient credit screening by banks. Fundamental changes are necessary to correct such a system. Revamping financial supervisory systems concerned with the health of bank management, introduction of a strict accounting system and transparency at the managerial level, are a necessity. Moreover, improvement in corporate governance, including elimination of cronyism, and transparency of corporate management should be advanced under government initiatives backed by public support. Whether or not East Asian economies can strengthen their capacity to cope with future financial crises depends very much upon whether or not East Asian countries succeed in their challenge to reform their banking and corporate structure.

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