Appendix 1

Characteristics of Systemic Banking System and Corporate Sector Crisis

According to Claessens et al. (2001), typically in a systemic – in part as a result of large shocks to foreign exchange and interest rates, and a general economic slowdown – the corporate sector and financial sectors will experience a larger number of defaults and difficulties to repay contracts on time and non-performing loans will increase sharply. This situation is often accompanied by generally depressed asset prices, such as equity and real estate prices, following run ups before the crisis, sharp real interest increases, and a slowdown of or reversal in capital flows. In countries with long-term structural problems that reached (too) large proportions, such as several transition economies, a systemic crisis may not be accompanied by the same asset price and capital flows behavior, in part as the run ups in prices and capital flows may not have occurred. Table A presents some key variables for a sample of systemic crisis countries for which we undertake some further empirical work in this paper. The table confirms the general characteristics of a systemic crisis.

The pattern of these systemic crises highlights the complicated coordination problems that arise among individual corporations, between the corporate and financial sectors, between the government and the rest of the economy, and with respect to domestic and foreign investors. In a systemic crisis, an individual corporation’s fate, and its owners’ and managers’ best course of actions, will depend on the actions of many other corporations and financial institutions, and the general economic outlook. The financial and corporate sectors, always already very closely intertwined, will need both restructuring in a systemic crisis, with actions affecting each other’s liquidity and solvency situation. The government will need to set both the rules of the game as well as be a main actor in the restructuring. And investors, domestic and foreign, will await the signs of actions of owners, government, etc., often implying a shortage of foreign and domestic capital when needed most.

The crisis and its coordination problem are typically aggravated by institutional weaknesses, many which likely gave rise to the crisis in the first place. There will often be deficiencies in the bankruptcy and restructuring frameworks; disclosure and accounting rules for financial institutions and corporations may be weak; equity and creditor rights might be poorly defined; the judicial efficiency will often be limited; etc.. There will typically also be a shortage of qualified management in the corporate and financial sectors, and a lack of qualified domestic restructuring and insolvency specialists, in part as there may not have been a history of corporate and financial sector restructuring [of this scale]. The government itself may face credibility problems, as it was possibly part of the cause of the crisis, and in general faces many time-consistency problems, e.g., how to avoid large bailouts while at the same time restart the economy.

These complicated coordination problems already suggest that a systemic crisis will be difficult to resolve. Many observers have tried to develop best practices lessons on how to best resolve these systemic crises.

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1 This appendix draws from Claessens et al. (2001).
Table A: Patterns of Systemic Banking Crises

<table>
<thead>
<tr>
<th>Country</th>
<th>Crisis year</th>
<th>Fiscal cost (% of GDP)</th>
<th>Peak NPL (% of loans)</th>
<th>Real GDP growth</th>
<th>Change in exchange rates</th>
<th>Peak in real interest rates</th>
<th>Decline in real asset prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Rep</td>
<td>1998</td>
<td>14.0</td>
<td>38</td>
<td>+0.4%</td>
<td>-3.1%</td>
<td>6.2%</td>
<td>-56.6%</td>
</tr>
<tr>
<td>Finland</td>
<td>1992</td>
<td>11.0</td>
<td>13</td>
<td>-4.6%</td>
<td>-5.5%</td>
<td>14.3%</td>
<td>-34.6%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1998</td>
<td>50.0</td>
<td>65-75</td>
<td>-15.4%</td>
<td>-57.5%</td>
<td>3.3%</td>
<td>-78.5%</td>
</tr>
<tr>
<td>Korea</td>
<td>1998</td>
<td>37.0</td>
<td>30-40</td>
<td>-10.6%</td>
<td>-28.8%</td>
<td>21.6%</td>
<td>-45.9%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>1998</td>
<td>16.4</td>
<td>25-35</td>
<td>-12.7%</td>
<td>-13.9%</td>
<td>5.3%</td>
<td>-79.9%</td>
</tr>
<tr>
<td>Mexico</td>
<td>1995</td>
<td>19.3</td>
<td>29.8</td>
<td>-6.2%</td>
<td>-39.8%</td>
<td>24.7%</td>
<td>-53.3%</td>
</tr>
<tr>
<td>Philippines</td>
<td>1998</td>
<td>0.5</td>
<td>20</td>
<td>-0.8%</td>
<td>-13.0%</td>
<td>6.3%</td>
<td>-67.2%</td>
</tr>
<tr>
<td>Sweden</td>
<td>1992</td>
<td>4.0</td>
<td>18</td>
<td>-3.3%</td>
<td>+1.0%</td>
<td>79.2%</td>
<td>-6.8%</td>
</tr>
<tr>
<td>Thailand</td>
<td>1998</td>
<td>32.8</td>
<td>33</td>
<td>-5.4%</td>
<td>-13.7%</td>
<td>17.2%</td>
<td>-77.4%</td>
</tr>
</tbody>
</table>

Data sources: “Crisis year” is the peak crisis year, from Caprio and Klingebiel (1999). The “fiscal costs as % of GDP” variable is from Honohan and Klingebiel (2000) and Tang, Zoli and Klycynikova (2000) in the case of the Czech Republic. The “peak non-performing loans as % of total loans” variable is from Caprio and Klingebiel (1999) in the case of Indonesia, Korea, the Philippines and Thailand, Lindgren, Garcia and Saal (1996) in the case of Finland and Sweden, Krueger and Tornell (1999) in the case of Mexico, and Tang, Zoli and Klycynikova (2000) in the case of the Czech Republic. The “real GDP growth” variable equals the percentage change in real fourth-quarter GDP in the crisis year compared to real fourth-quarter GDP one year before the crisis year. CPI inflation is used to get the real growth in GDP, and the growth in GDP is in terms of local currency. GDP data are from IFS (IMF). The inflation rate equals the percentage change in the CPI during the crisis year and is from IFS. The “change in exchange rate” equals the percentage change of the exchange rate versus the US dollar during the first quarter of the crisis year. An increase in the exchange rate indicates an appreciation. The exchange rate data are from IFS. The “real interest rate spike” equals the peak in the real money market rate during the crisis year. For the Czech Republic and the Philippines, the real discount rate is reported instead of the money market rate, due to data unavailability. The interest rate data are from IFS. The “real growth in asset prices” variables is the largest drop on an monthly basis in the stock market index during the crisis year compared to the level of the stock market index in January of the year before the crisis year. The return is in local currency and corrected for inflation. They use the Datastream globalmarket indices for Finland, Mexico and Sweden, and the IFC global market indices for the other countries.

Taken from: Claessens et al. (2001).
Appendix 2

Relative Strengths and Weaknesses of Three Approaches to Corporate Restructuring

(I) Market-led Approach to Corporate Restructuring

(1) Neo-liberal free market advocates argue that a market-led approach can help achieve economic efficiency, discipline and more resilience in the banking and corporate system.\(^1\) Government intervention is considered to be counter-productive, and unlikely to achieve these desired outcomes.\(^2\)

- However, these benefits cannot be assumed \textit{a priori} (theoretically) to materialize since markets (for e.g. the capital market) and information are "imperfect" in reality. Furthermore, market approaches (that rely on private funds) may not be viable or workable simply because of a lack of funds or market players.\(^3\)

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\(^1\) It works as follows: If the insolvent corporation is worth more as a going concern than after break-up, private individuals or firms could then opt to buy the corporation as a going concern (through a takeover, for example). The person or corporation willing to pay the highest price or valuation for the corporation (i.e. through a competitive bid or in an "auction") would obtain the corporation and put the corporation and its assets to the highest valued use. If, on the other hand, the firm is valued on a break-up basis, then it would have to undergo liquidation proceedings, since there would not be any interested party to take it over as a going concern. Hence, corporations that "do not deserve" to survive, or are "not fit enough", will be "eliminated". This "weeding out" process will thus, argue some, create a more resilient and stronger corporate sector, and consequently, a more resilient banking sector in the long run. See also Krugman's (1998a) analysis on fire-sale FDI.

