LESSONS FROM THE ASIAN CRISIS: FINANCIAL STRUCTURE AND CORPORATE ORGANIZATION

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"The Asian crisis represents the first 21st century financial crisis ..."
FT editorial, 12/5/97

"Sayonara to Japan Inc."
WSJ, 12/3/97

"'Asian Model,' R.I.P."
FT, 12/4/97

The Main Protagonists

Center stage

International banks
Asian banks
Asian industrial groups

Behind the scenes

Asian style (of crony) capitalism sanctioned by the political process.

Focus of This Presentation

The financial structure of Asian countries

The organization of the Asian firms

Main Thesis of This Presentation

The industrial group is not an uniquely Asian phenomenon.

The crisis occured despite the organizational features of industrial groups and their relations to banks.

Full-fledged capital markets can avert financial crises caused by ill-designed political processes.

The South-East Asian Financial Structure

Historical background

Financial repression: allocation of credit and interest rates set by the authorities.

Bank dominated financing; weak and underdeveloped securities markets.

Recent developments - last 10 years

Extensive or full liberalization of international capital flows.

Effective liberalization of credit and interest rates.

Remaining restrictions in the entry of foreign financial services firms.

Restrictions in foreign ownership of equity and real assets.

Spectacular growth of equities markets; but limited float of significant company stocks.

Limited or no bond markets, especially for corporations.

Persistent firm dependence on bank financing.

Major shortcomings

Serious imbalance between indirect (private) and direct (public) financing.

Dominance of private financing.

Reasons:

- Favorable (lower) spreads over the basic cost of money for private funds due to

    - high moral hazard risk and need for monitoring
    - high informational asymmetry between users and suppliers of funds
    - low recontracting (and financial distress) costs for bank loans.

- Government and industrial group influence can further lead to underpricing of above costs in the case of bank loans and thus price out funds from public markets.

Dominance of short- vs long-term funding.

Banks are traditionally short-term lenders.

Moral hazard problems necessitates the use of short-term loans to increase monitoring.

Implications of bank-based financing:

Negative:

- Government influence and bank-client cronyism can produce artificially low cost of capital which can cause over-investment.

- It retards the growth of public, equity and bond, markets.

- It promotes short-term financing which increases the insolvency risk.

- It constraints the financing of new growth oriented firms.

Positive:

- Relational banking improves firm monitoring.

- Short-term financing sustains monitoring.

- Banks as creditors have incentive to steer firms toward low-risk investments.

Implied conclusions from the above:

- Bank-based, short-term financing should have promoted disciplined and restrained financial behavior on part of Asian firms.

But...

- Influence of government and private interests undermined the banks' ability to uphold their own economic interests and check their clients' abuse of credit funds.

- Lack of public bond and equity markets as alternative sources of capital eliminated signals on "true" cost of capital and valuation of Asian firms.

The Industrial Group Is Not Just An Asian Thing

"The group is a multicompany firm which transacts in different markets but which does so under common entrepreneurial and financial control."

Nathaniel Leff
Econ. Dev. & Cult. Change, 1968

The group is not an Asian phenomenon only.
Groups exist in Latin America, Continental Europe, and Asia.

Bank-dependent firms also exist in Canada, and existed in the U.S. around the turn of the century.

Traditional Views on Group Organization

Group characteristics:

Concentrated ownership or extensive cross-ownership.

Participants are linked by interpersonal trust on basis of similar ethnic or communal background: weak separation of ownership and control.

Bank dependent for their financing.

Broadly diversified.

Reasons for ownership concentration:

Underdeveloped equity markets prevent wide difusion of shareholdings.

Narrow base of capital suppliers due to concentration of wealth.

Avoidance of takeover threats.

Reasons for bank-dependent financing:

Underdeveloped capital markets with

a. high costs of information production and dissemination, hence severe informational asymmetries.

b. high costs of monitoring of corporate performance if left to securities markets.

Desire for easy and cost-efficient renegotiation of terms of financing (ease of recontracting).

Preferential credit terms under symbiotic or relational banking. Many groups establish their own banks or rely on political or interpersonal connections to secure preferential access to bank lending.

Avoidance of ownership control erosion from new equity financing.

Reasons for business/market diversification:

Underdeveloped capital markets limit efficient portfolio diversification of the capital of group owners.

Heavy dependence on (bank) debt requires reduction of revenue volatility.

Conclusion:

- The group is a natural and efficient response to the imperfections of managerial and, especially, capital markets.

- The group and bank-based financing co-exist.

