

September 1999

# INTERNATIONAL FINANCE

## Actions Taken to Reform Financial Sectors in Asian Emerging Markets



G A O

Accountability \* Integrity \* Reliability

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**General Government Division**

B-281526

September 28, 1999

The Honorable Spencer Bachus  
Chairman  
Subcommittee on Domestic and International Monetary Policy  
Committee on Banking and Financial Services  
House of Representatives

The Honorable Michael N. Castle  
Member  
Subcommittee on Domestic and International Monetary Policy  
Committee on Banking and Financial Services  
House of Representatives

This report responds to your request that we analyze efforts to improve the financial sectors<sup>1</sup> of emerging market countries, most of which experienced crises since 1980.<sup>2</sup> Financial crises limit emerging countries' economic growth<sup>3</sup> and foreign trade and strain their abilities to service and repay international obligations. Developed countries, including the United States, have felt the repercussions of these crises through losses on loans to and investments in emerging markets and through diminished exports to these countries.

To address your request, we focused on three countries—Indonesia, South Korea,<sup>4</sup> and Thailand. We chose these countries, among other reasons, because when we began our review, they had been receiving large capital flows, were experiencing financial crises, and were making changes in their financial systems. We focused on the banking sectors in these countries because their economies, like most developing and transition countries, relied more heavily on bank financing than on stock or bond issuance or other types of market financing. Specifically, our objectives were to determine (1) the nature of weaknesses in the countries' financial sectors, (2) the extent to which the countries have achieved reforms in

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<sup>1</sup>The financial sector of a country's economy is the complex of financial markets on which financial instruments are traded and financial institutions that create and trade financial instruments.

<sup>2</sup>We use the term "emerging markets" broadly to include countries that others classify as "developing countries" or "countries in transition" as well as newly industrialized economies such as, for example, Korea.

<sup>3</sup>See Strengthening Financial Systems in Developing Countries: The Case for Incentives Based Financial Sector Reforms, Biagio Bossone and Larry Promisel, World Bank, (Wash., D.C.: 1998).

<sup>4</sup>We will refer to South Korea, officially named the Republic of Korea, as Korea throughout this report.

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their financial systems, (3) the extent to which the countries have implemented international principles for banking supervision, and (4) U.S. government and multilateral institutions' efforts to effect changes in the financial sectors of these emerging markets.

We conducted our work in Washington, D.C.; New York City, New York; Jakarta, Indonesia; Tokyo, Japan; Seoul, Korea; Basel, Switzerland; and Bangkok, Thailand, between September 1998 and August 1999, in accordance with generally accepted government auditing standards. Appendix I describes our methodology.

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## Results in Brief

The governments of Indonesia, Korea, and Thailand are implementing multiple changes to reform their financial institutions and markets and banking supervisory structures. Many of these changes are being undertaken in response to a financial crisis. Some regulatory and legal changes have been implemented in the short term, while other objectives may take many years to accomplish due to the extent of the problems and the enormity of the changes required. Currently, how robust the countries' financial systems are to future disruptions is an open question, given the risks to the financial systems posed by the continued weaknesses of the corporate sectors of all three countries.

Although the structure of the banking systems and related weaknesses in the three countries differed prior to the crises, they had some fundamental similarities. The economies of each country relied heavily on debt financing and restricted the access of foreign financial institutions. At the same time, the countries' legal systems did not provide adequately for the enforcement of contracts or provide mechanisms for resolving defaulted corporate debt. Moreover, the financial data of many businesses were not reliable for credit or investor analysis because accounting practices in those countries were weak. The countries did not have adequate legal and institutional frameworks ensuring their bank supervisors' independence and enforcement authority. The countries did not have deposit insurance systems that forestalled runs on bank deposits.

Indonesia, Korea, and Thailand have made or are making changes to address banking system and related weaknesses, with early priority given to resolving nonviable banks and debtor companies. Some insolvent or weak banks have been closed or merged. Ongoing efforts include the sale of assets of failed banks and the recapitalization of banks, with the latter partially dependent on the corporate debt workout process. All three countries are changing laws to expedite resolution of loans in default. Also, Korea and Thailand have changed or strengthened accounting

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practices by adopting internationally accepted accounting standards. Most changes have been made only recently, allowing little time for assessment of their effect on improving the transparency and independence of the financial systems. The changes implemented or planned should, if applied fully, serve to reduce the vulnerability of the financial systems of these countries to currency depreciation and a reversal of credit and capital flows.

Each of the three countries has partially implemented international principles for effective bank supervision, but it is too early to determine the effect of this on actual bank management or supervisory practices. Implementation has involved, among other things, (1) increasing bank supervisors' independence and enforcement authority, (2) adopting more stringent standards for capital adequacy of financial institutions, (3) stricter rules for identifying loans at risk of default and determining loan loss reserves for these loans, and (4) limits on foreign exchange exposure. However, an examination staff that can fully implement revised examination standards is widely expected to require years to develop. A key indicator in determining the effectiveness of adopting these supervisory principles is whether bank supervisors will take prompt corrective actions concerning poorly performing or insolvent banks in the future.

Efforts of the U.S. and multilateral institutions (the International Monetary Fund (IMF), the World Bank, and the Asian Development Bank (ADB)) to effect changes in emerging markets have focused on the countries' immediate needs to resolve nonviable banks and debtor companies as well as long-term goals to improve financial systems. In responding to the countries' immediate needs, IMF has made financial sector reform a key condition for financial assistance. The World Bank has been providing financial and technical assistance for implementing specific reforms in the financial and corporate sectors, such as assistance in writing banking regulations, in these three countries. ADB has provided loans in the three countries to focus on banking sector reforms that included streamlining their regulatory frameworks and improving transparency in the banks. The U.S. Treasury Department is supporting financial sector reform by working through the multilateral institutions. In addition, the Federal Reserve and the U.S. Treasury, including the Office of the Comptroller of the Currency (OCC), are providing bilateral assistance through financial system technical advisors and bank supervisory training for all three countries.

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## Background

With their central role in making payments and mobilizing and distributing savings, banks are a key part of a country's economy and the international

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financial system.<sup>5</sup> Weaknesses in a country's banking system can threaten financial stability both within that country and internationally.<sup>6</sup> These problems are not limited to emerging markets. Persistent problems in Japan's banking system, for instance, have limited that country's economic growth and prospects for growth elsewhere.

The financial crises in Indonesia, Korea, and Thailand began in the second half of 1997. Banking systems in many Asian emerging markets were at the core of the region's financial crisis.<sup>7</sup> The crises resulted in sharp declines in the currencies, stock markets, and other asset prices. By December 1997, the Korean won (Korea's currency) had depreciated by 55 percent in relation to the U.S. dollar. By January 1998, the Indonesian rupiah (Indonesia's currency) had fallen by 81 percent and the Thai baht (Thailand's currency) by 56 percent. During the second half of 1997, dollar returns on Asian equity markets yielded a loss of 56 percent. The crises threatened the countries' financial systems and disrupted their real economies. Private capital flows via short-term international bank credit and investment flows to Asia declined by about \$100 billion during 1997 from 1996 levels. Most of the decline in capital flows to the Asian region reflected declines in flows to the three study countries plus Malaysia and the Philippines where net inflows of \$73 billion in 1996 were replaced by net outflows of \$11 billion in 1997. Most of the turnaround in these countries arose from a \$73 billion turnaround in net bank lending flows—with the largest share of outflows recorded from Thailand and Korea at some \$18 billion each.<sup>8</sup>

Financial crises in emerging markets have either been precipitated by or exacerbated by problems in banking systems.<sup>9</sup> Countries with weak and ineffectively regulated banking systems are less able to manage the negative consequences of volatile capital flows and exchange-rate pressures. Establishing a strong framework of regulatory policies and institutions to underpin the financial sector is key to maintaining financial

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<sup>5</sup>See Bank Soundness and Macroeconomic Policy, Carl-Johan Lindgren, Gillian Garcia, and Matthew Saal, International Monetary Fund, (Wash., D.C.: 1996).

<sup>6</sup>See Preventing Bank Crises: Lessons From Recent Global Bank Failures, Gerard Caprio Jr., William Hunter, George Kaufman, and Danny Leipziger, World Bank, (Wash., D.C.: 1998).

<sup>7</sup>See The Asian Financial Crisis: Causes, Cures, and Systemic Implications, Morris Goldstein, Institute for International Economics, (Wash., D.C.: 1998).

<sup>8</sup>See International Capital Markets: Developments, Prospects, and Key Policy Issues, International Monetary Fund, (Wash., D.C.: Sept. 1998).

<sup>9</sup>See International Financial Crises: Efforts to Anticipate, Avoid, and Resolve Sovereign Crises (GAO/GGD/NSIAD-97-168, July 7, 1997).

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stability. The task of bank supervision is to ensure that banks operate in a safe and sound manner and that they hold sufficient capital and reserves to support the risks that arise in their business.

The costs associated with financial sector problems, particularly in emerging markets, have been very large in terms of foregone growth, inefficient financial intermediation, and impaired public confidence in financial markets. The resolution costs have been largely borne by the public sector. The United States had its own financial sector problems in the 1980s and early 1990s with savings and loan institutions. We estimated a direct cost to the economy for resolving these problems of about \$153 billion or two to three percent of gross domestic product (GDP).<sup>10</sup> The estimated fiscal cost of systematic bank restructuring in Mexico since 1995 is on the order of 12 to 15 percent of GDP.<sup>11</sup> Resolving banking crises may cost between 45 to 80 percent of GDP in Indonesia, 15 to 40 percent of GDP in Korea, and 35 to 45 percent in Thailand, according to central bank or market estimates.<sup>12</sup> In early 1997, one financial expert suggested that since 1980, the resolution costs of banking crises in all developing and transition economies had approached \$250 billion dollars.<sup>13</sup> Most of the resolution costs in Asian crisis countries have yet to be incurred, and taxpayers in Indonesia, Korea, and Thailand will largely foot the bill.

Financial crises in emerging economies can be costly for developed countries, particularly as the importance of emerging countries in the world economy and in international financial markets has grown. Developing countries now purchase one-fourth of developed countries' exports. Thirteen percent of global stock market capitalization comes from emerging market countries. The share of emerging market securities in portfolios in developed countries is relatively small but has been increasing. To the extent that financial crises depress developing countries' growth and foreign trade, strain their abilities to service and to repay private capital inflows, and eventually add to the liabilities of

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<sup>10</sup>See p. 13 of *Financial Audit: Resolution Trust Corporation's 1994 and 1995 Financial Statements* (GAO/AIMD-96-123, Jul. 2, 1996).

<sup>11</sup>See *Banking Crises In Emerging Economies: Origins And Policy Options*, Morris Goldstein and Philip Turner, BIS Economic Paper No. 46, Bank for International Settlements, (Basel, Switzerland: Oct. 1996).

<sup>12</sup>The cost of restructuring will depend on factors such as domestic and external macroeconomic conditions, the effectiveness of corporate restructuring, and the efficiency with which bank restructuring is implemented, according to an IMF document. Private market estimates of resolution costs exceed official government estimates.

<sup>13</sup>*Banking System Failures In Developing Countries: Diagnosis and Prediction*, Patrick Honohan, Working Paper No. 39, Bank for International Settlements, (Basel, Switzerland: Jan. 1997).

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developing countries' governments, developed countries are likely to feel repercussions.

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## Weaknesses in the Countries' Financial Systems

The financial systems of Indonesia, Korea, and Thailand are different from systems in many industrialized countries in several ways. Contrasting their financial systems with the U.S. financial system is particularly illustrative. The U.S. financial system emphasizes arms-length relationships between businesses and institutions that provide financing, whether through debt or equity markets, or other forms of financing. Indonesia, Korea, and Thailand place greater emphasis on debt financing through bank loans than on equity financing,<sup>14</sup> have closer relationships between banks and the companies that borrow from them, and have greater government direction in credit allocation decisions.

While these nations experienced years of strong economic growth, their financial systems have not been resilient when facing large capital outflows and currency depreciations. Reasons for this lack of resilience vary, but certain weaknesses in their financial systems appear as common themes. These weaknesses included (1) weak credit analysis, problems that banks faced in enforcing loan agreements in the case of defaults; (2) weak accounting practices that precluded effective credit analysis by banks or investors; (3) lack of hedging against foreign currency exposure by corporate borrowers;<sup>15</sup> and (4) weaknesses in bank supervision that limited the governments' ability to respond to financial problems.

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## Characteristics of Robust Financial Systems

While countries financial systems do not need to be mirror images of one another, several characteristics are widely viewed as crucial to making a financial system robust or able to weather shocks. These characteristics were set forth in April 1997 by Deputy Finance Ministers of the Group of Ten (G-10)<sup>16</sup> in its strategy for fostering financial stability in countries

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<sup>14</sup>Reliance on debt financing per se is not necessarily a weakness. As we noted in *Competitive Issues: The Business Environment in the United States, Japan, and Germany*, (GAO/GGD-93-124, Aug. 9, 1993), Japanese and German businesses have relied more heavily on debt financing than U.S. businesses. In Indonesia, Korea, and Thailand, however, the inability or unwillingness of creditor banks to rollover short-term loans during the East Asian financial crisis was a key to the severity of this crisis.

<sup>15</sup>World Bank officials told us that banks historically encouraged corporations to borrow without hedging to achieve the illusion of lower interest costs.

<sup>16</sup>The G-10 is made up of 11 major industrialized countries that consult on general economic and financial matters. The 11 countries are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.



experiencing rapid economic growth and undergoing substantial changes in their financial systems.<sup>17</sup> The G-10 calls for, among other things,

- a legal environment where the terms and conditions of contracts are observed and where legal recourse, including taking possession of collateral, is possible without undue delay;
- comprehensive and well-defined accounting principles that command international acceptance and provide accurate and relevant information on financial performance;
- standards for disclosure of key information needed for credit and investment decisions that are high quality, timely, and relevant;
- effective systems of risk management and internal control with strict accountability of owners, directors, and senior management;
- financial institutions that have capital that is commensurate with the risks they bear;
- openness and competitiveness in banking and financial markets subject to essential prudential safeguards;
- safety net arrangements—deposit insurance, remedial actions, and exit policies—that provide incentives for depositors, investors, shareholders, and managers to exercise oversight and to act prudently;
- supervisory and regulatory authorities that are independent from political interference in their execution of supervisory tasks but are accountable in the use of their powers and resources to pursue clearly defined objectives; and
- authorities with the power to license institutions, to apply prudential regulation, to conduct consolidated supervision, to obtain and independently verify relevant information and to engage in remedial action.