\(^2\) To take it further, according to Cui (1999: 9), "the stronger believers of the 'invisible hand' want to show that even if there are some 'market failures', 'government failures' are always larger." Therefore, they want to show that the attitude 'let the market take care of itself' is always the right solution. If any, the role of government is to enhance the enabling environment, including allowing hostile mergers and acquisitions (takeovers), liberalizing rules pertaining to foreign investment and promoting capital market development.

\(^3\) Market-based methods can only be applicable if private capital is available and private investors are willing to participate in mergers and acquisitions, inject fresh capital, roll over loans, etc. However, competitive auctions may fail to take place because of the existence of the "financing problem", "absence of competition problem" and/or lack of well-informed bidders. For more on these issues, see Aghion, Hart and Moore (1992). Hotchkiss and Mooradian (1998: 3), referring to Gertner and Picker (1992), highlight the acquisition problem that results from asymmetric information. However, the fact that market-led approaches can lead to sub-optimal results does not imply total rejection of this approach. Every approach may have its own deficiencies. As such, circumstances should determine the most appropriate approach tool to solve problems at hand. According to Cui (1999: 8), Hayek would argue that "when 'markets failures' are identified by pointing out violations of the assumptions of the First Theorem, the 'survival of the fittest' argument could be used against government regulation to correct these 'failures'. This is because, according to Hayek and Coase, private dealing and 'spontaneous order' can always resolve these 'market failures' in a better way. To Hayek, the 'survival of the fittest' argument should not only be applied to the individual firm level, it should also be applied to the natural selection of 'rules and institutions'. This is why Hayek criticizes 'social Darwinism', because it wrongly 'concentrated on the selection of the individuals rather than that of institutions and
Unlike the claims of supporters of market-led approaches, Baird (1993) and Bradley and Rosenzweig (1992) argue that Chapter 11 (as one approach towards market-led corporate restructuring which is – in fact – highly dependent on supportive regulation) fails to provide managers with appropriate incentives to allocate corporate resources to their highest-valued uses. Furthermore, some argue that Chapter 11 may not be the most effective or efficient bankruptcy procedure.

The efficiency of mergers and acquisitions, and hostile takeovers, as disciplining mechanisms remain controversial, with considerable empirical evidence and many studies casting doubt that these approaches will necessarily correct managerial and other inefficiencies.

2) A market-led approach claims it would enhance systemic efficiency and safety. These benefits follow if market players who are better capitalized and managed are able to increase their market shares at the expense of those who are weak and potentially threaten systemic stability.

practice. (Hayek 1982: I.23) It is the natural selection of the fittest institutions that provides the strongest argument for the "invisible hand paradigm."

Moreover, the (indirect) costs involved in maximizing the value of assets under Chapter 11 may be high (which dissipates the value of the assets). According to Bebchuk (1997: 4), "the Chapter 11 process involves substantial administrative costs. Indeed, the fees paid to lawyers, accountants, and other professionals in a Chapter 11 reorganization of a publicly traded company are often on the order of tens of millions [of] dollars."

Bankruptcy proceedings will commence when corporations are unable to pay their creditors or service their debts, or when lenders are unwilling to roll over debts and insist on repayment. However, it would be considered a loss if financially insolvent corporations are considered economically viable. For some theorists, market-based approaches have a liquidation bias. Wijnbergen (1997) explained that even though bankruptcy proceedings allow for debt restructuring (specifically debt equity conversion) in principle, this rarely occurs in practice. Aghion and Moore (1992) found that even carefully crafted bankruptcy laws have a strong liquidation bias built in, with 95 percent of "Chapter 11" cases eventually going the liquidation route. This is where the government can ensure that corporations that are illiquid, or even insolvent do not undergo automatic liquidation if they are economically viable (though some may not be profitable in the short term). However, other bankruptcy proceedings could be more effective and "efficient" compared to Chapter 11 (Aghion, Hart and Moore, 1992).

See Maher and Andersson (2000), specifically Section IV.3 and the various studies referred to by them for a review of the debate over the effectiveness of market mechanisms (specifically, hostile take-overs). Referring to the US and UK, Mayer (1996) found little evidence to support the premise that takeovers were motivated by the poor corporate performance of "target" corporations prior to the takeover bid. Rather, factors such as changes in corporate strategy or rent seeking behaviour were found to be the primary objectives or motivating factors behind the takeovers. Other possible motivating factors include increases in firm size and firm growth, and tax motives (for mergers and acquisitions). But this does not necessarily imply that markets do not play a role in corporate control, what is required is to fine tune existing incentives and regulations to improve the effectiveness of the mechanisms.

This can be aptly referred to as the "survival of the fittest by natural selection" argument. Many market fundamentalist economists including Friedman, Hayek, Buchanan, Becker and Alchian invoke the argument of "survival of the fittest by natural selection" as justification for relying on the "invisible hand" (Cui, 1999).
However, this change in market structure may lead to greater market
congestion (and hence less competition) that may prove to be of a concern for
the government, in terms of social welfare and pricing. Furthermore, the
"current" bargaining process, say, under Chapter 11, does not necessarily
guarantee an optimal and efficient capital structure after reorganization (as
claimed by market advocates).

(3) It is argued that equitable cost sharing arrangements under a market-led approach
would help mitigate problems of moral hazard and create incentives for more efficient
monitoring as all relevant parties would have a stake in the corporation. It is argued
that once "ownership" or "property rights" are established, misuse of resources will
be minimized.

However, the claim of equitable cost sharing assumes that government-led
approaches are necessarily less equitable, and do not impose costs on debtors or
the "party" at fault. This may not be true, since governments may "force" all
parties involved to accept a "haircut" and to share costs.

Even if a market-led approach is feasible, moral hazard may not be minimized if
the management responsible for causing the problems in the first place is not
removed or goes unpunished. This has a great chance of happening with mergers
(as the chances of a change in management with mergers is less than with a
hostile takeovers or acquisitions, ceteris paribus).

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8 However, this does not imply that "perfect competition" is a real option. Neoclassical
economists assume that a market characterized by perfect competition is always the best or ideal
form of market structure. Sloman (1997: 176) notes that "perfect" competition refers to
competition that is total. There is a total absence of power, a total absence of entry barriers, a
total absence of product differentiation between producers, and total information for producers
and consumers on the market. Perfect does not mean 'best', however. Just because it is at the
extreme end of the competition spectrum, it does not follow that perfect competition is desirable.
He further argues that "to say that perfect competition is desirable and that it is a goal towards
which government policy should be directed are normative statements." He also points out that
"by using perfect competition as a yardstick, and by using the word 'perfect' rather than 'total',
economists may be surreptitiously persuading their audience that perfect competition is a goal we
ought to be striving to achieve."

9 See Bebchuk (1988), Bebchuk (1997) and Hart (1999) for an explanation of the bargaining
procedure in Chapter 11.

10 Roe (1983) - as quoted by Bebchuk (1997: 5) - "suggests that the nature of the existing
bargaining process often leads to an inefficient choice of structure for the reorganized company –
and, in particular, to excessive debt in the capital structure." Hotchkiss (1995) empirically
supports this argument - a large portion of the corporations have to undergo financial
restructuring within a subsequent few years after reorganization.

11 For example, the government may require corporations to sell their non-core assets (to any
interested party, including the government) as part of a financial restructuring plan to improve
their balance sheet, instead of the government injecting liquidity (by giving them more loans, for
example) into corporations to keep them afloat. In that sense, corporations are expected to
internalize costs of their actions and to share the costs of restructuring.

12 Retaining those responsible for causing the insolvency of the corporation without punishment,
could signal that future mismanagement and bad performance will be tolerated. As such,
management may not be "threatened" or motivated enough to put in the "required" effort to
improve performance of the corporation. However, removing those with "insider information"
4) There is a currently favoured view that a market-led approach (when feasible) is better than a government-led approach in handling corporate distress. Market-led approaches are attractive because they limit the burden on taxpayers since these approaches utilize private rather than public resources to facilitate restructuring.

- However, there is possibility that market-led advocates underestimate the costs of market-led approaches to the public since they tend to be more time-consuming as they involve “bargaining” and negotiations among various parties (as under U.S. bankruptcy procedure Chapter 11). This indirectly imposes a cost on the public in terms of forgone output during the negotiation and “bargaining” process. The longer it takes to come to an agreement or consensus — because the number of creditors and the variety of claims increases — regarding whether to “reorganize” the corporation, the less attention will be paid to producing good and services, the greater the chances of lower production, ceteris paribus.

(5) Market-led approaches, some argue, reduce the likelihood of governments ending up as principal owners of banks and enterprises. From this perspective, this would distract the government’s focus from providing public services and macroeconomic management of the economy to manage corporate enterprises, increase government expenditure and crowd out access to scarce resources.

- However, state-owned enterprises may be essential for furthering development objectives or policies.
- Government owned enterprises are not necessarily less efficient as critiques of privatization policies and theories suggest.

(6) Some argue that a market-led approach generally works better in recovering non-performing and bad loans than a bureaucratically administered system. Competition in the acquisition and disposal of assets should eventually make for more efficient debt workouts.

- However, according to Blaustein (2001), the market-based solution is unlikely to reduce debt to sustainable levels for many companies even in the medium term, thereby making them vulnerable to volatility in interest rates and market conditions.\footnote{Blaustein (2001) cites Korea as an example. A purely market-based solution in Korea would result in an average debt-equity ratio of the largest chaebols of over 400 percent in the year 2000. Although the Korean debt-equity ratio has always been high, this would still be above historical levels and much higher than is common in market economies.}

\footnote{This forgone output is calculated as the difference between “normal” output levels and the lower production level during the “bargaining” process.}

and experience of the organization while facing limited supply of competent and professional managers may be counter-productive. Hence, there need to be some performance criteria and management incentive system in place to induce better performance, should the old management be retained.

\footnote{Nevertheless, even a government or bank-led approach would face the same difficulties, but to varying degrees.}
(1) Government-led Approach to Corporate Restructuring

A government-led approach can be fast since there is a party (the government) who is ready to undertake the restructuring program, unlike a market-led approach that relies on the voluntary “availability” of private buyer(s) or investor(s), which may not be sufficient and difficult to organized to undertake massive financial commitments.  

- However, the World Bank (2000) argues that “government funds are not required for corporate restructuring, and their supply may even hinder private resolution as stakeholders are induced to seek these subsidies.”

- Even though it may be relatively faster than a free-market approach (under certain circumstances), there would be immense fiscal obligations, and costs to taxpayers would ultimately be higher – both in the form of higher taxation in the future to subsidize (current and, potentially, future) government support for banks and corporations as well as foregone public expenditure.

- Also, there is a risk that the speed of the restructuring process could be compromised because later re-privatization of state-owned enterprises (be they financial institutions or corporations) can be costly and time consuming process, since it is normally meets with strong resistance by the employees of state-owned enterprises and can be bogged down by bureaucratic delays and corruption (Park, 2000).

(2) Since the centralized AMC has taken over the assets of distressed banks and helped recapitalize them, then banks (severely distressed themselves) will not have to force corporations (potentially economically viable, but financially distressed) to undergo liquidation.  

This ensures that viable corporations can be preserved and their debts and operations given some breathing space and time to be restructured.

- However, centralized AMCs, argue some, are fraught with weaknesses. Among others, the most important is the argument that even with incentive measures built in, government-owned agencies still run the risk of poor management with a lack of motivation to restructure corporations.

16 See Aghion, Hart and Moore (1992) for an illustration of the “financing problem” using IBM as an example.
17 The World Bank (2000c: 91) further stressed that, “The proper role for governments is to facilitate resolution of financial claims and foster the allocation and mobility of assets. In the absence of efficiently functioning systems to resolve financial claims, governments in all the crisis countries have instituted out-of-court mechanisms to encourage financial settlements. Beyond these immediate measures, also aiding in the short term, are ongoing efforts to achieve effective bankruptcy regimes and improved accounting standards. Once financial property rights have been clarified, the market system and the private sector should be in a position to undertake the required reallocations of productive assets, but governments can play an important role in permitting greater asset mobility.” In other words, the government’s role is only limited to creating an enabling and favorable environment for the functioning of the market and private sector. However, such measures are time consuming, while the severity and urgency of the problems may require quicker, pro-active and “direct” government action.
19 Wijnbergen (1996) gives an example of the incentive problem due to using “hospital for sick enterprises” (enterprises “turned around” under public sector control). According to Wijnbergen (1996: 48), “the successful implementation of the ‘hospital agency’ would lead to its quick
When governments are involved in corporate restructuring, there is a possibility that it may be fraught with problems of weak discipline of corporations to bear costs and improve operational performance if such corporations have strong political and economic influence ties with the government. Simply put, it could lead to acute moral hazard problems.

Blaustein (2001) suggests that large loans that break the links between banks and corporations, thereby eliminating bank involvement, may reduce the value of assets, as banks have privileged access to "insider" information.

There is a possibility that restructured firms ("stigmatized" as "hospital patients") will find it hard to regain access to the banking system (Wijnbergen, 1996).

(III) Recapitalized Bank-led Approach to Corporate Restructuring

(1) This approach can be relatively fast (relative to court reconciliation, argue Gray and Holle, 1996) and will indicate to the market that problems are being resolved. Some argue that banks are a more efficient way of debt restructuring (than a centralized AMC) if effective private ownership is established with debt converted into equity, instead of debt write downs and full collection of what remains. Debt equity conversion offers a more promising way for the efficient use of assets controlled by enterprises than liquidation into a thin capital market and a depressed economy.

However, if banks end up holding large amounts of equity, they can become more vulnerable to stock market fluctuations, thus increasing new uncertainty and risk.

(2) Banks generally play a big role in restructuring because of the unique information they possess about their corporate customers (Fries and Lane, 1994).

However, even if banks have "insider" knowledge regarding their clients, they may not have the expertise to advice on the organizational, managerial or operational restructuring of their client corporations.

abolishment. However, the jobs and continuing influence of the Agency’s officials depend, on the contrary, on it continuing rather than shutting down.” Wijnbergen (1996: 48) cites the case of the Italian state holding company IRI that has overstayed its statutory obligation to dismantle itself within five years of inception in 1948 to become the largest industrial conglomerate in Italy up till the present.

Haggard (2000: 142) suggests that “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 creditors, but neither may have incentives to meet their obligations”. However, this may not occur and the government can take tough measures (see Haggard, 2000: 142) to maximize the value of assets, though this requires an unusually high degree of technical capacity and political independence.

Blaustein (2001) notes, “Past experiences, particularly in countries with weak institutions, suggest that many times an agency ‘sits’ on its loans, often in fear of antagonizing the ‘powers that be’, the same powers who often contributed to the bad loans in the past.”

According to Haggard (2000: 143), “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”.

See Wijnbergen (1996) for an analysis of the kind of incentives needed to “persuade” the banks to undertake corporate debt restructuring of state-owned enterprises (SOEs) in Poland. From the Polish experience, one can still draw some insight into private corporate debt restructuring programs.
Second, banks (especially in developing countries) may lack the technical capacity and skills to effectively monitor and restructure a large number of enterprises.22

(3) Advocates of bank-led corporate restructuring argue that banks have the incentives to encourage their clients to restructure their operations in order to become viable in the new environment.