## Characteristics of Effective Banking Supervision

In June 1996, the G-7 heads of government<sup>18</sup> called for the Basel Committee on Banking Supervision—a committee of banking supervisory authorities, which was established in 1974 by the central bank governors of the G-10 countries—to participate in efforts to improve supervisory standards in the emerging markets. In response, the Basel Committee issued core

<sup>17</sup>See “Financial Stability in Emerging Market Economies: A Strategy For The Formulation, Adoption and Implementation of Sound Principles And Practices To Strengthen Financial Systems,” by the Working Party on Financial Stability In Emerging Market Countries, Deputies of the Group of Ten (G-10), April 1997. Representatives of Argentina, France, Germany, Hong Kong, Indonesia, Japan, Korea, Mexico, the Netherlands, Poland, Singapore, Sweden, Thailand, the United Kingdom, and the United States participated in this work.

<sup>18</sup>The G-7 consists of seven major industrialized countries that consult on general economic and financial matters. The seven countries are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

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principles for banking supervision in September 1997.<sup>19</sup> The Core Principles provide operational guidance for

- preconditions for banking supervision—bank supervisory agencies with clear responsibilities, operational independence, and adequate resources; legal protections for supervisors; legal powers to authorize banks and address compliance and safety and soundness concerns;
- licensing and structure—clearly defined permissible activities; licensing authority with the right to set criteria and reject applications;
- prudential regulations and requirements—minimum capital requirements that reflect the risks undertaken by banks, independent evaluation of bank practices relating to granting loans and making investments, adequate practices for evaluating the quality of assets and the adequacy of loan loss provisions and reserves; identification of loan concentrations to single borrowers or groups of related borrowers, lending on arms-length basis; procedures for controlling country risk, transfer risk, and market risk;
- methods of ongoing banking supervision—on-site and off-site supervision; regular contact between bank supervisors and bank management; independent evaluation of information supplied by banks; and ability to supervise on a consolidated basis;
- information requirements—satisfaction that a bank has adequate records and financial statements that fairly reflect a bank’s condition;
- formal powers of supervisors—adequate supervisory measures to bring about corrective actions against a bank;
- cross-border banking—practicing global consolidated supervision, adequately monitoring and applying prudential norms to the banking organization’s foreign operations; establishing contact and information exchange with other countries’ supervisors; requiring local operations of foreign banks to operate at the same high standards as required of domestic institutions and having powers to share information with home-country supervisors to supervise on a consolidated basis.

These core principles are intended to serve as standards against which countries may evaluate the adequacy of their supervisory systems as well as guidance to countries that are changing their systems. Bank supervisors from Indonesia, Korea, and Thailand participated in developing the Core Principles. The G-10 central bank governors endorsed these principles.

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<sup>19</sup>See “Core Principles for Effective Banking Supervision,” Basel Committee on Banking Supervision, (Basel, Switzerland: Apr. 1997). The document was prepared by a group containing representatives from the Basel Committee (Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) and representatives from Chile, the Czech Republic, Hong Kong, Mexico, Russia, and Thailand. Also associated with the work were Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland, and Singapore.

Deficiencies in capital adequacy regulation are a problem area in the financial sectors of emerging markets in which international standards for prudential regulation have been particularly visible. In 1988, the member countries of the Basel Committee on Banking Supervision agreed to a method of ensuring capital adequacy, called the Basel Capital Accord, which has since been expanded.<sup>20</sup> The corresponding core principle states that

“banking supervisors must set minimum capital requirements for banks that reflect the risks that the banks undertake, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established by the Basel Capital Accord.”

Many countries adopted this standard for internationally active banks. However, differences among the countries in accounting practices, such as classifying and reserving for delinquent loans, can affect a bank’s level of capital. Differences in accounting rules can make capital levels appear higher than if the country followed stricter international rules. For example, in Thailand, an unsecured loan had been considered substandard after it was 6 months past due,<sup>21</sup> while best practices in international accounting classify a loan as substandard when it becomes 90 days past due. Because reserves against specific substandard loans do not count as part of a bank’s capital, banks would not have reserves for loans that are overdue 90 days but less than 6 months, thus overstating their capital reserves when compared to international best practices.

## Weaknesses in the Financial Systems of Indonesia, Korea, and Thailand

Prior to their financial crises, all three countries we studied fell short of meeting several of the criteria for a robust financial system and the principles for effective bank supervision. While these three countries’ economies relied heavily on debt financing, they had inadequate procedures for the enforcement of loan contracts and workouts, according to IMF and World Bank documentation. In Indonesia, for instance, legal problems impeded banks’ abilities to enforce loan contracts and sell loans. Banks did not have ready access to collateral on their loans and had limited rights to liquidate the collateral. Korean bankruptcy laws and procedures lacked clear economic criteria in judging a company’s viability and did not allow for creditor participation in designing a company’s restructuring plan. In Thailand, family groups generally controlled banks, and the result was that these banks loaned to their owners’ business

<sup>20</sup>For more information on capital adequacy and capital standards for banks see [Risk-Based Capital: Regulatory and Industry Approaches to Capital and Risk](#) (GAO/GGD-98-153, July 20, 1998).

<sup>21</sup>A secured loan was considered past due at 12 months.

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interests. With the increasing defaults on bank loans, Thailand's weak legal frameworks for foreclosure and bankruptcy of the debtor often meant that it could take up to 10 years to foreclose on an institution and collect collateral.

Similarly, since accounting practices in these three countries were weak, financial data on borrowers in these countries were not transparent or reliable enough to support credit or investment analysis. Korea's corporations (called chaebols), for example, had a complex system of cross-guarantees that made it difficult to identify the entity that would ultimately be responsible for a loan.

Bank supervision in these three countries was hindered by aspects of the countries' legal system. In Indonesia, few banks were closed or merged because of unclear legal authority to do so, according to IMF documentation. In December 1996, a governmental directive was issued to provide a firmer basis for Bank Indonesia (the central bank and supervisory agency) to close insolvent banks, but political considerations inhibited action. In Thailand, bank supervisors could be held personally responsible for causing losses to the state. The fear of legal liability limited their willingness to take corrective actions or, in certain circumstances, to close failing institutions, according to a World Bank official.

Although Korea had a deposit insurance system and Indonesia and Thailand did not, existing arrangements were inadequate in the face of the financial crises that began in 1997. Prior to the crisis, in Indonesia, Korea, and Thailand, the perception was that a large part of the deposit base was covered by implicit government guarantees. This perception changed when the crises broke. For example, initial efforts during the financial crisis to bolster confidence in banks through partial government guarantees of deposits were not successful in Indonesia. Indonesia promised compensation only to small depositors of the banks that were closed at the beginning of the program. The guarantee was not widely publicized, and no announcement was made regarding the treatment of depositors in other institutions that remained open. After several waves of deposit runs, a comprehensive scheme covering all bank depositors and creditors was introduced.<sup>22</sup>

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<sup>22</sup>According to IMF, although the deposit insurance system in Korea may have been inadequate at the onset of the crisis in late 1997, a blanket guarantee on all deposits of financial institutions until the year 2000 was provided in November 1997. This was largely successful in preventing a run on deposits as nonviable banks were closed. Later, in order to reduce moral hazard problems, the deposit insurance

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Deficiencies in the corporate governance of individual financial institutions were another weakness. Prior to the crisis, poor credit-risk management led to the weak condition of financial systems in Indonesia, Korea, and Thailand. Inadequately managed banks failed to undertake adequate credit appraisals. Lax credit risk management led to deterioration in the quality of loan portfolios. For example, excessive lending to borrowers with limited ability to service foreign exchange denominated loans in the event of a large depreciation or devaluation.

Appendix II provides a more detailed discussion of weaknesses in the financial systems of each country.

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## Countries Are Taking Steps to Improve Operation of Their Financial Sectors

The governments of Indonesia, Korea, and Thailand have taken or are taking a variety of actions in response to their ongoing financial crises. They have begun to close banks that are insolvent, merge weak banks with stronger banks, sell bad assets, and assist the recapitalization of banks that have not been targeted for closing or merger; many of these actions are ongoing. They also have created frameworks involving various degrees of government mediation to facilitate corporate debt workouts. Financial sector restructuring<sup>23</sup> in Indonesia, Korea, and Thailand has involved efforts to restore confidence in the countries' banking system by guaranteeing deposits, strengthening regulatory structures, adopting internationally accepted accounting standards, and creating legal frameworks for bankruptcy and governance. Countries are also attempting to ease barriers to competition from foreign banks. The challenges posed by the financial sector and corporate debt restructuring in East Asia have been considerable, however, and many of the problems that led to financial crisis persist. The corporate and financial sectors in all three countries are interwoven, so restructuring them is inherently a complex and lengthy process.

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system was amended with the provision that only principal for accounts of 20 million won (about \$16.7 thousand) or more would be protected for accounts opened after August 1, 1998. We used the conversion rate of exchange of \$1 to 1,200 won.

<sup>23</sup>We use the term "restructuring" broadly to capture the reform efforts that these countries were making to their financial sectors and financial aspects of their corporate sectors.

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## Countries Have Begun To Close and Merge Financial Institutions; Sell Bad Assets; and Recapitalize Remaining Institutions

As the crisis developed, the three countries had to take actions to limit the damage to their banking systems. Similar approaches were taken in each of these countries to bolster these systems. Each of the countries moved to close and/or merge failing institutions. Each set up an institutional arrangement to sell the loans of these banks as well as nonperforming loans from banks that remained open. In general, the proceeds from the sale of assets from distressed institutions are to go towards repaying the cost to the governments of restructuring the financial systems. Finally, each country moved to recapitalize those banks that remained open through various financial arrangements. While the capital levels of these banks generally were reported to be below the standards for internationally active banks, the levels are now generally higher than during the crisis.

According to the World Bank, the initial reform programs in these three countries were (1) directed at reducing instability and uncertainty in the domestic financial markets, and (2) assisting governments in developing an institutional framework to restructure and resolve nonviable financial institutions in a cost-effective manner. Because of the magnitude of the immediate financial problems these three countries faced, the initial reforms were carried out while considering the stress of the reforms on the local economies. Indonesia, for instance, faced a situation where almost all the banks were insolvent. Thailand faced several episodes of bank runs during 1997. In December 1997, about half of Korea's merchant and commercial banks were insolvent or did not meet capital adequacy standards. Over the longer-term, the goal is to build stronger and more competitive financial systems and accompanying regulatory systems to minimize the likelihood of future problems in the financial sector. Table 1 outlines several of the efforts these countries have undertaken so far to improve their financial sectors.

**Table 1: Countries Efforts to Improve Their Financial Systems**

Action taken	Closed and/or merged financial institutions	Liquidity support <sup>a</sup> and recapitalization of financial institutions	Selling bad assets
Indonesia	As of July 1999, 66 banks have been closed, the state has intervened in 30 banks, and banks have exited through merger.	<p>Bank runs in Indonesia led to stepped-up liquidity support from Bank Indonesia.<sup>b</sup> In June 1998, Bank Indonesia was providing \$22.7 billion<sup>c</sup> or 17 percent of GDP in liquidity support.</p> <p>The government of Indonesia developed a recapitalization scheme for private banks by categorizing banks depending on capital levels. Seventy-three banks with capital to asset ratios of 4 percent or better did not need to participate. Thirty-eight banks had ratios below 4 percent but above negative 25 percent; 21 of these 38 banks were closed. Seventeen banks with even lower capital did not qualify for recapitalization and were closed. Bank recapitalization was to be financed through (1) private capital injected by bank owners and (2) the issuance of government bonds.</p> <p>The long-term cost of bank restructuring is estimated to be \$85 billion, or 51 percent of GDP, according to national authorities and IMF staff estimates.</p>	<p>In January 1998, the Indonesian Bank Restructuring Agency was established to take over and rehabilitate ailing banks and manage nonperforming assets of intervened banks. The book value of assets to be liquidated by the Indonesian Bank Restructuring Agency (IBRA) was \$3 billion. Each state bank has targeted its 20 largest delinquent corporate borrowers for loan recovery, restructuring, or bankruptcy filing. Recoveries from sales of assets are to be used to buy back government shares in banks.</p>
Korea	As of January 20, 1999, 86 financial institutions (including commercial banks, merchant banks, insurance firms, and nonbank financial institutions) had been closed or suspended operations.	<p>According to Korean official sources, the government has provided about \$53.3 billion<sup>d</sup> or 15 percent of GDP, to recapitalize intervened banks and purchase nonperforming loans from distressed financial institutions. The Bank of Korea (central bank) provided foreign exchange support to commercial banks as foreign creditors reduced their exposure on short-term lines of credit. During November and December 1997, the Bank of Korea placed about \$23 billion of official reserves in deposit at foreign branches and subsidiaries of domestic foreign institutions to cover the banks' short-term lines of credit, a portion of which has since been repaid, according to IMF documents.</p> <p>Established the Korea Deposit Insurance Corporation, modeled after the U.S. Federal Deposit Insurance Corporation. Korea Deposit Insurance Corporation, by the end of 1998, issued about \$17.5 billion of its government-guaranteed bonds for recapitalizing the banks and depositor protection.</p>	<p>Expanded the Korea Asset Management Corporation's charter to be similar to the former U.S. Resolution Trust Corporation. As of June 30, 1999, the Korea Asset Management Corporation had issued 20.3 trillion won worth or about \$16.9 billion of government-guaranteed bonds to purchase nonperforming loans acquired from distressed banks. It announced plans to sell over 50 percent of nonperforming loans by end-2001. It also plans to dispose of over 97 percent of the total amount of acquired nonperforming loans within the next 5 years; the sales price is to be determined by market conditions. According to OCC, asset disposition by the Korea Asset Management Corporation has been very slow to date.</p>

Action taken	Closed and/or merged financial institutions	Liquidity support <sup>a</sup> and recapitalization of financial institutions	Selling bad assets
Thailand	As of August 1999, the Bank of Thailand closed 1 private bank and 57 finance companies. In addition, 3 private banks and 12 finance companies were merged.	By early 1998, the Bank of Thailand's Financial Institutions Development Fund had committed approximately about \$20 billion <sup>e</sup> of liquidity support to private banks and finance companies to keep them operational. The Bank of Thailand made allowance for issuing about \$7.5 billion of bonds with a 10-year maturity to support the recapitalization effort. Private banks and finance companies are to be recapitalized through Bank of Thailand's recapitalization program to provide capital to banks based on banks meeting certain requirements, including writing down bad loans. State banks are to be recapitalized through the Financial Institutions Development Fund. Through the recapitalization program, two private banks have received capital support. Five state banks were to be recapitalized by the Financial Institutions Development Fund. In addition, at least six private banks and several finance companies have raised about \$6 billion from private instruments through market-led recapitalization.	In October 1997, the Financial Restructuring Agency was established to review suspended finance companies and liquidate finance company assets by auction. The Asset Management Corporation was set up to act as bidder of last resort for bad assets. Several auctions took place between June 1998 and August 1999. The Financial Restructuring Agency sold over 70 percent of closed finance companies' assets, of which roughly 25 percent was acquired by the Asset Management Corporation.

<sup>a</sup>Liquidity support is the amount of funds provided by a central bank to a country's banks.

<sup>b</sup>Bank Indonesia is the central bank of the Republic of Indonesia. The Governor of Bank Indonesia and its seven Managing Directors are normally appointed by the president for terms of five years.

<sup>c</sup>We use an exchange rate of \$1 for 7,500 rupiah.

<sup>d</sup>We use an exchange rate of \$1 for 1,200 won.

<sup>e</sup>We use an exchange rate of \$1 for 40 baht.

Source: GAO analysis of documents from the governments of Indonesia, Korea, Thailand and IMF and the World Bank as well as interviews of officials.

The process for resolving troubled financial institutions has been difficult and contentious in the three countries, and progress has varied. For example, prior to the crisis, Indonesia did not have an agency with the authority to resolve failing financial institutions. Therefore, it established the Indonesian Bank Restructuring Agency (IBRA) in January 1998 to take over and rehabilitate ailing banks, as well as manage the nonperforming assets of banks requiring government assistance. As part of its efforts to resolve failing banks, Korea had experienced delays in its plans to sell two of the largest banks of which the government had taken control. While Korea had committed to selling these banks as part of its agreement with IMF for financial assistance, Korea requested a waiver to allow a delay in accepting bids for these sales because the government had not reached agreement with foreign bankers on the terms to purchase the banks. Thailand officials reported that selling the assets of closed finance companies has been a lengthy and political process. To deal with the selling of assets, the Thailand government set up two agencies—the Financial Sector Restructuring Authority and the Asset Management



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Corporation. The asset sales have resulted in lower returns than originally anticipated, though returns in the most recent auction have been significantly higher, according to the IMF. According to Thailand officials, debtors have been suspected of purchasing back their nonperforming loans (at a discount) through intermediaries at the Financial Sector Restructuring Agency auctions. World Bank officials told us that these allegations have not been substantiated.

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### Governments Are Facilitating Corporate Debt Workouts, but Difficulties Remain

The governments of Indonesia, Korea, and Thailand are facilitating the workout<sup>24</sup> of loans that are not being repaid and are instituting frameworks for voluntary debt restructuring.<sup>25</sup> The approach, level of progress, and degree of government involvement in corporate debt restructuring differ between the three countries for a variety of reasons. Common goals, however, include removing nonperforming corporate loans from bank portfolios to allow new lending to corporations and sharing the cost among lenders, borrowers, and the governments. In general, corporate debt restructuring in all three countries has been hindered due to the lack of tax, legal, and regulatory infrastructures needed for debt restructuring and the limited institutional experience in the region with debt workouts, according to IMF documentation. The restructuring process has also been complicated by the complex nature of corporate and banking sector relationships and the large number of participants (creditors and debtors) involved in these efforts. The delay in corporate restructuring has affected the economic recovery of the three countries because of the resulting high debt servicing costs, higher interest rates, and the lack of available credit to small and medium-sized companies. Continued weaknesses in the corporate sector pose risks to these financial systems, according to a Federal Reserve official and others that we spoke with.

The corporate sector in Indonesia was hard hit by the economic crisis and a large part of it was insolvent. The government of Indonesia announced a workout structure for creditors and debtors called the Jakarta Initiative in September 1998. Under this initiative, the Indonesian government envisages that workouts of debt to foreign commercial creditors will take

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<sup>24</sup>A loan workout is an agreement between the lender and borrower to take remedial measures. Remedial measures could be, for example, the rescheduling of principal and interest payments over a longer period, forgiveness, or an equity for debt swap. A loan workout may temporarily take the place of a foreclosure in which the lender attempts to sell at auction any collateral pledged by the borrower.

<sup>25</sup>The voluntary debt restructuring approach draws on the London Approach, which is an informal and adaptable framework for private debt workouts that relies on voluntary agreement. The principles are (1) if a corporation is in trouble, banks maintain credit facilities and do not press for bankruptcy; (2) decisions about the firm's future are made only on the basis of comprehensive information shared among all parties; (3) banks work together; and (4) seniority of claim is recognized, but there is an element of shared pain.

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place voluntarily on a case-by-case basis. The initiative provides general principles for the out-of-court voluntary restructuring of domestic and foreign debt with a view to accelerating debt restructuring, promoting interim financing to borrowers, and providing company information so that creditors can evaluate restructuring proposals. Indonesia established the Indonesian Debt Restructuring Agency and the Jakarta Initiative Task Force to implement this initiative. The Indonesian Debt Restructuring Agency is designed to facilitate foreign exchange payments made by Indonesian companies to their foreign creditors. The task force has a mandate to facilitate negotiations between creditors and debtors and is to provide a forum for one-stop approval of regulatory filings that are required in the context of corporate restructuring. The task force may recommend that the public prosecutor initiate bankruptcy proceedings in the public interest. These measures were complemented by strengthened bankruptcy law. The potential threat of foreclosure and initiation of bankruptcy proceedings provides an important incentive for the successful conclusion of restructuring agreements under the Jakarta Initiative. In May 1999, the Indonesian finance minister announced a more intensive program for corporate restructuring that called for, among other things, identification and publication of the names of noncooperating debtors, starting with the largest debtors. As of July 1999, 22 of 234 insolvent companies had reached agreements, and about 10 percent of foreign and domestic debt of the Indonesian companies involved in the process had been restructured. Creditors have generally not been willing to meet debtors' requests for partial forgiveness.

Korea's corporate sector restructuring is being led by creditor banks under principles agreed to by the government and business leaders in early 1998. The government assisted the private sector initiative by strengthening Korea's legal and institutional framework for financial and corporate restructuring. In addition, the government formed the Corporate Restructuring Coordination Committee to act as an arbitrator. In December 1998, Korea's largest chaebols, or business groups, announced their intent to undertake corporate restructuring and debt workouts. The agenda for corporate reform includes

- adoption of combined financial statements from fiscal year 1999,
- compliance with international accounting standards,
- reinforcement of voting rights of minority shareholders,
- mandatory appointment of outside directors,
- establishment of external auditors committee,
- prohibition of cross-subsidiary debt guarantees from April 1998, and
- resolution of all existing cross-debt guarantees by the year 2000.

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In May 1998, Korean creditor banks began to assess the viability of large client firms showing signs of financial weakness. According to Korea's Ministry of Finance and Economy, creditor banks listed 55 firms as nonviable, with outstanding loans of approximately 5 trillion won or about \$4.2 billion, and denied new credit to them, effectively putting them out of business. Corporate workout programs also were extended to small- and medium-sized Korean firms.

Although there are signs of more corporate workouts taking place, there remain impediments in Korea to restructuring the large corporations (chaebols). Large Korean chaebols are reported to still wield considerable power and have cross-shareholdings that complicate liquidation. For example, bank managers and financial analysts we met with in Korea said that different companies within a chaebol or industrial group have guaranteed each other's loans, making it difficult to determine who ultimately was responsible for repayment or to resolve any delinquent loan. In addition, the chaebols have reported raising additional foreign financing due to the economic recovery, and Korean banks have continued to provide lending to the chaebols, according to the Korean Ministry of Finance and Economy and the Financial Supervisory Commission.<sup>26</sup>

To encourage banks to restructure their holdings of corporate debt, Thailand's government relaxed classification rules for nonperforming loans. Under the relaxed rules, nonperforming loans are classified as performing immediately upon restructuring, subject to certain conditions, instead of after what was previously a 3-month wait. In addition, it granted more favorable tax treatment to both borrowers and creditors for forgiveness of indebtedness and transfers of loan collateral, which is to be in place until December 1999.

To mediate debt workouts, the government of Thailand established a Corporate Debt Restructuring Advisory Committee with representatives from the financial and corporate sectors and chaired by the Bank of Thailand. Thailand's voluntary approach, called the "Bangkok Approach," is a noncompulsory framework, that companies are encouraged to follow in corporate workouts involving multiple creditors. Some financial market

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<sup>26</sup>Korea established the Financial Supervisory Commission to handle the majority of restructuring related responsibilities during the crisis. Korea also established the Financial Supervisory Service in January 1999 as a universal financial system supervisor that combines the former banking, nonbanking, insurance and securities supervisors. The Financial Supervisory Commission governs the Financial Supervisory Service. At the time of our visit to Korea, the reform activities were referred to broadly under the auspices of the Financial Supervisory Commission. Throughout the report, we will refer to their activities as the Financial Supervisory Commission, which includes the Financial Supervisory Service. To date, distinctions between the two were becoming more apparent.

experts have viewed progress as being slow. As of May 1999, the Committee's efforts resulted in approximately 137 successfully restructured cases out of the 680 companies focused on and had several hundred more cases still pending. To expedite the process of restructuring, a binding debtor-creditor plan and intercreditor agreement have emerged from the private sector. The debtor-creditor plan is a binding agreement, that commits signatories to follow a set framework for debt restructuring. As of June 1999, 84 local and foreign financial institutions, including all Thailand banks, finance companies, all foreign banks, and 300 debtor firms, had signed the agreements and begun the process, according to IMF.

## Countries Have Initiated Legal and Administrative Changes

As part of the IMF and World Bank reform programs to strengthen the financial sector, the three countries needed to make changes in their legal and administrative systems. The nature of the changes differed among the countries, however, reflecting each country's legal, administrative, and judicial systems that existed before the changes began. Because of their importance in resolving loans to insolvent borrowers, changes to bankruptcy laws have been among the most important changes in the legal structure underlying the financial systems of these countries.

The World Bank has encouraged the three countries we reviewed to provide the necessary legal framework for systemic restructuring. Rebuilding the legal system at the same time that the banking system and corporate sector are being restructured, according to the World Bank,<sup>27</sup> means establishing

- transparent forms of ownership that clearly define liability of borrowers;
- judicial and alternative dispute resolution procedures to enforce contracts;
- a modern regime of secured lending, including the possibility of secured interests in all forms of property as well as accurate, maintained, and publicly available registries for all properties used as collateral; and
- procedures and institutions to permit foreclosure on collateral in a timely and efficient manner.

Without such solid legal foundations, the World Bank warned that any systemic bank restructuring, no matter how successful it appears, will stand only until the next banking crisis.

Changes in foreclosure procedures and bankruptcy law were important for all three countries. These laws are intended to provide a credible and

<sup>27</sup>"Systemic Bank and Corporate Restructuring: Experiences and Lessons for East Asia," Stijn Claessens and Margery Waxman, The World Bank Group, 1998.

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transparent way to resolve the debts, including bank loans, of insolvent borrowers, according to IMF documentation. For example, in Thailand, the law provided few options—a foreclosure could take up to 10 years in the courts. In 1998 and 1999, Thailand changed its bankruptcy law, although there was substantial political opposition because some of the legislators feared that they would become liable for loans that they had personally guaranteed, according to various officials. Indonesia also changed its bankruptcy laws, which dated back to Dutch colonial rule, but problems remain in the ability of the courts to enforce the newly established commercial law. Whether or not the new commercial court can expeditiously process bankruptcy applications is an open question, according to a State Department official. Indications of success in implementing changes in the laws of Indonesia and Thailand would include faster resolution of bankruptcy cases in a more transparent manner.

The countries also changed other laws affecting the structure and operation of businesses. In Korea, a change in the law to eliminate cross-guarantees within subindustry groups by the end of March 2000 could have substantial effects on corporate governance. Indonesia also eliminated some restrictive marketing arrangements.

Appendix III discusses these changes in greater detail.

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## Indonesia, Korea, and Thailand Are Taking Steps Towards Adoption of International Accounting Standards

To improve data disclosure and transparency, the countries we studied are taking steps towards adoption of international accounting standards. It has been broadly recognized that there is a need for international accounting standards. Two broad overlapping approaches include standards developed by (1) the Financial Accounting Standards Board, which are followed in the United States, called the U.S. Generally Accepted Accounting Principles (GAAP) and (2) the International Accounting Standards Committee, which are followed by many other industrialized countries, called the International Accounting Standards (IAS).

Accounting, which is the primary method of recording economic transactions and provides the information required for businesses to operate, is vital for a developed market economy. The lack of good accounting data adds an element of risk (and cost) to all economic transactions, especially for the banking system, which relies on financial statements for credit decisions. A set of accounting standards provides a first step to providing this information; further steps (not addressed in this report) would include developing a strong, independent audit function to verify that businesses' financial data are prepared in accordance with

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these standards. World Bank officials told us that there is a need not only for international accounting standards but for use of truly independent international auditors as opposed to state auditors or local franchisees of international firms.