- Even if banks have the incentive to do so, they may not actually be able to act on these incentives and push through the restructuring of corporations. Empirical evidence (Gary and Holle, 1996) based on the Polish bank conciliatory procedure (BCP) suggests that banks had limited power to effect the necessary operational restructuring; in fact, Gary and Holle (1996) found little or no evidence of operational restructuring.21

(4) Theoretically, this approach could ultimately lead to lower costs if bank recapitalization (considered an up-front “investment” by the government) is accompanied by substantive changes in corporate governance and bank operations (Blaustein, 2001).

- Nonetheless, according to Blaustein (2001), experience shows that governments routinely inject capital into insolvent institutions without affecting sufficient change in bank governance and operations, suggesting that things are always easier said than done. To date, most bank recapitalization programs instituted by governments have been unsuccessful.24

- Moreover, there is a possibility that in their attempt to retrieve bad and non-performing loans, some banks may aggravate the situation by lending into arrears (even when the business is not viable – assuming that banks are given the task of “triage”25) to avoid say, provisioning; rolling over loans to heavily indebted large borrowers [crowding out alternative credit uses], and/or foreclosing loans and seeking earlier repayments from creditworthy borrowers, undermining their

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22 As indicated by Blaustein (2001), “although technical assistance is rapidly improving the banks' restructuring capacity, it will take time before they can effectively restructure enterprises.”

21 Bonin and Leven (2000: 5) found that state-owned banks in Poland were not effective agents of change for two reasons. First, the banks usually did not have the necessary expertise to design proper business plans and to induce the necessary operational restructuring. Secondly, state-owned banks tend to be influenced by government policy and find it impossible to resist soft lending for political reasons; thereby becoming conduits of government subsidies that distort their portfolios because of political decisions. State-owned banks, they argue, are “particularly vulnerable to incentive problems when dealing with large state-owned enterprises that may be too big or too political to fail”.

21 Blaustein (2001) further noted that when facing the trade-off between maintaining confidence and preserving incentives for good banking (that is, minimizing moral hazard), most countries favored maintaining confidence by extending large-scale guarantees or continuing to recapitalize banks, with little guarantee that recapitalization would either be sufficient or occur only once. Repeated recapitalization could increase costs to taxpayers.

25 According to Enoch, Garcia, and Sundararajan (1999: 46), triage is defined as “the division of institutions between those that need no help, those that are worth helping, and those that are beyond help”. According to Claessens, Klingebiel and Laeven (2001: 7), a triage involves a separation of “corporations into viable, not financial distressed corporations, viable, but financial distressed corporations, and unviable corporations”.

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viability or the viability of the resuscitation effort (because firms have less possibility of responding to opportunities when faced with a credit crunch).  

These incentive incompatibilities may ultimately result in higher overall costs.

- Also, banks may be too weak, compared to corporations in restructuring negotiations, e.g. in the case of corporations considered to be “too big to fail” (TBTF). Dealing with corporations that are TBTF may result in weak restructuring plans and hamper “tougher” restructuring ultimately result in greater fiscal costs.

\[26\] There is a possibility of another danger when incentives meant to promote and accelerate debt repayment are counterproductive. If the time period to clear the old debt of corporations is considered “too short”, then banks may opt for substantial debt forgiveness, instead of rescheduling such old debt, for fear that their debtors would not be able to meet such a tight repayment schedule.

\[27\] See Wijnbergen (1996) Section 4. for a possible solution to this problem.

\[28\] However, with greater public scrutiny and accountability, such political “abuses” have a tendency to be lower.
Appendix 3

Types of Government Involvement When Such Involvement is Warranted in Ascending Order of Government Involvement

(1) Government Mediation²

Government mediation – between corporations and banks, or between banks – is considered to be the “mildest” form of government intervention, and is justified when market failures or other factors inhibit banks from effectively leading debt restructuring. Factors such as lack of cooperation, excessive negotiating power with either debtors or creditors, or a lack of incentives for banks or corporations to work out the debt (usually arising from poor supervision and bad governance) can prolong or even prevent debt restructuring, resulting in (avoidable) excessive costs, and even, the unnecessary liquidation of debtors. This occurs when such factors impede the close coordination needed for effective restructuring, including the sharing of information between banks, formulation and implementation of a common or coordinated strategy, and the provision of new credit during the negotiation process.

To ensure a smoother restructuring process, the parties can ask the government to mediate informally, or in more structured framework. An impartial government mediator can aid bank restructuring by establishing a set of guidelines for triage and financial engineering, providing expertise, facilitating the sharing of information and establishing a more congenial atmosphere for negotiation.

(2) Government Schemes

Financial incentives to facilitate debt restructuring through a pre-set government-financed scheme can be useful if corporate debt problems are pervasive and impose negative externalities on the economy at large. Financial incentives are required when there are too many distressed corporations for banks to handle, and when corporate debt becomes too high, resulting in negative externalities such as squeezing credit to viable borrowers, or an unsustainably high level of corporate foreign debt that curtails capital inflows.

Government schemes usually involve insurance or subsidy incentive made available to creditors and debtors on a voluntary basis. These incentives include compensation to creditors for lengthening debt maturities and grace periods, interest rate and exchange rate guarantees, and equity injections. In order for the incentives to be effective, additional government policies including adjustments to fiscal and monetary policy stances to provide a supportive macroeconomic environment, and improvements

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¹The appendix draws heavily from the work of Stone (1998).
²In general, “mediation involves the engagement of an independent person for the purpose of reaching a possible resolution of a dispute or issue. The resolution is reached through a consensus of the persons involved in the dispute or issue or having an interest in its resolution. The mediator has virtually no powers (other than as may be agreed to by the parties) and certainly no power to determine the dispute or issue other than by consensus or agreement between the parties. The mediator acts more like a conciliator, endeavouring through meetings and discussions to focus on central and material matters and to encourage the parties to reduce and distil their differences to the point where they may be able to come to a mutually satisfactory determination” (World Bank, 2000a: 82).
in supervision, governance, and the legal system must be in place. However, the benefits of such schemes (which include more expedient debt restructuring for the relevant parties and mitigation of negative externalities) must be weighed against the fiscal costs of the scheme before deciding how far to go.

(3) Direct Bank Recapitalization
Direct bank recapitalization by the government would be appropriate when corporate debt problems are pervasive enough to undermine the health of the banking system, and banks are willing and able to work out the debt on their own. The severity of the problem is reflected in the widespread interruption of corporate loan payments. This would most probably translate into macroeconomic instability, thereby reducing or wiping out bank capital. Further exacerbating the situation is the high likelihood that in their attempts to rebuild their balance sheets, decapitalized banks opt to widen the spread between deposit and lending rates – resulting in subsidization of “highly” unsuccessful corporations by taxing other corporations – or cut back on new lending to creditworthy borrowers.

If the only thing preventing banks from restructuring debts and working out loans is the lack of new capital (where banks have both the incentives and capacity to work out loans and restructure debts), then government involvement should (only) be limited to restoring bank capital. However, before public funds are used to capitalize banks, existing shareholder equity should be written down, including for loan provisioning, to ensure tax payers do not bear more than they need to.

The clearest way for governments to recapitalize banks is by buying new equity shares, although recapitalization can and does take many forms. Banks can then narrow interest rate spreads and reduce unsustainably high levels of debt through write-offs. Recapitalization is more effective if it is linked to specific measures to restructure debt. The fiscal cost of bank recapitalization can be very large, and again, must be gauged carefully against the benefits.

(4) Government Asset Management Corporation
A new government asset management corporation is called for if the number of troubled corporations is large and there are microeconomic factors which severely inhibit the likely efficacy of debt restructuring. The most important of these factors are decapitalized and poorly managed banks, a shortage of bank expertise in needed to work out bad debts, an uneven balance of power between banks and corporations, a lack of corporate capacity and willingness to provide reliable financial information, and again, systemic negative externalities such as a credit squeeze or unsustainable high foreign debt.