For example, the Business Advisory Council of the Asia-Pacific Economic Cooperation (APEC) organization has reported that

“ [I]nformation is a crucial ingredient for investor confidence and participation. Building long-term investor participation depends on transparent financial information based on clear accounting rules and full disclosure of material information. Lax accounting and disclosure standards impede capital formation by damaging the credibility of an economy’s capital market and reducing participation in it . . . . Use of recognized accounting standards attracts investors and enhances the ability to tap debt and equity markets for new capital.”

The World Bank requires the use of international accounting standards in preparing financial statements to improve comparability between projects and countries. If a country’s accounting practices do not meet international accounting standards, it must disclose any material departures from those standards and the impact of those departures on the financial statements presented.

The recent economic crisis highlighted the need to adhere to international accounting standards. For example, Korea had not adopted international accounting standards prior to the 1997 crisis. A complicating factor in Korea’s financial crisis was that the level of usable reserves at the central bank, the amount of short-term debt of commercial banks, and the magnitude of corporate cross-guarantees were not readily apparent from publicly available data.<sup>28</sup>

## Koreans Adopting International Accounting Standards

As Korea began its financial sector reforms, it became necessary for Korea to modify its accounting standards. Many officials we spoke with in Korea said they considered the improvement of accounting standards in Korea to be a major reform. In December 1998, as an effort to improve transparency, credibility, and international comparability of financial information, Korea’s Financial Supervisory Commission issued guidance to upgrade accounting standards to the level of international standards. Among others, the IMF and World Bank required the Korean government

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<sup>28</sup>According to Treasury officials and IMF documents, a leak of IMF documents to the press revealed specific information on two Korean banks as well as the low levels of usable international reserves that had not been readily available from public sources.

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to upgrade accounting standards and disclosure rules to meet international standards, including meeting IMF's data dissemination standards.<sup>29</sup>

Korea's accounting reform process has proceeded in several areas, including (1) defining which financial accounting standards will be the primary sources of Korean generally accepted accounting principles, (2) establishing accounting standards for financial institutions, and (3) establishing accounting standards for combined financial statements. According to Korean government documents, Korea set international accounting standards established by the International Accounting Standards Committee as its benchmark. Where international accounting standards do not exist or are not sufficient to address particular accounting issues, Korea plans to adopt U.S. standards as an alternative benchmark. For example, the Financial Supervisory Commission established accounting standards for combined financial statements for firms subject to external audit for fiscal years starting on or after January 1, 1999. Korea also revised its standards to eliminate the alternative treatment for the foreign currency gains or losses. As a result, firms must recognize any gains or losses arising from foreign currency translation in the current income statement, regardless of its source. However, according to OCC, improvement is still needed in many areas, including financial statement disclosure and nonperforming loan classification.

The Korean government also announced in November 1998 that it had implemented several improvements in its debt reporting system, based on recommendations by the IMF and the World Bank. For example, the Korean government adjusted its reporting of total external liabilities to consider the results of a comprehensive loan-by-loan survey of outstanding external liabilities and the introduction of several methodological improvements to incorporate best international practices. Some of these changes included improved sectional classification, exchange rate valuation adjustments, consolidated reporting of preshipment export financing liabilities, and comprehensive reporting on residents' holding of offshore foreign debt instruments.

### Thailand and Indonesia Have Made Accounting Changes

Thailand and Indonesia also had to modify their accounting standards to meet international standards. However, there was less emphasis on improving accounting standards in Thailand because the quality of financial information was better than in the other East Asian countries, according to an IMF official. The Bank of Thailand has completed a review of current accounting, auditing, and disclosure requirements for financial

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<sup>29</sup>For more information on IMF's data dissemination standards see GAO/GGD/NSIAD-97-168.

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institutions; and new specific rules on accounting, external auditing, and financial disclosure are expected to be issued for banks and finance companies and other financial institutions by the end of December 1999. In Indonesia, the IMF conducted a review concerning Indonesia's adopting and implementing accounting and auditing rules that meet international standards. As of July 1999, Indonesia had not made substantial changes to its accounting practices, according to a World Bank official. However, in recent months, as part of the IMF supported program, audits based on international standards by international firms were initiated for key financial institutions, including the central bank. Decisions on bank closures and recapitalization have been made on the basis of these audits. World Bank officials told us that, although work remains to be done on accounting issues, Indonesia's use of an international approach in classifying loans and provisioning for losses has dramatically improved the accuracy of bank financial statements.

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## Countries Have Eased Some Restrictions on Competition From Foreign Banks

As part of their commitment to overhaul the weak and noncompetitive financial system, the study countries have eased some restrictions so that foreign banks are more free to compete with domestic banks for the provision of financial services.<sup>30</sup> The over-reliance of debt financing from domestic banks and restrictions on financing through foreign financial institutions contributed to the weak financial systems in these countries. Obstacles remain, hindering full participation by foreign financial services firms.

Although foreign banks can offer a full range of banking services in Indonesia, U.S. banks reported some restrictions relating to ownership, computation of capital, personnel, and directed lending, according to U.S. Treasury documentation. The government of Indonesia is easing restrictions on foreign bank participation in the market for Indonesian financial services. The Indonesian government promised, in its June 1998 letter of intent with IMF, to lift all restrictions on foreign ownership of banks as it amended the banking law. Foreign ownership of publicly listed banks was limited to 49 percent of outstanding shares. The government promised to eliminate discriminatory capital requirements for joint venture banks<sup>31</sup> by the end of 1998. Under prior rules, these banks were required to have twice the capital of domestic banks, and capital was computed using

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<sup>30</sup>A U.S. Treasury official told us that although foreign banks are receiving some benefit from relaxed restrictions, other financial services providers, such as securities and insurance firms, have not benefited from the easing of restrictions.

<sup>31</sup>Joint venture banks have been permitted since 1988, provided that the local joint venture partner has an equity interest of at least 15 percent.



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only capital of the branch and not the capital of the parent bank. There are restrictions on the number of work permits a foreign company could obtain for foreign nationals. Also, foreign banks are limited to opening branches in Jakarta and seven other cities in Indonesia. Finally, U.S. banks reported difficulties complying with a government regulation requiring 20 percent of new lending to go to small- and medium-size enterprises, according to the U.S. Treasury Department. On March 25, 1999, Indonesia issued regulations for implementing the banking law amendments, clarifying that all legal and administrative restrictions to the entry of foreign investment into the banking system had been removed.

Korea has undertaken reforms that substantially liberalize its capital markets, well beyond commitments undertaken when Korea joined the Organization for Economic Cooperation and Development in 1996. In addition, restrictions on foreign investment in Korea have been largely dismantled. Korea, under its IMF program, allowed foreign banks to purchase equity in domestic banks without restriction, provided that the acquisitions contributed to the efficiency and soundness of the banking sector. Korea also made changes to allow foreign financial institutions to participate in mergers and acquisitions of domestic institutions. Despite improvements, according to the U.S. Treasury's National Treatment Study, foreign banks operating in Korea continue to face competitive barriers. The major problem continues to be the requirement to consider local branch rather than parent company capital. This affects foreign banks' funding and lending operations.

The presence of foreign banks in Thailand has increased in recent years and now accounts for about 13 percent of commercial bank assets, according to the Bank of Thailand. Until the 1997 financial crisis, there were several restrictions on foreign banks operating in Thailand, according to U.S. Treasury documentation. For example, foreign banks had a 25 percent ceiling on their ownership of domestic banks. After the crisis, Thailand relaxed foreign bank ownership regulations to allow majority foreign ownership for banks for a 10-year period to facilitate recapitalization of the financial sector. However, after a 10-year period the foreign banks cannot increase their existing holdings in Thailand banks, according to IMF. Other restrictions also limit the expansion of foreign banks in Thailand, including a limit on the number of branches, legal lending limits based on locally held capital of the foreign branch, and limits on the number of expatriate managers, according to U.S. Treasury documentation.

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## International Bank Supervisory Principles Partially Implemented

All three of the countries we examined have begun changing their bank supervisory and regulatory systems to meet international standards. In particular, the countries have begun to change their supervisory systems to align them with the Core Principles for effective supervision developed by the Basel Committee on Bank Supervision, as discussed earlier. Similarly, they have adopted or are currently implementing capital adequacy regulations for banks that are based on the framework developed by the Basel Committee, the Basel Capital Accord. Like most countries, however, Indonesia, Korea, and Thailand do not adhere to all of the principles.

While these changes are being made, the impact that they will have on the business of banking in the three countries is not yet clear. Changes in supervision and regulation are only part of the necessary changes affecting banking and financial services—legal and accounting changes, among other “preconditions” for effective bank supervision, are also important. Further, some of the changes in supervision and regulation are inherently long term. For example, it will take time to develop a cadre of bank examiners who have experience with the new standards.

A survey by the Basel Committee found that many nations have not fully implemented the Core Principles. Relying on self-assessments by the 124 member countries, the Committee noted several common themes that we also observed in the three study countries, including

- the difference between “having a regulation in place and having the regulation effectively implemented,”
- the inability to attract and retain qualified staff to fully implement the Core Principles, and
- not having a framework setting limits on concentration of lending and on connected lending.<sup>32</sup>

Table 2 profiles the steps that Indonesia, Korea, and Thailand have made in adopting selected international standards for bank supervision and regulation.

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<sup>32</sup>Connected lending concerns loans extended to bank owners or managers and their related businesses. The associated risks are the lack of objectivity in credit assessment and undue concentration of credit risk.

**Table 2: Implementation of Selected International Supervisory Principles in Indonesia, Korea, and Thailand**

International standard	Indonesia	Korea	Thailand
<b>Preconditions</b>			
<u>Operational independence:</u> International standards call for an effective bank supervisory system with clear responsibilities for each agency involved and with operational independence for the supervisors to take actions in good faith, free from political pressure.	According to the Banking Act of 1992 and its amendments and the Bank Indonesia Act of 1999, Bank Indonesia has its independence as the sole banking supervision authority in Indonesia. Bank Indonesia has the right to supervise both commercial and rural banks. The right to supervise banks comprises the right to license, the right to regulate, and the right to impose sanctions.	Korea established the Financial Supervisory Commission effective April 1, 1998, and the Financial Supervisory Service in Jan. 1999, combining existing banking, securities, and insurance supervisory agencies to provide (1) consistent oversight to all financial industries, and (2) operational independence from the Ministry of Finance and Economy.	Bank of Thailand's operational independence is to be strengthened in a future Central Bank Act.
<b>Licensing and structure</b>			
<u>Licensing:</u> International standards call for applicants to be qualified as a way to better ensure that a bank is operated in a safe and sound manner.	Bank licensing authority was moved from the Ministry of Finance to Bank Indonesia to lessen political influence. Conditions for establishing new banks have been tightened: sources of capital are to be scrutinized; bank owners and managers must pass a fit and proper test; organization, ownership structure, and operating plans and projected financial condition are assessed. Foreigners may now own up to 99 percent of Indonesian banks.	Licensing authority was granted to the Financial Supervisory Commission in April 1999. Prior to this, the authority for licensing and revoking licenses had been with the Ministry of Finance and Economy.	Issued regulations regarding finance company entitlement to a banking license. The Ministry of Finance is the licensing authority.
<b>Prudential regulation</b>			
<u>Capital Adequacy:</u> International standards set by the Basel Committee provide for minimum capital levels that reflect, in part, the risks that a bank has in its loan portfolio.	Bank Indonesia has a set of capital requirements based on international standards. Indonesian banks are to hold capital equal to 4 percent of risk-weighted assets by end-1999 and 8 percent at end-2001, which is consistent with the Basel Capital Accord.	The Financial Supervisory Commission has adopted the Basel Capital Accord for internationally active banks, phasing them in by Dec. 2000. —by March 1999, banks were to have at least a capital ratio of 6 percent (using international accounting standards); —by March 2000, banks' capital ratio is to be at least 8 percent; —by Dec. 2000, banks' capital ratio is to be at least 10 percent.	The capital adequacy ratios were changed in 1998 to comply with Basel Capital Accord. Capital adequacy standards in Thailand are to be based on classification and provisioning standards that are to come into full effect in 2001.

International standard	Indonesia	Korea	Thailand
<b>Loan classification</b>			
<u>Loan loss provisioning:</u> International standards call for banks to establish and adhere to policies for evaluating the adequacy of loan loss reserves.	The five loan classification categories are pass, special mention, substandard, doubtful, and loss, with respective provisioning of 1 percent, 5 percent, 15 percent, 50 percent, and 100 percent. The general loan loss reserve was increased from 0.25 percent of the loan portfolio to 1.0 percent.	Provisions for “precautionary assets” were increased from 1 percent of assets to 2 percent. For substandard loans, reserves are to be 20 percent; for doubtful loans, 75 percent; and for loss, 100 percent.  Korea revised its criteria for the calculation of capital ratios to prevent counting reserves for loans classified as substandard or lower as part of a bank’s capital by deducting the provisions of those classified as substandard or lower from a particular class of capital.  Loan-loss provisions will also be required for payment guarantees of commercial banks.	Regulations reflected an increase in loan loss reserves for 5 categories. —Pass is 1 percent, —Special mention is 2 percent, —Substandard is 20 percent for unsecured loans, —Doubtful is 50 percent for unsecured loans, and —Loss is 100 percent for unsecured loans.  The substandard classification historically had no provisioning—it was changed to 15 percent in 1997 and to 20 percent in 1998.  The provisioning for the doubtful loans changed from 100 percent to 50 percent for unsecured loans.
<u>Lending limits:</u> International standards call for lending to related companies and individuals on an arm’s-length basis and limits restricting bank exposures to single borrowers or groups of related borrowers.	Bank Indonesia’s rules on legal lending limits are the same as international rules. Bank Indonesia has said that it will enforce a limit on loans to one borrower or one group of borrowers. For a single borrower or group of borrowers related to a bank there is a 10 percent rule—lending can be no more than 10 percent of bank capital. For borrowers not related to the bank the rule is a maximum of 30 percent from December 1998 to 2001, a maximum of 25 percent by 2002, and 20 percent by 2003.	To address Korea’s corporate networks of cross-guarantees, Korea set banks’ equity capital limit to 25 percent for lending to large shareholders and their affiliates, and other restrictions on connected lending. The excess over the 25 percent limit is to be progressively reduced and eliminated by Jan. 1, 2001.  On directed lending, Korea requires banks to provide 35 percent of new won-denominated lending to small and medium-sized companies.	A new law on commercial banking and financial institutions that includes lending limits is being drafted.
<u>Foreign exchange exposure:</u> International standards call for banks to have adequate ways to manage international risks and adequate reserves against these risks.	Banks are to limit net open foreign exchange positions (i.e., unhedged exposures) to 20 percent of capital by June 2000. Bank Indonesia also increased reporting requirements on foreign exchange transactions so that exposure is to be reported daily in a consolidated form.	Introduced control systems on funding and maturity gaps of banks’ foreign exchange exposure and expanded its monitoring of foreign exchange exposures to include offshore accounts.	As of October 1998, banks were limited to net open foreign exchange positions of 15 percent.

International standard	Indonesia	Korea	Thailand
<b>Methods of ongoing supervision</b>			
<u>On-site supervision:</u> International standards call for independent validation of supervisory information either through on-site examinations or use of external auditors.	Bank Indonesia has about 400 bank examiners for regular examinations and, when necessary, can employ public accounting firms to examine banks.	The Financial Supervisory Commission was revising its guidebooks on examination regulations and providing additional training for its supervisors.	Examination guidebooks are being revised and supervisors are being provided with additional training. A World Bank official noted that considerable technical assistance is planned in this area.
<u>Off-site supervision:</u> International standards call for supervisors being able to do off-site monitoring to identify potential problems, thereby providing early detection and prompt corrective action before problems become more serious.	Bank compliance directors are to analyze compliance with banking regulation and report monthly. Enforcement warnings can only be issued twice prior to removal of bank management.	The Financial Supervisory Commission is expanding its off-site surveillance system to capture more data in a more timely manner.	The Bank of Thailand requires banks to file reports on their balance sheets, capital levels, loan classification, changes in lending or borrowing, and loans over 5 million baht (about \$125,000). It plans to develop an early warning system for financial system risks.
<b>Formal powers of supervisors</b>			
<u>Supervisory authority:</u> International standards call for bank supervisors to have at their disposal adequate supervisory measures to bring about corrective action.	Indonesia will establish an independent bank supervisory body no later than 2002 to take over the task of supervising banks in the Indonesian banking system. Bank Indonesia will retain its privileges to examine banks if deemed necessary.	Korea established the Financial Supervisory Commission to separate supervisory power from the Ministry of Finance and Economy and gave authority to the Financial Supervisory Commission to order prompt corrective actions in cases of unsound financial institutions.	Independence remains a problem for bank supervisors. Thailand law provides that a bank supervisor can be held personally liable for loss to the state; supervisory staff has expressed concerns that the law could be broadly interpreted and its enforcement could be subject to political influence.
<b>Information requirements</b>			
<u>Financial statements:</u> International standards call for banks and other financial institutions to prepare reliable financial statements.	Reliability of bank financial statements is still questionable. Bank Indonesia is making an effort to improve the system of bank reporting and check the accuracy of reported data. Indonesia has made some moves towards internationally accepted accounting standards.	Korea is phasing in international accounting standards and requiring firms to report audited, consolidated financial statements.	The Bank of Thailand completed a review of current accounting, auditing, and disclosure requirements for financial institutions and finance companies. New rules on accounting, external audits, and disclosures are to be issued by Dec. 1999.
<b>Cross-border banking</b>			
<u>Global consolidated supervision:</u> International standards call for adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by banking organizations worldwide, including their foreign branches and subsidiaries.	Bank Indonesia follows the international standard for cross-border banking.	The Financial Supervisory Commission increased the frequency of its monitoring from quarterly to monthly and enlarged the scope of monitoring to include overseas subsidiaries and off-shore accounts.	While foreign bank branches are supervised in the same way as domestic banks, prior approval from their home supervisors is not required and Thailand supervisors are not authorized to share information with other national supervisors. The commercial banking law, in draft form, would allow such information sharing.

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Source: GAO analysis.

In each country, progress in implementing international standards for bank supervision and regulation has to be understood in the context of the business practices impeding adoption of these measures. The practice of directed and/or connected lending illustrates these barriers. In all three countries, directed and or connected lending was a long-standing practice. In Korea, for instance, connected lending occurred within the chaebol or industry groups woven together by cross-ownership and loan guarantees among the companies forming the group. A bank within a group was expected to provide funding to other companies within the group that held shares in the bank, in the same manner that the bank is expected to hold shares in companies to which it made loans. The government would at least tacitly approve such lending as a means of increasing the economy's growth rate. In Indonesia, directed and connected lending were problems, with many state bank loans going to projects favored by the government and many private bank loans going to large business conglomerates associated with private banks.

Connected and directed lending also reflected the inability of banks in the three countries to analyze the creditworthiness of many borrowers. In the United States and other industrial countries, credit analysis is possible because the borrowers' financial statements are prepared and audited according to defined and accepted accounting principles. In the United States, "generally accepted accounting principles" for private companies are defined by the Financial Accounting Standards Board. Using financial data prepared under such consistent guidelines allows a bank to understand the creditworthiness of borrowers. When there are no such consistent guidelines, however, credit analysis is difficult. Financial analysts in these countries noted that bank managers had not relied on credit analysis to lend. Rather, lending decisions in these countries had been made by the reputation of the borrowers—those who were "well connected" would be considered better credit risks than other borrowers because it was considered likely that the government would guarantee the loan. Progress in implementing rules against connected and directed lending, and in seeing bank loan decisions based on credit analysis, thus, depends on progress in implementing accounting standards.

Another reform effort undertaken in these three countries included strengthening the authority and operational independence of their financial supervisors. The Basel Committee reported that the responses to its survey on the protection of supervisors revealed that approximately

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one-third of the respondents have yet to develop legal protection for their supervisors, although some were drafting new regulations to do so. Supervisors lacking operational independence from political pressure and having inadequate supervisory powers to bring about corrective actions were contributing factors to the recent financial crisis in the three countries we studied.

The international standards require a clear, achievable, and consistent framework of responsibilities and objectives be set by the government for the supervisors. However, the standards also require that supervisors have operational independence to pursue their objectives, free from political pressure and with accountability for achieving them. Banking supervisors also must have at their disposal adequate supervisory measures to bring about corrective action when banks fail to meet prudential requirements, such as minimum capital adequacy ratios, when there are regulatory violations or where depositors are threatened in any other way.

Implementing these standards has posed challenges for the three countries studied. For example, a major reform in Korea was its establishment of the Financial Supervisory Commission in April 1998 and the Financial Supervisory Service in January 1999 to provide consistent oversight to all financial industries (banking, securities, insurance, and nonbank institutions). Korea strengthened the formal powers of its financial supervisors by granting them operational independence from the Ministry of Finance and Economy and consolidating financial supervision into one agency (formerly four). However, according to Korean officials, 10 to 12 positions at the newly established agency were filled with former Ministry officials, who could rotate back to their Ministry positions after a few years. In addition, the Financial Supervisory Service was staffed with the same supervisors who had previously been at the Bank of Korea. According to officials we spoke with in Korea, this raised questions about the independence of the new Financial Supervisory Commission. They asserted that it would take time for the new agency to operate independently of the Bank of Korea and the Ministry of Finance and Economy.

Korea also adopted prompt corrective action procedures to strengthen its financial supervisory powers. For example, the Financial Supervisory Commission established a three-step corrective measure to be imposed on unsound financial institutions, according to the seriousness of problems. For unsound financial institutions, the Financial Supervisory Commission can now order a management improvement that includes the merger of banks, the firing or suspension of senior managers, appointment of an

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acting manager, transference of operations, and merger or purchase and assumption, among other measures. Korean officials we met with said that one sign of progress would be if the Financial Supervisory Commission took corrective action against a Korean bank. There has been one such action recently. According to a Ministry of Finance and Economy press release in June 1999, the Financial Supervisory Commission designated a bank as a nonviable financial institution under provisions of the new law. The bank is to be subject to an order, whereby funds are to be sought through the Korea Deposit Insurance Corporation and the Korea Asset Management Corporation to purchase the bank's nonperforming loans and recapitalize the bank.<sup>33</sup> According to Korean documents, additional funding may be needed in the course of selling the bank to a foreign buyer or to add more provisioning as the bank reclassifies its loans.

Bank supervisors in Thailand may be held personally liable for loss to the state without immunity for their job performance under the Government Enterprise Act. This act effectively states that if a supervisor causes loss to a government entity through the course of his work, he/she can be criminally prosecuted. Both the issues of losses and application of the law are broadly defined and could potentially be subject to political influence. While bank supervisors want to change this law, many of the legal staff at the Bank of Thailand opposed the change, reasoning that a supervisor who is properly performing his/her duties would not be subject to liability. According to a World Bank official, this issue was still unresolved.

Progress in fully implementing some of the international standards will take time. The ability to conduct effective onsite examinations is a key component of adherence to the Basel Core Principles. The effectiveness of the examination, in turn, depends on the qualifications of the examiner staff and its experience. In the United States, for instance, while the bank supervisory agencies have extensive formal training programs for examiner staff, they rely heavily on on-the-job training for developing qualified examiners. Officials at these agencies said that, as a rule of thumb, it takes about 8 years for an examiner to become fully qualified. While the United States and other governments have provided training and technical assistance to the bank and financial supervisory agencies in Indonesia, Korea, and Thailand, the supervisors in these three countries have not had time to develop an examiner staff with experience operating under the international standards that the countries have recently adopted.

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<sup>33</sup>The Korea Deposit Insurance Corporation provides capital to banks in return for an equity stake in the bank. The Korea Asset Management Corporation purchases and sells nonperforming loans from distressed banks.



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## Bilateral and Multilateral Approaches to the Challenges of Financial Sector Reform in Emerging Markets

While national authorities have the primary authority for addressing banking problems, the United States and other industrial nations have provided assistance to Indonesian, Korean, and Thailand efforts to improve their financial supervisory systems. Much of this assistance has been provided through international financial institutions, such as the World Bank or IMF. The assistance has two related components:

- promoting financial stabilization and addressing the immediate causes of the financial crises affecting these countries, and
- promoting reforms to build a stronger framework for financial supervision and regulation to minimize the likelihood of a recurrence.

In promoting financial stabilization and addressing immediate causes and consequences of the financial crises, the United States and the international financial institutions have provided technical assistance and, in the case of international financial institutions, funding to enable the countries to close nonviable banks, to resolve nonperforming loans, and to restructure and/or recapitalize open institutions. The United States and the international financial institutions also support longer-term efforts to increase the competency of the supervisory agencies in the three countries. Finally, when possible, the United States and international financial institutions have sought to promote the political independence of the regulatory process.

While the Basel Committee does not provide direct assistance to countries that are changing their systems, its standards for bank supervision and regulation provide guidance both to the countries and to the international organizations that provide assistance. It counts on countries to adopt and implement its principles voluntarily. However, the Basel Committee does not assess international compliance with these standards. Rather, it relies on self-reporting by countries on how they have implemented the bank supervisory standards. In 1994, we recommended that federal bank regulators seek an expanded role for the Basel Committee in fostering greater international implementation of the supervisory standards.<sup>34</sup> We suggested that Basel Committee could facilitate a peer review process for bank supervisors that would provide independent, expert assessments of implementation of the Core Principles and guidance on possible improvements.

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<sup>34</sup>See International Banking: Strengthening the Framework for Supervising International Banks (GAO/GGD-94-68, Mar. 21, 1994).

IMF, the World Bank, and other international financial institutions that provide direct assistance use the Basel principles in assisting countries to strengthen their supervisory arrangements in connection with their work aimed at promoting financial stabilization and supporting improved supervisory qualifications. To the extent that Basel principles for banking supervision are conditions of funding, then these international financial institutions judge compliance with these principles by countries receiving financial assistance.

## Promoting Financial Stabilization

In each of the three countries we examined, the immediate objective of international assistance to restructure the financial systems was to assist the countries efforts to close nonviable banks, resolving nonperforming loans, and restructuring and recapitalizing remaining institutions.

In the aftermath of the financial crises in Indonesia, Korea, and Thailand, IMF has been providing financial assistance to these three countries. IMF assistance, however, is conditioned on a country undertaking policy reform intended to address the underlying cause of the crisis.<sup>35</sup> In each of the three countries, weaknesses in their financial systems were major elements leading to the crises, according to the IMF, so each country's agreement with IMF stipulated actions that the country was to take to address these weaknesses. These conditions covered

- closure of insolvent financial institutions, with their assets transferred to a resolution or restructuring agency, merger of other institutions, recapitalization of some institutions;
- announcement of limited use of public funds for bank restructuring, with actual funds made explicit in country budgets;
- measures to significantly strengthen prudential regulations, including loan classification and provisioning requirements, and capital adequacy standards;
- measures to strengthen disclosure, accounting and auditing standards, and the legal and supervisory frameworks;
- efforts to liberalize foreign investment in ownership/management of banks;
- the introduction of more stringent conditions for official liquidity support;
- strengthening prudential regulation on loan exposure;
- the introduction of a funded deposit insurance scheme; and
- restructuring domestic and external corporate debt and closing nonviable firms.

<sup>35</sup>See International Monetary Fund: Approach Used to Monitor Conditions for Financial Assistance (GAO/GGD/NSIAD-99-168, June 22, 1999).

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In Indonesia, for instance, conditions for financial assistance included closing banks with capital ratios worse than negative 25 percent, and those between negative 25 percent and positive 4 percent that did not submit acceptable plans for their revitalization, merging four large banks and transferring their problem loans to IBRA, and submitting a draft law to the Parliament to institutionalize Bank Indonesia's autonomy.

The IMF has also supported the process of coordinating workout efforts between international creditors and debtors in resolving severe private sector financing problems. Included in this process is IMF's pursuit of more effective bankruptcy laws at the national level. Bankruptcy reform has been a particularly contentious issue in Thailand, for instance.