A government-financed asset management corporation can buy bad loans, provide equity to banks and corporations, negotiate with debtors and take an active financial and operational role in restructuring. If bankruptcy courts are ineffective, an asset management corporation can also serve as an out-of-court bankruptcy mechanism, since passing legislation and building institutional infrastructure for effective bankruptcy procedures can take time (van Wijnbergen, 1992). The debt taken on by the asset management corporation is usually written down (though in Malaysia’s case, the corporations do not seem to have been penalized at all), and can be converted to equity.

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1 There are other ways by which the central bank or the government can help banks “financially”. See Dziobek (1998: 9-12).
and eventually sold to the public. The asset management corporation realizes economies of scale in the specialized area of corporate debt restructuring and can develop secondary debt markets. Banks benefit from greater capital, while corporations can expect to have their debt restructured more quickly.\footnote{For a summary of the advantages and disadvantages of a centralized public asset management corporation or company, see Box 1. Klingebiel (2000: 5-6) offers a more critical look at the various strengths and weaknesses of public AMCs. Furthermore, according to Mako (2001b), public AMCs are ill-suited for corporate operational restructuring [but that does not necessarily imply that they cannot and will always fail to do so] even though under special circumstances, public asset management companies may be able to play a useful role in financial stabilization and resolution of some assets (for more details, see Mako, 2001b).}
Appendix 4

Analysis: The unwillingness of sellers to acknowledge the true extent of their problems (and to part with previously over-valued assets) is the main reason corporate restructuring is not progressing faster.

...Many assets were grossly overvalued when the crisis hit and have deteriorated further in the past two years...

- Many companies in the region invested heavily in diverse ventures (real estate, manufacturing, infrastructure, etc.) without focusing on true competitive advantage and economic value added

- When the crisis hit, it was a shock to see that asset value much less than expected; currency collapses exacerbated the problem of those who borrowed in USD and other foreign currencies

- Because of limited transparency and accountability, owners of these companies continued to run their businesses less than ideally

- Many companies have now been transferred to government-owned asset management companies, after experiencing declining valuation

...few are willing to take the responsibility for huge losses if the assets are disposed off at “true market value”

- Fear of “loss of face” of company owners, bankers and government officials has delayed asset sales

- The pressure to deny the extent of the problems is immense due to the likely social impact of closures of large enterprises

- Unrealistic expectations of “recovery” for the problem to work itself out had not only slowed restructuring, but also imposed additional costs on various parties

- With favorable repayments and low interest rates, — masking problems and delaying recognition — firms do not adequately address underlying issues of risk management and good economic decision-making, leading to superficial corporate restructuring

Analysis: The slow pace of corporate restructuring is linked to the uneven efforts to introduce/implement appropriate mechanisms...

Mechanisms used to promote corporate restructuring...

- Government assistance to borrowers
- Government intervention as facilitators and mediators of debt restructuring
- Asset management companies
- Corporate Debt Restructuring Agencies to encourage voluntary workouts

...are most effective when

- Banks are forced to deal with their bad debts
- Restructuring is pursued by establishing legal and judicial channels with a high degree of integrity (bankruptcy, legal systems, etc.)
- Market mechanisms for the disposal of assets in a transparent manner are in place

...but uneven efforts by various countries have resulted in few restructurings

- Governments provided assistance to banks, but in return, often got limited (or no) commitment to restructure enterprises
- Some governments have set up debt restructuring agencies with weak mandates (Korea, Indonesia); but their hence, progress has been slow and muddled
- Asset management companies have been set up but their ability to restructure corporations has not been proven
- Attempts to introduce comprehensive bankruptcy laws have been hampered by the judicial processes, yielding mixed results
- Vested interests as well as close relationships between borrowers, lenders and governments have delayed real restructuring in many cases

Appendix 5

IMF Recommended Policy Measures for Economic Recovery

The IMF and World Bank were in agreement that structural reform programs were the immediate priority as they perceived the crisis to be primarily the result of structural problems and imbalances in East Asian economies or lack of "good" corporate governance. The structural and institutional reform programs (together with insistence on conducting corporate restructuring programs) were initially designed to restore market confidence and develop a strong institutional foundation sustainable for growth in the medium and long term.

Nonetheless, notes Park (2000: 47), "completion of operational restructuring (resolution and recapitalization of financial institutions and corporate debt workout) and institutional reforms does not automatically guarantee recovery and resumption of growth." In fact, it can be argued that restructuring and reforms could deepen the economic downturn in the short-run, unless complemented by expansionary macroeconomic policies. In all crisis countries, policy makers were indecisive as to when they should reflate the economy and what instruments — monetary and fiscal — should be employed.¹

Inappropriately, the IMF adopted a tight monetary (and fiscal) policy stance at the very beginning (ostensibly to aid or facilitate corporate restructuring), which was not appropriate for existing economic conditions of the crisis economies at the time. What was required, critiques argued, was the need to adopt counter-cyclical expansionary macroeconomic, especially fiscal policy (e.g. Park, 1999) in light of the prevailing situation. A tight (or contractionary) policy — supposedly to "discipline" and "tightly" "ill-conceived spending" — would inadvertently exacerbate the situation further, eroding the industrial base, increasing unemployment and possibly causing social unrest and disruption.

To reinforce the above argument, according to Park (1999: 15), "This policy dilemma arises because the macroeconomic approach to restructuring through high and tight money [proposed by the IMF] was flawed from the beginning. A high-interest policy is an effective tool for restructuring, as it discourages over-leveraging by corporations and accelerates the exit of marginal firms. However, pushed beyond reasonable levels, it can also force otherwise solid firms into insolvency, at which point it loses all justification. Specifically, high interest costs can wreak havoc with a firm's balance sheet, which in turn can hold back financial normalization by aggravating the NPL problem for banks, ending up in a downward spiral of corporate and financial deterioration."

¹ An analogy by Park (1999: 18) illustrates this point. Referring to the Korean economy, he notes: "The key elements of the reform for Korea's economic recovery are the normalization of the financial sector and resolution of the problem of over-investment in the real sector. Government policy to date can be likened to running after these two rabbits, which illustrates the difficulty in implementing reform."
Appendix 6

Malaysia’s Asset Management Company, Syarikat Pengurusan Danaharta Nasional Bhd, or Danaharta

Syarikat Pengurusan Danaharta Nasional Bhd, or Danaharta, the national asset management company was set up on 20 June 1998 in the aftermath of the 1997-98 Asian financial crisis under the Ministry of Finance to acquire non-performing loans from banks, or to put it differently, to carve out bad debts from local banks. Unlike the asset management companies in South Korea and Thailand, Danaharta is neither a rapid disposition agency nor a warehousing agency. Rather, it was granted a wider range of restructuring options, with the only stipulation being maximizing recovery value. Furthermore, Danaharta could not only take legal action to recover security through the bankruptcy process and sell the loans to a third party, but could also take a more active role in rehabilitating companies since Danaharta’s powers include the power to force management and ownership changes within the companies.

Nonetheless, given the risks associated with such a strategy (as highlighted in Box 1), Danaharta outlined strict loan restructuring guidelines to avoid many problems of moral hazard. Refer to http://www.danaharta.com.my for its asset acquisition guidelines, framework for acquisition methodology, background to and summary of The Pengurusan Danaharta Nasional Berhad Act 1998 and other information. The following table compare the special administration and other workout opportunities used as general guidelines for developing countries.