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### Promoting Reforms to Minimize the Likelihood of Recurring Crises

In addition to assisting the immediate need to foster financial stability, international assistance sought to promote longer-term improvements in bank and financial market supervision. The assistance sought to help the countries strengthen supervisory institutions so that they would be independent of political interference and would have adequate authority to achieve their goals. International assistance also sought to increase the technical qualifications of the supervisors through training programs.

IMF has also provided technical assistance on banking sector issues. In Indonesia, for instance, IMF has provided a long-term advisor to Bank Indonesia from the Bank of France as well as a payments system expert from New Zealand. IMF has provided technical assistance in drafting the new Bank Indonesia law. IMF has funded training of bank supervisors by finance officials from Australia, Japan, and the United States. In Thailand, IMF has taken the lead role in such areas as strategies for commercial banks, legal frameworks for the central bank law, laws for supervisory agencies and deposit insurance, and other banking laws.

The World Bank is also currently providing financial assistance for Indonesia,<sup>36</sup> Korea,<sup>37</sup> and Thailand.<sup>38</sup> Part of the overall assistance package is directed at supporting financial sector reform and principles for a framework for restructuring corporate debt. In the financial sector the World Bank played an especially important role in

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<sup>36</sup>In Indonesia, the World Bank disbursed \$899 million in 1997 and \$1.2 billion in 1998.

<sup>37</sup>In Korea, the World Bank disbursed \$3 billion in 1997 and \$2 billion in 1998.

<sup>38</sup>In Thailand, the World Bank disbursed \$365 million in 1997 and \$700 million was approved for 1998.

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- formulating and implementing the strategy for dealing with commercial banks, finance companies, and for specialized institutions;
  - assessing the solvency of the banking system and the standing of main institutions, based on bank audits;
  - developing plans for dealing with insolvent institutions, for disposing of the assets of closed banks, and for handling the nonperforming assets of banks that were to be publicly supported;
  - improving the overall financial infrastructure including strengthening bank supervision and redesign of prudential regulation according to the Basel standards;
  - providing expertise on instituting deposit insurance schemes;
  - updating banking laws to include provisions that had been lacking, including limitations on cross-ownership between banks and enterprises; and
  - strengthening the development of money markets and capital markets through the encouragement of new institutional investors, asset securitization, standardization of government bond issues, and improvement of securities market prudential regulation and self-regulation.

The World Bank is seeking to promote more sound, more competitive, and better supervised banking systems. The goal of one loan was to rebuild an efficient financial sector, contain further bank losses, and protect productive assets of corporations by

- completing portfolio reviews for banks,
- establishing an independent review committee to verify the sound and transparent functioning of the Indonesia Bank Restructuring Agency, and
- establishing a framework that defines the government's participation in restructuring of private corporate debt.

The World Bank and IMF also are seeking to effect change through a joint effort with the government of Canada to create the Toronto International Leadership Center for Financial Sector Supervision. The objective of this center is to strengthen financial markets by enhancing the leadership capabilities of public sector executives whose responsibilities include banking supervision. The center uses a program of classroom sessions where financial supervisors share their experiences about financial institution and systemic failures and rescues with other financial authorities. Program components include

- dealing with owners and managers of problem institutions,

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- using the media and rating agencies to increase public understanding of risks and issues,
  - insulating the supervisor from personal legal risk,
  - keeping politicians abreast of potential risks in the system,
  - promoting change within the supervisor's institution, and
  - developing reporting procedures that keep information flowing up.

The World Bank is also providing technical assistance for financial sector reform in Indonesia, Korea, and Thailand. In Indonesia, the World Bank financed a firm of international consultants to advise the Indonesia Bank Restructuring Agency. The World Bank financed the hiring of a number of international accounting firms to perform portfolio reviews of IBRA banks and state banks. It also financed the hiring of a legal team to assist in drafting the regulation for establishing IBRA and for the guaranteeing depositors and creditors. The World Bank also supported the Jakarta Initiative framework for encouraging debtors to workout their debts with creditors.

The World Bank has been assisting Korea's corporate workout program. The World Bank provided Korea with expertise and a technical assistance loan of about \$33 million to employ outside experts as advisors for the design and implementation of corporate workout programs. In Thailand, the World Bank has been involved jointly with the IMF in many of the financial sector restructuring and supporting policy issues. The World Bank has taken the lead in coordinating asset disposal, bank audits and restructuring, and strategies for specialized institutions. In addition, the World Bank is also developing and revising policies for bank supervision, prudential regulations, and corporate debt restructuring.

ADB was active in the three-study countries. In Indonesia, the ADB approved a \$1.5 billion loan for Indonesia. Among other actions and in coordination with the IMF and the World Bank, the loan was directed to

- assess the financial status and, where feasible, restructure existing banks;
- strengthen the supervisory capacity of Bank Indonesia;
- rationalize the supervision and regulation of nonbank financial institutions;
- rationalize the legal and regulatory environment to facilitate debt recovery and structural adjustment; and
- improve accountability and transparency in both the public and private sectors.

ADB has provided financing for the portfolio reviews of the banks not under IBRA's control and is to provide expert assistance to Bank Indonesia

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to assess bank business plans prepared for the bank recapitalization program.

In Korea, ADB approved a \$4 billion financial sector program loan to address

- restructuring financial institutions,
- recapitalizing financial institutions,
- strengthening prudential regulation and supervision, and
- capital market liberalization and development.

In Thailand, the ADB approved the Financial Markets Reform Program Loan to address a variety of issues, including

- undertaking immediate resolution of finance company nonperforming loans and rehabilitation of unliquidated finance companies;
- establishing institutional structure for resolution and/or rehabilitation;
- undertaking financial restructuring of finance companies;
- strengthening market regulation and supervision, particularly focused on the Stock Exchange of Thailand (SET) and the Securities and Exchange Commission (SEC);
- improving risk management;
- facilitating investor-issuer access to the domestic financial market; and
- developing long-term institutional sources of funds by promoting pension systems.

U.S. agencies have provided bilateral and technical assistance to the financial supervisory agencies in the three countries, as have other national governments. Treasury and Federal Reserve officials told us that they have bilateral meetings with their counterparts in these countries to encourage changes in their financial systems. U.S. bank supervisors have been providing technical assistance and training to banks and bank regulators in these countries, covering such areas as corporate governance, credit and market risk management, information technology, and bank supervisory and examination techniques. The Department of the Treasury, for example, has advisors working with IBRA. OCC and the Federal Reserve System also provide training for bank supervisors in these countries.

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## Self-Reporting on Countries' Implementation of International Standards

The Basel Committee does not independently assess the extent to which countries have adopted international standards for bank supervision, either in their laws or in practice. The committee's information on implementation is based on self-reporting by countries on their actions. In 1998, the committee surveyed countries on their implementation of the Core Principles and published a report on the survey results.<sup>39</sup>

In 1994, we recommended that U.S. bank supervisors seek to increase the Basel Committee's role in encouraging and monitoring international implementation of standards for bank supervision.<sup>40</sup> One way we suggested for increasing the committee's role was to have it perform as a clearinghouse for information on international supervisory practices. The committee's report on its survey of countries is an example of this clearinghouse role.

We also suggested that the committee could facilitate peer reviews for bank supervisory agencies desiring such reviews and that the committee's role could include providing guidance on the conduct of the reviews, including safeguarding confidential supervisory information. A U.S. Treasury official told us that peer review is unlikely to happen and that monitoring the implementation of bank supervisory and other standards will most likely be performed by IMF, the World Bank, or another new entity. We continue to believe that peer reviews could provide a mechanism for expert, independent assessments of the implementation of the standards.

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## Multilateral Institutions Are Coordinating Assistance Efforts

The IMF and the World Bank set up a Financial Sector Liaison Committee to coordinate their efforts and minimize overlap. In general, IMF focuses on macroeconomic and stabilization issues while the World Bank focuses on long-term economic development, structural and sectoral economic reforms. The Liaison Committee seeks to avoid inconsistent advice and duplicative efforts as well as to help optimize resources and facilitate joint work—including identification and dissemination of standards and good practices. However, according to IMF and World Bank officials and documents, the collaboration, particularly in the early stages of the crisis, has not always worked. Initially, there were problems in operational coordination between the World Bank and IMF staffs due to lack of continuity and differences of opinion. For example, in the early stages of

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<sup>39</sup>"Results of the Survey on the Core Principles for Effective Banking Supervision," Basel Committee on Banking Supervision, Basel, Switzerland, 1998 (BS/98/103).

<sup>40</sup>International Banking: Strengthening the Framework for Supervising International Banks (GAO/GGD-94-68, Mar. 21, 1994).

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responding to the Asian crisis, the IMF undertook a lead role in bank restructuring—an area of primary responsibility of the World Bank. Letters of intent, covering financial sector policies that the World Bank was to take the lead, were negotiated with country governments and IMF staff without the full involvement of the World Bank staff. However, according to IMF and World Bank documents, efforts undertaken to resolve these problems through regular meetings have been generally successful.

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## Conclusion

Full implementation of the reform agenda will take many years to accomplish due to the extent of the problems and the enormity of the changes required. To date, the three countries were still finalizing bank closings and bank recapitalizations and disposing of assets from distressed institutions. Accurate accounting is vital for a developed market economy, and changes in accounting systems are under way. Major challenges lie ahead in completing the financial sector reforms. More needs to be done to ensure that bank supervisors have the authority to take prompt corrective action against failing or insolvent banks. Concerns have been expressed, by officials in these countries and others, that once IMF and World Bank money is disbursed, the countries will have less incentive to continue politically unpopular financial reforms. If the lack of reform results in diminished access to international capital markets there still may be sufficient pressure for reform. However, if such access does not diminish, these countries may continue to be destabilizing influences on the international financial system.

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## Agency Comments and Our Evaluation

We requested comments on a draft of this report from the Department of the Treasury, the Department of State, the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, OCC, IMF, and the World Bank. In written comments, Treasury generally concurred with our analysis of current reform and restructuring efforts in the financial sectors of Indonesia, Korea, and Thailand (see app. IV). In written comments, the World Bank found the draft informative and balanced and described its ongoing initiatives to strengthen financial sectors (see app. V).

We also received technical comments on a draft of this report from the Treasury, the Federal Reserve Bank of New York, OCC, IMF, and the World Bank. These comments were included in this report where appropriate. The Board of Governors of the Federal Reserve System did not comment on the draft report. State Department officials told us they concurred with our report.



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As we agreed with your offices, we plan no further distribution until 30 days from the date of this letter unless you publicly release its contents sooner. We will then send copies of this report to Representative Jim Leach, Chairman, and Representative John LaFalce, Ranking Minority Member, House Committee on Banking and Financial Services; Representative Benjamin Gilman, Chairman, and Representative Sam Gejdenson, Ranking Minority Member, House Committee on International Relations; Senator Phil Gramm, Chairman, and Senator Paul Sarbanes, Ranking Minority Member, Senate Committee on Banking, Housing, and Urban Affairs; and Senator Jesse Helms, Chairman, and Senator Joseph Biden, Ranking Minority Member, Senate Committee on Foreign Relations. We are sending copies of this report to: the Honorable Madeleine K. Albright, Secretary of State; the Honorable Lawrence H. Summers, Secretary of the Treasury; the Honorable John D. Hawke, Jr., Comptroller of the Currency; the Honorable Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, and William J. McDonough, President of the Federal Reserve Bank of New York. We are also sending copies to IMF, the World Bank, the Asian Development Bank, and the embassies of Indonesia, the Republic of Korea, and Thailand. Copies will be made available to others upon request.

This report was prepared under the direction of Susan S. Westin, Associate Director, International Relations and Trade. Major contributors to this report are listed in appendix VI. If you have any questions please contact me on (202) 512-8678 or Susan Westin on (202) 512-4128 if you or your staff have any questions about this report.



Thomas J. McCool  
Director  
Financial Institutions and Markets Issues

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**Abbreviations**

ADB	Asian Development Bank
GDP	gross domestic product
IBRA	Indonesian Bank Restructuring Agency
IMF	International Monetary Fund
OCC	Office of the Comptroller of the Currency

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# Objectives, Scope, and Methodology

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Our objectives were to determine (1) the nature of weaknesses in the financial sectors of the three countries, (2) the extent to which the countries have reformed their financial systems, (3) the extent to which international principles for banking supervision have been implemented by the countries, and (4) U.S. government and multilateral efforts to effect changes in the financial sectors of these emerging markets.

To select case study countries, we analyzed emerging market countries based on several criteria, including U.S. bank exposure, private capital flows, direct foreign investment, bank intermediation in the economy, and the history of banking crises to determine how the countries differed. We selected Indonesia, Korea, and Thailand because they (1) had received larger capital flows compared with other emerging market countries, (2) participated in developing the Basel Core Principles for effective supervision, (3) were geographically proximate, and (4) were receiving assistance from IMF and the World Bank.

To meet our objectives, we interviewed and obtained documents from U.S. government officials from the Federal Reserve System and the Federal Reserve Bank of New York; the Department of the Treasury, including the Office of the Comptroller of the Currency; the Department of State in Washington, D.C., and embassy officials in Indonesia, Japan, Korea, and Thailand. In the United States, we interviewed officials of an association representing international banks, four U.S.-based banks, and two European-based banks. We also interviewed officials from international organizations, including IMF; the World Bank, in Washington, D.C., Indonesia, and Thailand; the Asian Development Bank in Indonesia; and U.S. representatives to the Basel Committee on Banking Supervision in Basel, Switzerland.

In Indonesia, we interviewed and obtained documents from Indonesian government officials from Bank Indonesia, the Ministry of Finance, the Indonesian Bank Restructuring Agency, the Planning Agency, and the Capital Markets Supervisory Agency. We also interviewed officials in Indonesia from six U.S.-based commercial and investment banks, five Indonesian Banks, one Canadian-based bank, one industrial group, and a business school.

In Korea, we interviewed and obtained documents from U.S. Embassy officials and Korean government officials from the Ministry of Finance and Economy, the Bank of Korea, the Finance Supervisory Commission, and the Bank Supervisory Authority. We also interviewed officials in Korea from four U.S.-based commercial and investment banks, four Korean

banks, the Korean Institute of Finance, the Korea Development Institute, and the Korea Securities Dealers Association.