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1 Sources for this appendix are Haggard (2000) and Danaharta’s website: http://www.danaharta.com.my/
2 A definition of an asset management company as provided by Danaharta can be obtained from its website: http://www.danaharta.com.my/default.html. “Assets” here refer to both loans and tangible assets, with the preferred source of repayment being realization of gain through reconstruction and rehabilitation of the asset while other forms of repayment include identified cash flows from acquired assets, existing business operations and disposal of collateral.
3 With paid-up capital of RM250 million (approximately $59 million), Danaharta raised RM25 billion in working capital in zero-coupon government-guaranteed bonds.
4 Danaharta has the legal framework to conduct liquidation procedures.
5 These included the ability to displace management and appoint “special administrators” to manage distressed companies, the requirement that shareholders take appropriate “haircuts” in any loan rescheduling, and the provision that borrowers are provided only one opportunity to implement a restructuring plan (Thillainathan, 2000).
<table>
<thead>
<tr>
<th>Area of comparison</th>
<th>Special Administration (Danaharta)</th>
<th>Administration (Australia)</th>
<th>Administration (UK)</th>
<th>Chapter 11 (USA)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Affected person</strong></td>
<td>Corporate borrower of Danaharta Group and its security providers only</td>
<td>Any company</td>
<td>Any company</td>
<td>Any company</td>
</tr>
</tbody>
</table>
| **Who can appoint** | Danaharta  
- At request of owners or management; or  
- On own initiative, but subject to approval of Oversight Committee | Company itself, chargee or liquidator/provisional liquidator | Court of petition by the company, its directors or creditors | Generally, company remains in possession, but court may appoint trustee – on its own or on petition by an interested party |
| **Oversight Committee** | 3 members appointed by Minister of Finance, one each from Ministry of Finance, BNM and SC | None | None | None |
| **Criteria** | Inability or likelihood of inability to pay debts or fulfill obligations to creditors | Insolvency or likelihood of insolvency | Inability or likelihood of inability to pay debts | Generally, inability to pay debts as they become due |
| **Purpose** | Survival as going concern, more advantageous realization than winding up, or public interest | Maximizes chances of survival, or results in better return than winding up | Survival as going concern, more advantageous realization than winding up; voluntary arrangement or deed of compromise | Reorganization results in creditors receiving at least as much as they would from liquidation |
| **Duration** | From appointment until termination (generally upon implementation of workout proposal) | From appointment until termination (generally upon approval of workout proposal) | From appointment until termination in accordance with court order | Generally not applicable, debtor remains in possession |
| **Role** | Control and management of assets and affairs:  
- Powers of existing officers | Control and management of assets and affairs:  
- Powers of existing | Control and management of assets and affairs:  
- Powers of existing | Generally not applicable, debtor remains in possession |
<table>
<thead>
<tr>
<th>Status</th>
<th>suspended</th>
<th>officers suspended</th>
<th>officers suspended</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>- No dealings without Special Administrator's consent</td>
<td>- No dealings without administrator’s consent</td>
<td>- No dealings without administrator’s consent</td>
</tr>
<tr>
<td>Protection</td>
<td>Agent of company under administration</td>
<td>Agent of company under administration</td>
<td>Agent of company under administration and court officer</td>
</tr>
<tr>
<td></td>
<td>12 month moratorium on all claims and proceedings, subject to extension</td>
<td>Moratorium on all claims and proceedings for duration of administration</td>
<td>Moratorium on all claims and proceedings for duration determined by court</td>
</tr>
<tr>
<td>Functions</td>
<td>Investigates assets and affairs and, as soon as reasonably practicable, submits workout proposal to Independent Advisor and Danaharta</td>
<td>Investigates assets and affairs, and within 21-28 days (unless extended), recommends workout, termination of administration or winding up to creditors</td>
<td>Investigates assets and affairs, within 3 months (unless extended), submits proposal to creditors and reports outcome to court</td>
</tr>
<tr>
<td></td>
<td>Company has 4 months to file plan of reorganization though period is usually extended. A trustee, if appointed, investigates assets and affairs, commences action against third parties and files a plan of reorganization</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Independent Advisor</td>
<td>Approved by Oversight Committee to review reasonableness of workout proposal, taking into account the interests of all creditors and shareholders</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Workout proposal</td>
<td>Requires approval of Danaharta and majority in value of secured creditors, and subject to regulatory approvals</td>
<td>Requires approval of majority in number and value of creditors</td>
<td>Requires approval of 75% of creditors</td>
</tr>
<tr>
<td>Binding nature</td>
<td>Once approved, workout proposal</td>
<td>Once approved, workout proposal</td>
<td>Once approved, workout proposal</td>
</tr>
<tr>
<td></td>
<td>Once approved, reorganization</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Modifications</td>
<td>Binds the company, its shareholders and creditors</td>
<td>Binds the company, its shareholders and creditors (except secured creditors who opt out)</td>
<td>Binds the company, its shareholders and creditors</td>
</tr>
<tr>
<td>---------------------</td>
<td>-------------------------------------------------</td>
<td>---------------------------------------------------------------------------------------</td>
<td>-------------------------------------------------</td>
</tr>
<tr>
<td></td>
<td>Must refer to Independent Advisor who will review reasonableness and decide whether to seek approval of secured creditors</td>
<td>Requires approval of creditors</td>
<td>Major modifications require agreement of administrator and creditors' approval</td>
</tr>
<tr>
<td>Qualifications of Special Administrator</td>
<td>Individual who is an approved company auditor or has requisite experience or ability</td>
<td>Individual who is an accountant or has requisite experience or ability</td>
<td>Insolvency practitioners</td>
</tr>
<tr>
<td>Qualifications of Independent Advisor</td>
<td>Merchant bank, accounting firm or other entity with the requisite experience or ability</td>
<td>Not applicable</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>

Table C: Purpose of Special Administration, Receivership & Liquidation

<table>
<thead>
<tr>
<th>Special Administration</th>
<th>Receivership</th>
<th>Liquidation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Workout for purpose of achieving:</td>
<td>To deal with assets of the company by enforcing security of a particular creditor chiefly for that creditor's benefit</td>
<td>Winding up leading to eventual dissolution of the company in liquidation</td>
</tr>
<tr>
<td>* survival of company under administration as going concern, or * more advantageous realization of assets than would be achieved on winding up</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Table D: Major Differences Between Special Administration and Section 176 Scheme

<table>
<thead>
<tr>
<th>Special Administration</th>
<th>Section 176 Scheme</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Initiated by Danaharta on its own initiative or at request of company’s management or shareholders</td>
<td>- Initiated by the company, shareholders, creditors or liquidator</td>
</tr>
<tr>
<td>- Requires approval of Oversight Committee</td>
<td>- No equivalent</td>
</tr>
<tr>
<td>- Special Administrator prepares workout proposal</td>
<td>- Person initiating the scheme prepares it</td>
</tr>
<tr>
<td>- Independent Advisor reviews reasonableness of proposal</td>
<td>- No independent review, but court sanction required</td>
</tr>
<tr>
<td>- Requires approval of majority in value of secured creditors</td>
<td>- Requires approval of majority in number representing 75% in value of creditors</td>
</tr>
<tr>
<td>- Automatic 12-month moratorium on all claims and proceedings</td>
<td>- Moratorium with court approval</td>
</tr>
</tbody>
</table>

Appendix 7

Danamodal Nasional Bhd, or Danamodal

The second institution established 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. The rationale for establishing Danamodal was three pronged: (1) to ensure that the banking sector recapitalization process is commercially driven and that investment decisions are made according to market-based principles; (2) delays in addressing recapitalization and non-performing loans issues will have a drag effect on the financial system and economic recovery; and (3) direct capital injection by the Government into banking institutions is not desirable and would lead to conflicts of interest in the future. To address problems of moral hazard inherent in such an exercise, Danamodal operated on the first-loss principle, under which losses arising from past credit decisions are born by shareholders. Refer to the BNM website: http://www.bnm.gov.my/danamodal/ff_vital.htm for a look at Danamodal’s vision and mission statement, guiding principles, and operating guidelines, as well as the stabilization measures undertaken by Danamodal and the financial system.