In Thailand, we interviewed and obtained documents from government officials from the Bank of Thailand, the Financial Institutions Development Fund, the Financial Sectors Restructuring Authority, the Asset Management Corporation, and the Ministry of Finance. We also interviewed officials from five U.S.-based commercial and investment banks, five banks and finance companies based in Thailand, and representatives of the Thailand Bankers Association.

We also reviewed and analyzed documents collected from U.S., Indonesian, South Korean, and Thailand government organizations, international organizations, and private firms. These documents included books, official correspondence, legislation, memorandums, regulations, reports, IMF and World Bank assessments of policies on financial sector reforms, letters of intent (public and nonpublic), World Bank project documents, Department of State cables, and testimony. Information, observations, and conclusions regarding foreign laws mentioned in this report do not reflect our independent legal analysis but are based on our interviews and documentation provided by those that we met with.

We requested comments on a draft of this report from the Department of the Treasury, the Department of State, the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, OCC, IMF and the World Bank. In written comments, Treasury generally concurred with our analysis of current reform and restructuring efforts in the financial sectors of Indonesia, Korea, and Thailand (see app. IV). In written comments, the World Bank found the draft informative and balanced and described its ongoing initiatives to strengthen financial sectors (see app. V).

We also received technical comments on a draft of this report from the Treasury, the Federal Reserve Bank of New York, OCC, IMF, and the World Bank. These comments were included in this report where appropriate. The Board of Governors of the Federal Reserve System did not comment on the draft report. State Department officials told us they concurred with our report.

We conducted our work in Washington, D.C.; New York City, New York; Jakarta, Indonesia; Tokyo, Japan; Seoul, Korea; Basel, Switzerland; and Bangkok, Thailand, between September 1998 and August 1999, in accordance with generally accepted government auditing standards.

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# Weaknesses in the Financial Systems of Indonesia, Korea, and Thailand

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## Indonesia

Prior to Indonesia's financial crisis, there were a variety of problems in Indonesia's banking system. Many of Indonesia's large business conglomerates owned at least one bank. State-owned enterprises and pension funds also established banks and increased the potential for connected lending. Since the late 1960s, entry of foreign banks into Indonesia was limited in that they were required either to form joint ventures with Indonesian banks, with a maximum of 85 percent foreign ownership, or buy shares of domestic banks on the stock exchange where the maximum foreign holding of stock in an Indonesian banks was set at 49 percent, according to IMF documentation.

Capital in Indonesian banks was typically overstated, because of inadequacies in loan classification and loan loss provisioning. Banks' assets were exposed to high risk because of, among other factors, concentrated and directed lending, and unhedged foreign currency borrowings by corporations. Between 1988 and 1994, the number of banks more than doubled from 111 to 240. There was a lack of information about the financial condition of most banks and corporations. Bank lending was influenced by business connections and political pressures and was based on collateral or "names" rather than cash flow analysis.

Banks had many overdue loan payments. In mid-1997, the Bank Indonesia reported overall level of nonperforming loans—10 percent—was high and approached levels witnessed in other countries before and during banking crises. IMF officials told us that the reported nonperforming loans were higher than 10 percent. Particularly problematic was the long-standing high level of nonperforming loans for state-owned banks that was attributed to politically directed lending. Rapid credit growth, foreign exchange borrowing,<sup>1</sup> and related party<sup>2</sup> lending had been inadequately managed. In addition, there was a growing exposure to the real estate market where prices tended to fluctuate and collateral was illiquid. For example, real estate lending grew 40 percent from mid-1996 to mid-1997. Banks' lending to a small number of large borrowers was also very high. Prior to the crisis, there was large-scale growth in connected and group. Most major banks were associated with corporate borrowers through a common majority owner.

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<sup>1</sup> Foreign exchange borrowing is borrowing in a currency other than the currency of the country in which the company or bank is located.

<sup>2</sup> Related party lending is lending to businesses that are associated with one another. We use the terms related party lending, connected lending, and group lending interchangeably.

Legal lending limits on loan to deposit ratios were violated by a number of banks. Depositors and bank owners were convinced that the government would never allow a bank to go bankrupt. Exit mechanisms for failed banks were not established. Prior to the crisis there were a number of insolvent banks whose resolution<sup>3</sup> was postponed. Some problem banks had a negative net worth. State banks had a poor track record on loan repayments, especially on loans extended to the largest and most influential Indonesian conglomerates.

Indonesian bank supervision, conducted by Bank Indonesia, was ineffective because of lack of independence and weak enforcement.<sup>4</sup> The Bank of Indonesia's Bank Supervision Department needed to be strengthened to effectively implement risk-based oversight of the banking system, according to government of Indonesia documents. Violations of Bank Indonesia's prudential principles were widespread. Compliance with prudential regulations was low. Violations of prudential regulations were sometimes met with regulatory forbearance. Prudential regulation needed to be strengthened, with respect to patterns of related party lending and the classification of nonperforming loans, according to IMF. For example, classification guidelines understated the level of nonperforming loans because of the liberal granting of options for restructuring and the ability to reclassify a loan back to performing status as soon as one payment was made and irrespective of anticipated future payments. Concentrated ownership and connected lending made it difficult for bank supervisors to evaluate the risk characteristics of a substantial part of the outstanding credit portfolio of private banks. On-site inspections yielded limited additional insight into the actual number of problem loans. Inadequate bank management contributed to a more concentrated credit extension to only a limited number of debtors, particularly to individuals or business groups that had close ties with the banks, according to Bank Indonesia. In some cases, bank supervisors allegedly abused their power for self-enrichment.

The absence of a deposit insurance scheme led to the provision of a central bank implicit guarantee for the survival of commercial banks that had systemic implications. Problem banks were more likely than healthy banks to have a strong political lobby. State banks were more immune to failure than private banks, while private banks with strong political

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<sup>3</sup> Resolution is the closing or merging of insolvent financial institutions.

<sup>4</sup> See Bank Indonesia. Report for the Financial Year 1997/1998. Jakarta: Indonesia, 1998.

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connections were less vulnerable to closure than private banks without strong political connections. No effective bank closure and exit regulation was in place, and few banks were closed or merged. Failed banks were generally absorbed into Bank Indonesia. In mid-1997, several banks with negative capital continued to operate. The reluctance to allow failures and enforce stringent disclosure<sup>5</sup> rules had reduced the impact of market forces and created opportunities for lending without due regard to risk assessment, according to IMF. The unclear resolution mechanism for problem banks led to a high-risk attitude among bankers.

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## Korea

Korea's favorable economic performance for the past 30 years masked weaknesses that contributed to the current crisis. Korea has a long tradition of government control of the financial sector, directing credit and preferential interest rates to promote key industries. The World Bank reported that in 1990, 46.3 percent of Korea's domestic credit was policy loans, or directed loans, extended by banks. Commercial banks have played a significant role in Korea's banking system. Assets of Korea's nationwide commercial banks totaled approximately \$318 billion, at the end of 1997. Because of government-directed credit decisions, commercial banks lacked a commercial orientation (i.e., they focused on increasing market share over improving profitability) and did not have a well-developed system of credit-risk management.

The close links between business, the banking sector, and the government encouraged the chaebols to expand boldly and to diversify and induced the banks to ignore the risk associated with their highly leveraged clients. Korean firms had made substantial investments, leaving Korea with excess production capacity and large debt burdens for Korean firms. Most of Korea's corporate debt was comprised of either short-term borrowing or from issuing promissory notes. At the end of 1997, it was not uncommon for a Korean conglomerate to be leveraged about 400-600 percent. At the end of December 1997, the 30 largest conglomerates owed about \$58.6 billion, in loans and payments to Korean banks, according to Korea's Office of Bank Supervision. The conglomerates' current liabilities (less than 1 year) accounted for 60 percent of total liabilities and roughly half of nominal gross domestic product (GDP) in 1996. Banks in Korea had also focused on short-term lending, in part, due to more favorable costs for short-term financing and limited access to the long-term capital markets.

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<sup>5</sup> Disclosure is the release by banks and companies of all information, positive or negative, that might bear on an investment decision.



The structure of the chaebols and the diversity of their holdings have been a strength in Korea because it could overcome capital market imperfections and benefit from managerial economies and vertical integration in a semi-industrialized economy. However, according to the Bank of Korea, the Korean economy has faced a “high-cost, low-efficiency” industrial sector and could not operate properly in a socioeconomic environment characterized by overregulation and “government meddling” in the financial and corporate sectors. A complex web of shareholdings and cross-guarantees between different firms (including the banks) within a chaebol has not only retarded transparency regarding ownership and financial health but also jeopardized the entire conglomerate as individual companies began to fail, according to World Bank documents.

The heavy debt burden increased bankruptcies. According to the Bank of Korea, the increase in bankruptcies contributed to the problems of an already weak banking system. Large Korean companies had not had much experience with bankruptcies prior to the crisis, and when Hanbo Steel was allowed to fail in January 1997, it caused considerable speculation about other corporations that may be allowed to fail. Prior to the crisis, Korea had a system of bankruptcy law, but its procedures for handling bankruptcies were weak. Korean laws permit both reorganization and liquidation under two processes, court mediation and court receivership, according to IMF documents. Korea’s court-supervised process for mediation was originally designed to help small companies settle debts without initiating the full bankruptcy process. The process allowed nonviable companies to postpone debts, continue to operate with their current management structure, and obtain new financing at lower interest rates. Since the beginning of 1997, many large companies registered for mediation under this process. Financial experts that we met with in Korea told us the mediation process was very slow, and the court system was unable to handle the additional workload. In addition, the IMF also noted that Korea’s bankruptcy laws and proceedings lacked clear economic criteria in judging a company’s viability and did not allow for creditor participation in designing a company’s rehabilitation plan.

The health of the financial system was further affected by deregulation that started in 1993, with World Bank assistance. Deregulation led to a removal of restrictions on cross-border capital flows, allowing greater financial innovation, increasing competition in financial services, and blurring distinctions between the various financial intermediaries. These changes were accompanied by a sharp increase in international borrowing by the corporate sector. The easing of financial prohibitions on debt financing encouraged borrowing that in many instances proved to be

unsustainable. The financial sector was further compromised by the Korean system of promissory notes (cross-guarantees) that were unsupported by sufficient credit analysis. In the absence of strengthened prudential supervision, these developments led to the accumulation of substantial loan losses. The Korean government estimated that nonperforming loans at the end of 1997 were about \$18.4 billion.

The weak state of the banking sector led to successive downgrades by international credit rating agencies and a sharp tightening in the availability of external financing. External creditors began to reduce their debt exposure to Korean banks in the latter part of 1997, causing a sharp decline in Korea's usable reserves. A large amount of these reserves were being used to finance the repayment of the short-term debt of Korean commercial banks' offshore branches. Historically, Korean authorities had a policy of not letting private banks go into default. Consequently, the Bank of Korea was providing foreign exchange support to commercial banks as foreign creditors reduced their exposure on short-term lines of credit. The total amount of foreign currency reserves that the Bank of Korea held at the end of December 1997 was \$20.4 billion, the usable portion of which was \$8.9 billion.<sup>6</sup> As of December 31, 1997, the total amount of Korea's private and governmental external liabilities was \$154.4 billion, calculated under IMF standards. The Korean government estimated that at the end of December 1997 external payments of about \$27.3 billion were due by the end of the first quarter in 1998. The ability of Korea to repay its short-term debts was dependent on the willingness of foreign lenders to extend the terms of existing loans and to offer new financing.

Korea continues to experience weaknesses in its financial and corporate sectors. Recent noteworthy events in Korea have been particularly illustrative of the difficulties Korea faces in addressing these weaknesses. These events include the breakdown in negotiations to sell intervened banks, the near bankruptcy of the Daewoo Group (a major Korean conglomerate) in July 1999, and recent allegations of stock price manipulation by Hundai Securities.

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## Thailand

The onset of the financial crisis in Thailand highlighted and exacerbated many of the weaknesses that existed in the banking system, such as weak

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<sup>6</sup> Under the IMF program, Korea tightened its definition of usable reserves and has reported its reserves under this stricter definition. Korea reported that its usable foreign exchange reserves as of end-June 1999 were \$60.4 billion. Previously, Korea had included its deposits with overseas branches of Korean financial institutions when reporting its foreign exchange reserves, thus overstating its usable reserves. Usable foreign currency reserves equal the total foreign currency reserves less the amounts on deposit with overseas branches of Korean financial institutions and swap positions between the Bank of Korea and other central banks. For more information on Korea's IMF program, see GAO/GGD/NSIAD-99-168.

supervision and regulation, lending to related entities and weak management. The Bank of Thailand's supervision of Thailand banks and finance companies was considered weak because supervisors lacked adequate resources and training and had an unclear framework for supervision. Generally, the process for supervision that existed did not focus on risk-based approaches that analyzed the risks facing the bank but focused on a compliance-based approach where satisfaction of certain regulatory rules was determined by bank supervisors.

Weak credit analysis also existed in Thailand, and bankers tended to focus on the available collateral, rather than the ability to repay. This absence of credit analysis, combined with a generally low standard of transparency and disclosure of financial information led to a fragile financial system in Thailand. Weak legal frameworks pertaining to foreclosure and bankruptcy often meant that it could take up to 10 years to foreclose on an institution and/or collect collateral as court proceedings were lengthy and expensive.

According to local bank officials, before the crisis, Thailand tightly regulated banks by making it difficult for banks to engage in higher risk financing and leasing. Therefore, according to these officials, banks created finance companies to engage in higher risk financing and leasing through a loophole in the banking laws. According to an international banker, over 100 finance companies were established before the Bank of Thailand implemented a law to regulate finance companies. According to another international banker, there was a finance company crisis in the mid-80s that should have required the Thailand government to set stricter regulatory requirements or "trip wires." However, this was not done. In the end, the Bank of Thailand facilitated the bailout of those finance companies—91 remained—by allowing banks to inject capital and take over finance company management. This set the stage for "moral hazard" problems in the future, wherein financial market participants expected that the government of Thailand would not allow failures of finance companies.