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1 This appendix draws from Haggard (2000) and the Danamodal website: http://www.bnm.gov.my/danamodal/ff_vital.htm

2 Danamodal fell under the central bank (Bank Negara Malaysia, or BNM), and was to be funded by capital raised in the form of equity and hybrid instruments, or debt, in both 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.
Appendix 8

Corporate Debt Restructuring Committee (CDRC)¹

The government also addressed the problems of the corporate sector (i.e. to restructure corporate debt over RM50mil) through the formation of a Corporate Debt Restructuring Committee (CDRC), a non-statutory body, in October 1998, under Bank Negara Malaysia (BNM). The CDRC was formed to provide a platform for both borrowers and creditors to work out feasible corporate debt restructuring schemes² without having to resort to legal proceedings, especially for large debtors. Put differently, the objective of the committee, like its counterparts in Indonesia, South Korea, and Thailand, was to minimize losses to creditors, shareholders, and other stakeholders through coordinated voluntary workouts that sidestep the formal bankruptcy procedure.³

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.⁴ The purpose of the committee was thus to persuade financial institutions not to precipitate insolvency.⁵

In August 2001, the CDRC – under new leadership – announced three new measures to spur corporate restructuring which included: (1) a revamp of CDRC membership to include representatives from Pengurusan Danaharta Nasional Bhd and the Federation of Public Listed Companies; (2) changes to the framework and approach of the CDRC to accelerate restructuring efforts;⁶ and (3) an increase in the frequency of

² The CDRC thus acts as an advisor and mediator between creditors and debtors in debt restructuring.
³ With the formation of the CDRC, companies have opted for this friendlier arrangement to resolve their debt problems, instead of going to court to defend themselves against the creditors.
⁴ For the most part, the usual receivership and liquidation administrations do not discriminate between viable and non-viable businesses, resulting in the inevitable closure of affected companies (in most cases). Section 176 has proven to be very unpopular with the financial institutions.
⁵ A CDRC workout includes initial meetings between debtors and creditors, appointment of independent consultants to design a restructuring programme for the debtor, an initial review of business viability, a formal standstill among creditors if the restructuring exercise proceeds, and oversight of restructuring plans. Even then, the arrangement is informal, has no legal status and can be called off by either side at any time. In the beginning, before certain changes were made and the power of the CDRC increased, it did not have Danaharta’s power to force management and ownership changes within companies (The New Straits Times, 9 August 2001).
⁶ Under the revised restructuring guidelines, a borrower must have a minimum aggregate debt of RM100mil (compared with RN50mil previously), exposure to at least five creditor banks, an ongoing, viable concern, and sufficient cash generation to cover operating expenditure, to be eligible for CDRC assistance. Furthermore, companies can be referred to the CDRC by corporate borrowers or bank creditors accounting for at least 25% of total debt. To speed up the restructuring process, deadlines would be set for each of the debt restructuring processes and each case should be completed within six to nine months, with debt reorganization agreements to be
financial disclosure, i.e. regular disclosure and quarterly reporting to keep the market abreast of the progress of restructuring (The Star, 10 August 2001).

The CDRC now has the authority to implement management changes. Furthermore, the agency can now appoint liquidators to settle non-performing loans (NPLs). Previously, the CDRC had merely acted as a mediator with limited authority between creditors and borrowers (The Star, 13 August 2001).

For a detailed look at the principles of the CDRC framework, its objectives, terms of reference, key principles governing the corporate workout process, processes and guidelines, revised debt restructuring guidelines, and revised framework, refer to the CDRC website, http://www.bnm.gov.my/CDRC/.

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signed within the first three months. In the first month, the CDRC would evaluate the case, form a creditors' steering committee and prepare an interim standstill agreement. In the subsequent three months, scheme advisors and solicitors would be appointed, and the workout proposal would be implemented after creditor approval had been secured (The Star, 10 August 2001)
Appendix 9

Government Rationale For Takeover of Putra and STAR LRT Systems

According to the government, the “bailout” of the light rail transit (LRT) operators was necessary because (1) it involved the public interest (the LRT system being part of the public transportation system); (2) liquidation would probably imply assets being divided and sold piecemeal, threatening the transportation system and commuter welfare, and (3) liquidation would imply that employees of STAR and Putra will be retrenched. Besides, the public transportation system has been the responsibility of the government through its various programs to provide affordable (quasi) public services.1 Also, a government takeover would help reduce the amount of NPLs in the banking system (and the debt of certain conglomerates)2.

Besides, the government claims the 1997-98 Asian crisis3 and operators not being allowed to charge full fares (which would burden the public)4 for failure of the LRT project to be profitable and financially viable (Sibexnews, 29 May 2001). Then Advisor to the Finance Ministry, Datuk Mustapa Mohamed claimed that a thorough analysis and feasibility study (taking into account the high growth of the country at that time, and traffic congestion in the city and the likely efficiency and environmental impacts on the country of not improving the traffic situation) had been conducted, indicating the project was feasible in terms of engineering, finance and profitability. The LRT project was undertaken based on those projections. However, the feasibility study did not factor in the possibility of an economic crisis and of such magnitude.

Yet, according to a former government minister for the federal territory, the government was quite aware that the project had a high probability of being unprofitable. To quote Shahir Samad: “From day one, we knew it wasn’t going to be a profitable project. In the end it will be the government that will assume the debts” (Fuller, 2000).

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1 According to Sebastian Chang, research head of Vickers Dallas Research (M) Sdn., “With this kind of infrastructure it’s difficult to make money. It should be in the hands of the government.” (The Star, 1 September 2001).
2 Putra is a subsidiary of Renong, where the latter is both the biggest industrial group and the biggest debtor in the country, with debts of more than RM20 billion (The Star, 21 September 2001 and The Sun, 2 November 2001).
3 Daim claimed: “The economic crisis has made it difficult for them to inject new capital or to pay back their loans, as the development and upgrading costs for a LRT are very high” (Fuller, 2000).
4 According to Dr Mahathir, if the LRT operators were allowed to charge full cost-covering fares, they would be very profitable because the usage of Putra was very high (almost three million passengers used the service every month). However, allowing this would prove problematic because the public felt that they should have a world class LRT service but was rather unwilling to pay world-class fares (Sibexnews, 29 May 2001).
Appendix 10

Corporate Performance of MAS After the 1997-98 Asian Financial Crisis

MAS, the Malaysian national airline carrier faced mounting debts and falling revenues following the 1997-98 Asian financial crisis. The situation has further exacerbated following the September 11 terror attacks in the USA.

Since the 1997-98 Asian financial crisis, MAS’s losses continued into the year 2002. Table E, F and G summarizes earnings estimate of the MAS group following the 1997-98 Asian financial crisis.1 The projected pre-Sept 11 earnings numbers (in Table E) and post-Sept 11 revised earnings estimates (Table F and G) highlight the impact of September 11 on the national carrier and the sensitivity of this “industry” to such external shocks.

Referring to Tables E and F, we observe that MAS’s group performance was steadily deteriorating after the Asian financial crisis. Prior to the crisis, MAS posted a net profit of RM33.02 million for the financial year ending 31 March 1997. For the financial year ending 31 March 2000 the group recorded a net loss of RM258.6 million and the situation worsened in the following year, posting a net loss of RM1,333.8 million, with losses per share rising from 33.6 sen to 173.2 sen respectively.2 According to Table G, the situation is not expected to improve dramatically for the financial year ending in 2002, with an estimated net loss of RM1.11 billion.3 Based on quarterly figures shown in Table F, generally weak corporate performance was expected through each quarter of 2001, with slight improvements from one quarter to the next; however, compared to the respective past year’s corresponding quarter, the situation has worsened.4

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2 Refer to The Star, 30 May 2001 for an analysis on the breakdown of turnover and costs, and the lower gain on sale from aircraft and leaseback for financial year 2001 compared to the previous corresponding year.
3 For a brief analysis on the profit position of the group, see The Sun, 27 November 2001.
4 For instance, for the second quarter ending September 30, 2001, MAS incurred a net loss of RM359 million compared to a net loss of RM270 million previously, attributing the loss to lower passenger and cargo carriage as well as weakening currencies. In addition, the national carrier saw net loss widening by 49% to RM772.8 million in the next half year from RM398 million in the corresponding first half of the previous year (The Sun, 27 November 2001).
## Table E: MAS Earnings and Earnings Estimates from Financial Year 1996/97 to 2003/04