According to Bank of Thailand documents, this expectation by financial sector participants was an important weakness in the financial system. The lack of a clearly stated policy on allowing financial institutions to fail gave a misleading sense of security to market participants. Along with other countries in the region, Thailand's financial system was often characterized as "no entry, no exit," meaning that it was as difficult to get a banking license as it was to let an institution fail.

Loan classification and loan loss provisioning practices were not done according to internationally accepted norms. For example, uncollected interest income was allowed to accrue for 12 months, thereby overstating banks' income and capital. These factors, combined with weak accounting standards, made transparency a problem that needed to be addressed.

Family groups generally control Thailand's banks, resulting in family lending, on a connected basis, to other family business interests. Since these other nonbank commercial interests have also been affected by the crisis, their financial problems have undermined confidence in the banking system. In addition, Thailand's system of interlinked family controlled companies has created particular problems for corporate restructuring. Creditors tend to associate restructuring of a parent company with restructuring of either related companies or unrelated companies with similar shareholders, despite the absence of cross-guarantees or other formal links between corporations.

Weak middle management was evident in domestic banks, according to a rating agency report. Bank management personnel at the very senior levels were experienced and competent; however, the middle and lower levels lacked quality staff. In addition, senior level staff recruits were often discouraged because of the family controls over the business and the consequent limits on promotions.

In addition, according to World Bank officials, although the Bank of Thailand is technically independent, its officials had been subject to political pressure. The pressure, combined with an unclear exit and entry strategy, resulted in the unwillingness of senior officials at the central bank to make "unfavorable" decisions, for example, to close insolvent institutions. Other sources stated that Bank of Thailand also made fundamental errors and at times, Bank of Thailand officials "turned a blind eye" to ill advised, (at times criminal) lending. According to a Thailand domestic bank official, in the precrisis days, supervision was soft and banks could "negotiate" with supervisors—within reason—if there was a problem. In addition to the supervisors' lack of authority of to close banks, they also did not (and currently do not) have any immunity for their job performance. That is, if supervisors cause losses to a government institution, by, for example, providing liquidity support that is not repaid, they can be held personally liable.

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# Legal, Administrative, and Judicial Changes in Indonesia, Korea, and Thailand

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## Indonesia

Indonesia has proposed and made changes to a variety of laws, with the intent of strengthening its financial system. A new bankruptcy law became effective on August 20, 1998. The bankruptcy law was considered an essential component of the framework for restructuring the enormous debt burden of the private sector, according to IMF documentation. Amendments to the banking law were passed by Parliament in October 1998. These amendments eliminated restrictions on foreign investment in publicly held banks; amended bank secrecy law, with regard to nonperforming loans, so that debtors could be publicly identified; and enabled bank mergers and privatization. The Central Bank Law—designed to increase the Bank of Indonesia’s autonomy—was submitted to Parliament in March 1999 and became operational in May 1999.

To implement the bankruptcy law, a Special Commercial Court to process bankruptcy applications was opened on August 20, 1998. The government of Indonesia has (1) appointed experts as ad hoc judges to the Commercial Court, (2) implemented an ongoing program of continuing education for judges, (3) developed a transparent court fee to generate increased resources for the court system that could be used for higher salaries for judges, and (4) made decisions of the court publicly available. Officials of the U.S. Department of State said that how well this court functions is viewed as an indicator of whether or not financial sector reforms are progressing and that initial decisions of the court lead to a mixed assessment. The first final ruling was controversial because the court dismissed the petition against the company because a related petition was pending against its subsidiary. The second final ruling was the court’s first order of bankruptcy against a debtor company. By mid-February 1999, the Commercial Court had received 42 petitions. There have been concerns that the amended bankruptcy law is not being implemented according to either its letter or spirit and that the bankruptcy law is not working effectively, according to IMF documentation.

Other legal and administrative reforms are to include

- lifting restrictions on debt for equity conversions,
- removing tax disincentives for restructuring,
- streamlining procedures and approval requirements applicable to the admission of foreign direct investment,
- a new arbitration law, and
- measures to provide for the registration of collateral.

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## Korea

Korea has made several legislative changes to strengthen its financial regulatory system and corporate governance, open its financial institutions

to foreign competition, and revise its labor laws. To strengthen its financial regulatory system, Korea revised its Bank of Korea Act to provide central bank independence, with price stability as its prime mandate. Korea also passed legislation to consolidate supervision of commercial banks, merchant banks, securities firms, and insurance companies into one agency, the Financial Supervisory Commission. This agency was given operational autonomy and has broad powers to deal with troubled financial institutions. To deepen Korea's capital markets, Korea also made several revisions to liberalize capital in Korea's bond and equity markets.

In an effort to improve corporate governance and the transparency of data, Korea passed legislation requiring that corporate financial statements be prepared on a consolidated basis and be certified by external auditors. Related legislative changes included provisions in Korea's Fair Trade Act that eliminated cross-guarantees by April 2000. According to Korean government documents, to reinforce management transparency and accountability, the top thirty chaebols (industry conglomerates) and all publicly held companies were required in February 1998 to organize an "independent audit committee" to represent minority shareholders and creditors. However, according to the World Bank, the independent audit committees will have two-thirds of its members from outside the company and one-third of its members from within, and will not represent minority shareholders and creditors. Korea has also strengthened the Korean Fair Trade Commission's supervisory function, by granting it the authority for 2 years to request financial information from the financial institutions, to give it the ability to investigate unfair inter-affiliate transactions of chaebols.

Korea reformed its insolvency laws in early 1998, with World Bank assistance. Korea established (1) economic criteria to judge a company's viability; (2) creditors' committees to strengthen the creditor role and set time limits on making court decisions; and (3) a special administrative body to provide expertise to the courts (such as in evaluating a company's financial situation and viability, nominating a receiver, and approving rehabilitation plans). New procedures to simplify market exit have important implications for corporate workouts, in that an expeditious exit scheme allows for more efficient negotiations for the workout programs between the creditor banks and the firms.

Korean officials noted the revision of Korea's Labor Standards Act, which legalized layoffs for managerial reasons, as a landmark achievement. It was common practice for Koreans to have employment for life. Social acceptance has not been easy, demonstrated by labor disputes between

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some of the troubled commercial banks and their labor unions as well as labor strikes at other companies. Korea has expanded its social safety net to allow for unemployment protection. Korea's employment insurance system has also been expanded to cover all regular, temporary, and daily employees, according to Korea's Ministry of Finance and Economy.

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## Thailand

The Government of Thailand reformed its bankruptcy laws twice since the onset of the crisis, in April 1998, and again in March 1999. In addition, the Government of Thailand has made some changes to laws relating to privatizing state enterprises and liberalizing foreign ownership of buildings. Other laws, relating to liberalizing key areas of the economy to foreign investment and changes to the bank regulatory system are still being considered by Parliament.

The bankruptcy laws in Thailand's 1940s Bankruptcy Act, which was in effect during the crisis, gave creditors and debtors only limited and drastic alternatives for dealing with problems. For example, liquidation was generally the only solution because foreclosure was almost impossible—it could take up to 10 years to go through court proceedings to foreclose and collect assets from a company. In addition, companies did not have the option to reorganize in an attempt to become viable or have protection for new financing to the company.

The Bankruptcy Act was modified in April 1998, and some of the problems associated with the law were addressed. The new legislation passed included bankruptcy procedures and a plan for reorganization that followed closely the U.S. and British practice on court jurisdiction. Under this new law, the courts and judges were given the power to guide the process very closely to the end. It was estimated that any reorganization plan would take 3 to 6 months for court approval. The law also added provisions to protect creditors who advance new money to debtors in the process of reorganization. However, after the passage of this law, it could still take 5 to 7 years to liquidate companies' solid assets and up to 10 years to collect assets, according to an international banker. On March 17, 1999, the Thailand Parliament revised the Bankruptcy Act to address issues raised by the amended 1998 act and passed a new bankruptcy courts bill and foreclosure-related bills (amendments to the Code of Civil Procedure). The passage of this legislation was delayed for months because senate members had personally guaranteed loans and were concerned that they would be held liable for them under the new laws and were therefore blocking passage of the new laws, according to various officials. In addition, parliament members were also concerned about increasing foreign ownership of Thailand owned corporations. Elements of

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the new laws include reducing the time for bankruptcy status from 10 to 3 years, creating bankruptcy courts, and streamlining foreclosure procedures to limit postponement of legal proceedings and to limit the number of appeals.

Several closely related laws, including bankruptcy and foreclosure laws, were passed by Parliament, as of April 1999. However, there have also been delays and nonpassage of other closely related legislation important to the economy. The other laws that have been passed by Parliament were an effort to open the market, particularly to foreign investment and ownership and to encourage privatization. These laws, the Condominiums Act, the Land Code, and the Lease Act, were all passed by Parliament by April 1999. The purpose of the Condominiums Act is to liberalize foreign ownership of buildings. The purpose of the Land Code is to liberalize foreign ownership of land. The purpose of the Lease Act is to deal with foreigners leasing property. According to IMF documents, the property-related laws were passed in an effort to revive the troubled property sector in Thailand. The “Corporatizations Law,” also passed by Parliament, would facilitate the privatization of state enterprises. However, it is awaiting clearance from the constitutional courts to be enacted.

Three key and closely related bills are still being drafted and reviewed. They include (1) a bill revising the Financial Institutions Law, which concerns commercial banking and finance companies; (2) a bill revising the Deposit Insurance Law; and (3) a bill revising the Central Bank Law. The revision of the Financial Institutions Law, which has been delayed repeatedly, would create the framework for important revisions to prudential regulations, including foreign exchange exposure, lending limits, accounting standards, and disclosure standards. The revision of the Deposit Insurance Law would eventually replace the blanket deposit guarantee currently in place, and the revision of the Central Bank Law would strengthen the powers, independence, and accountability of the Bank of Thailand.

Other proposed laws include the Currency Act, which would free up excess foreign exchange backing of the currency. The passage of the Currency Act has been delayed. The proposed Secured Lending Law, which aims to expand securitizable<sup>1</sup> assets, is to be submitted by the end of 1999. The proposed Foreign Investment Act, which would liberalize foreign participation in certain business sectors, has not yet been passed, although

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<sup>1</sup> Securitization is the conversion of assets into marketable securities for sale to investors.



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it was sent to the lower house of Parliament after the committee work had been completed on March 5, 1999.

Thailand has also completed preliminary work for the privatization of (and share divestiture from) public enterprises in the areas of energy, utilities, communications, and transport, according to IMF documents. In addition, the Thailand government established a secretariat for privatization and proposed legislative measures to facilitate privatization of “noncorporatized” public enterprises.

# Comments from the Department of the Treasury



ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C.  
September 15, 1999

Mr. Thomas J. McCool  
Director, Financial Institutions and Markets Issues  
U.S. General Accounting Office  
441 G Street, N.W.  
Washington, D.C. 20548

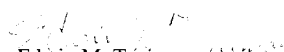
Dear Mr. McCool:

In response to your letter to Under Secretary Geithner of August 27<sup>th</sup>, the Treasury Department appreciates the opportunity to review and comment on GAO's draft report entitled "International Finance: Financial Sector Reforms In Asian Emerging Markets Are Underway" (GAO code 233580).

We found the report to be a good, comprehensive summary of current reform and restructuring efforts in the financial systems of Korea, Indonesia, and Thailand. We noted that the report contains no conclusions or recommendations regarding United States Government policies toward these countries.

We have no other general comments that we wish to convey to you at this time. However, we do have a number of specific, technical comments that we have already provided to you separately. If the Treasury Department can assist GAO in any other way regarding the report, please let us know.

Sincerely,

  
Edwin M. Truman  
Assistant Secretary  
(International Affairs)

# Comments from The World Bank

**The World Bank**  
Washington, D.C. 20433  
U.S.A.

MANUEL CONTHE  
Vice President  
Financial Sector

September 17, 1999

Mr. Thomas J. McCool  
Director  
Financial Institutions and Market Issues  
United States General Accounting Office  
Washington, D.C. 20548,

Dear Mr. McCool:

Thank you for providing the World Bank the opportunity to comment on the September 1999 draft GAO Report: "Financial Sector Reforms in Asian Emerging Markets Are Under Way."

The draft is an informative and balanced analysis of the weaknesses that led to the financial crises in Thailand, Korea and Indonesia, the steps that these countries have taken to reform their financial systems, and of the efforts of the international community.

The World Bank has placed great importance on providing rapid and practical assistance and on coordinating our efforts with those of the IMF and the other IFIs to assure that advice given is sound and consistent. As the draft report describes, the Bank has provided extensive financial and technical assistance to the Asian crisis countries to enable them to rebuild safe financial systems as rapidly as possible.

In light of the Asian crisis, the Bank responded with organizational and financial initiatives (e.g., the New Spending Authority and the Strategic Compact) seeking not only to manage programs in crisis countries but also to assist countries vulnerable to financial crisis. The Bank has set aside funds to help client countries develop their financial sectors, strengthen weak financial systems to prevent further distress, and to provide long-term support to ensure that reform programs are effectively implemented. The Bank has also supported initiatives of the international community to strengthen financial systems in emerging economies. We have intensified our efforts with the Basle Committee to devise and implement procedures for assessing compliance with the Basle Core Principles for Effective Banking Supervision. Together with the IMF, we have developed a program of joint financial sector assessments of member economies to identify vulnerabilities that could potentially contribute to a financial crisis.

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**Appendix V**  
**Comments from The World Bank**

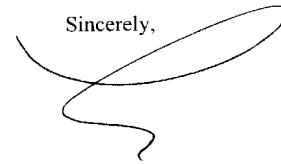
Mr. Thomas J. McCool

-2-

September 17, 1999

The Bank plans to remain at the forefront of international efforts to help strengthen financial systems and to assist our member economies in responding when crises do occur.

Sincerely,

A handwritten signature in black ink, consisting of a large, sweeping loop followed by a wavy tail.

# GAO Contacts and Staff Acknowledgments

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## GAO Contacts

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Susan S. Westin (202) 512-4128

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## Acknowledgments

Patrick S. Dynes, Nima P. Edwards, Debra R. Johnson, James M. McDermott, John H. Treanor, Desiree W. Whipple

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