<table>
<thead>
<tr>
<th></th>
<th>FY96/97</th>
<th>FY97/98</th>
<th>FY98/99</th>
<th>FY99/00</th>
<th>FY00/01</th>
<th>FY01/02E*</th>
<th>FY02/03E*</th>
<th>FY03/04E*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating profits (RM m)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(873.7)</td>
<td>(1264.5)</td>
<td>(363.9)</td>
<td>(97.5)</td>
<td>312.6</td>
</tr>
<tr>
<td>Net profit (RM m)</td>
<td>333.02*</td>
<td>(259.85)</td>
<td>(700.05)</td>
<td>(258.6)</td>
<td>(1333.8)</td>
<td>(604.0)</td>
<td>(455.3)</td>
<td>(17.6)</td>
</tr>
<tr>
<td>EPS (sen)</td>
<td>43.8</td>
<td>(33.7)</td>
<td>(90.9)</td>
<td>(33.6)</td>
<td>(173.2)</td>
<td>(78.4)</td>
<td>(59.1)</td>
<td>(2.3)</td>
</tr>
<tr>
<td>NTA per share (RM)</td>
<td>-</td>
<td>2.81</td>
<td>1.68</td>
<td>1.74</td>
<td>0.89</td>
<td>0.63</td>
<td>0.56</td>
<td>1.05</td>
</tr>
</tbody>
</table>

Note: * MAS's financial year ends on 31 March.

* Note that these projections were made without taking into account the Sept 11 terrorist attacks on the US, which had not occurred at the time the estimates were calculated and announced, implying that the estimates/forecasts could have been higher than was actually the case after September 11.

* Includes depreciation and forex costs, but excludes interest costs and income from aircraft sales and non-flight operations.

* This figure is before transfer of profits to general reserve.


## Table F: MAS Earnings Figure for Financial Year 2000/01

<table>
<thead>
<tr>
<th></th>
<th>FY00/01 ending March 31, 2001*</th>
<th>Q1 ended June 30, 2001*</th>
<th>Q2 ended Sept 30, 2001*</th>
<th>Cumulative basis for 6 months ending Sept 30, 2001*</th>
<th>Q3 ending Dec 31, 2001*</th>
<th>Cumulative basis for 3 quarters ending Dec 31, 2001*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax profit (RM m)</td>
<td>(1330.0)</td>
<td>(413.35)</td>
<td>(359.15)</td>
<td>(772.50)</td>
<td>(354.83)</td>
<td>(1,127.33)</td>
</tr>
<tr>
<td>Net profit (RM m)</td>
<td>(1333.8)</td>
<td>(413.82)</td>
<td>(358.98)</td>
<td>(772.80)</td>
<td>(340.05)</td>
<td>(1112.85)</td>
</tr>
<tr>
<td>Earnings per share (sen)</td>
<td>(173.2)</td>
<td>(53.74)</td>
<td>(46.62)</td>
<td>(100.36)</td>
<td>(44.16)</td>
<td>(144.53)</td>
</tr>
</tbody>
</table>


* Announcements of quarterly reports of unaudited consolidated balance sheets by MAS.
### Table G: MAS Earnings Estimates for Financial Years 2001/02, 2002/03, 2003/04

<table>
<thead>
<tr>
<th>Earnings Estimates</th>
<th>FY01/02E</th>
<th>FY02/03E</th>
<th>FY03/04E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax profit (RM mil)</td>
<td>(1320.0)(^1)</td>
<td>(255.0)(^1)</td>
<td>341.0(^3)</td>
</tr>
<tr>
<td>Net profit (RM mil)</td>
<td>(1110.0)(^2)</td>
<td>(628.3)(^2)</td>
<td>341.0(^4)</td>
</tr>
</tbody>
</table>

Sources:
1. Revised estimates provided by MAS as reported by *The Star*, January 9, 2002.
3. Revised estimates provided by MAS as reported by *The Star*, January 9, 2002.
4. Revised estimates provided by MAS as reported by *The Star*, January 2, 2002.
Corporate Performance of the Renong and UEM Group After the 1997-98 Asian Financial Crisis

The performance of the Renong group following the Asian financial crisis has obviously deteriorated, with the exception of the financial year ending 30 June 2000. The generally depressed stock and property markets, and weakened overall macroeconomic performance affected final demand, playing a part in the poor financial performance of the group. From a pre-tax profit of RM703 million recorded during the financial year ending 30 June 1997, the group recorded a pre-tax loss of RM812 million for the financial year ending 30 June 1998.

The group attributed the weakened performance to the credit squeeze that had put severe constraints on the group’s property development projects under Prolink Development Sdn Bhd (Prolink), while tight liquidity had adversely affected Prolink’s two major land sales totalling RM1.2 billion, with two others terminated as well. Another factor that contributed to the weak financial performance was the provision and realization of foreign exchange losses due to the depreciation of the ringgit against the US dollar, that caused US denominated debt to balloon. Moreover, the increase in interest rates – from 7.46 percent on 15 August 1997 to 11.04 percent on 26 June 1998 (Bank Negara Malaysia, Interbank Interest Rates) – raised the burden of debt and exacerbated cash flow problems for the more leveraged companies within the group such as Putra. The poor performance of the stock market resulted in losses from the disposal of investments and the need to make provisions for further diminution in the value of investments, and delayed the initial public offering (IPO) of certain companies.

The group’s financial performance deteriorated further for the financial year ending 30 June 1999, with the group registering a pre-tax loss of RM1.26 billion, up by 84 percent from RM0.81 billion last year. Troubled companies, such as Faber, have contributed to this scenario. In addition, the need to make loss provisions for the loss of value in assets such as property (whose value has fallen due to the depressed property market values), especially Prolink assets, have contributed to the group’s losses.

Group performance improved considerably for the financial year ending 30 June 2000, with the group registering a pre-tax profit of RM380 million, compared to a huge pre-tax loss of RM1.3 billion for the previous year. This improvement is attributable to the fruitful restructuring efforts undertaken in 1999, which greatly benefited from the improved economic climate – better property values and stock market conditions; making the sale of property by Prolink and IPOs more feasible.

However, the group sank into the red again for the financial year ending 30 June 2001 by recording a large pre-tax loss of RM1.185 billion on the back of provisions of Renong’s investment in Putra LRT assets, expected to be taken over

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1 This section draws from the annual reports of Renong from financial year ending 30 June from 1998 until 2001.

2 The interest rates are based on a 3-month daily average of interbank deposit rates at the Interbank Money Market in Kuala Lumpur.
by the government by June 2002. The write down in the value of Putra represented a contingent loss of RM1.032 billion. Furthermore, the change in status of Faber and Park May from subsidiary companies to associate companies resulted in a loss on dilution of RM106 million. Further provision for diminution in the value of quoted warrants of RM83 million also contributed to the loss.

<table>
<thead>
<tr>
<th>Table H: Renong Earnings for Financial Years 1996/97 - 2000/01*</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operating Profit/(Loss) (RM m)</strong></td>
</tr>
<tr>
<td>342</td>
</tr>
<tr>
<td><strong>Profit/(Loss) Before Taxation (RM m)</strong></td>
</tr>
<tr>
<td><strong>Profit/(Loss) After Taxation (RM m)</strong></td>
</tr>
<tr>
<td><strong>Profit/(Loss) Attributable to Shareholders (RM m)</strong></td>
</tr>
<tr>
<td><strong>Net Earnings/ (Loss) per Share (sen)</strong></td>
</tr>
<tr>
<td><strong>Dividend per Share (sen)</strong></td>
</tr>
<tr>
<td><strong>Net Tangible Asset per Share (sen)</strong></td>
</tr>
</tbody>
</table>

Note: *For financial year ended 30 June.