The Modern View of Groups

The modern discussion of corporate governance models that resemble the "group" model includes also firms with strong relations and dependence on a Main Bank.

Perceived benefits of the bank-dependent corporate governance model:

It improves monitoring of managerial performance.

It reduces agency conflicts between creditors and equity owners.

It reduces costs of financial distress.

It reduces "wasteful" corpotate takeover wars.

It tends to support longer-term business strategies.

Implication:

Bank (i.e., creditor) emphasis on liquidity and solvency coupled with close monitoring of firm performance should limit business failures.

This model is at the heart of the current debate on the decontrol of the American banking system.

Until recently, American academics and commentators have lamented the institutional obstacles for effective monitoring of the American corporation.

What Should Have Protected the Asian Groups?

Close relations to banks: This should ease credit problems and enhance monitoring.

High use of debt: This should exert strong discipline on cash flow management.

Heavy short-term borrowing: This should put groups under closer scrutiny by their banks as they engaged in repetitive bank loan transactions.

Wide diversification: This should have reduced revenue volatility.

But...

What then Went Wrong?

- Government pressure for fast growth led to bank overlending.
- Political clout of groups constrained the prudential monitoring of banks.
- Perception of government acting as a guarantor of last resort made bank lending rekless.
- Group and bank myopia missed the risk of creating overcapacity and overproduction due to simultaneous growth of all groups.

What Can We Conclude from All This?

- The economic structure and model of financing of the Asian groups was supposed to shield them from ruinus behavior.
- However, the removal of the threat of bankruptcy, i.e., economic demise, due to ill-designed governmental policies and cronyism weakened fatally the safevalves of the group organization against failure.
- Banks failed miserably in their monitoring role.
  But why? Didn't they want to protect their value?

  Yes, but fell victims of their perception that governments will bail them out. Alternatively, they fell victims of poor economic analysis and/or hubris.

What Can We Say about the Performance and Future of the Group Model?

No evidence of systematic failure of groups.

We need to distinguish between firm value maximization (where groups may be poor performers) from value preservation.

Groups will diminish in importance as reasons to exist gradually disappear, that is as:

Secusities markets - primary and secondary - grow
Opportunities to fund new ventures improve
Bank dependence lessens
Market competition inceases
Market for corporate control grows
Quest for value maximization intensifies

International capital flows will not affect groups as long as local banks are the gatekeepers of capital.

What matters is decontrol of financial and product markets in local economy.

Canada and Continental Europe suggests that groups can live on.

Groups and Banks: The Various Models

Latin America: Usually group owns a bank or financiera.

Canada: Strong relations of corporations to major chartered banks.

Continental Europe: Strong relations of corporation to universal banks.

Japan: Corporations are linked to the main bank of the keiretsu.

Other Asian countries: groups (like Korean chaebols) form close symbiotic relations to main bank or gain access to bank funding through informal government mandate.

U.S. (turn of the century): Corporate dependence on prominent investment banks; investment bankers on corporate boards.

SOME FINANCIAL FACTS

Int'l bank exposure in Southeast Asia (excluding Singapore and Hong Kong) - summer 1997: $389.4 bil.

Japan	32%	
US	8	(Citicorp)
UK	8	
France	10	(Credit Lyonnais)
Germany	12	
Other	30	

After summer 1997, int'l bank loans to SE Asia cut by $100 bil. (equal to 2/3 of the money lent in previous two years).

Bond Funding

SE Asia borrowing from foreign bond markets: Avg of $3 bil in 1990-93; $8 bil. in 1993.

Indonesia

Fully convertible currency since 1977

Deregulation of financial sector in 1988.

Stock market capitalization (1997): US$ 100 bil.

Private-sector bank lending: 60% of total lending.

Firm debt to foreign banks: $65 bil.

South Korea

Debt owed by insolvent firms: 2% of M2 (money supply)

1995 - Liberalization of bank domestic and int'l borrowing and lending.

15 new merchant banks created through partial financial liberalization in 1996; they gained clients by giving S-T loans to finance 20-yr assets.

Bad bank loans: US$ 50 bil.

Bank loans owed to foreign banks: US$ 70 bil. w/ 1-yr. term.
Total int'l loans: $200 bil. w/ 1-yr term.

Increase in Korean bank loans from abroad from application year to join OECD (1994) to entry year (1996): $52 to $108b.

Korean firm debt breakdown (Feb. 1998):

$40 bil. of S-T debt to foreign banks
86 bil. of L-T debt to foreign banks
368 bil. to domestic creditors ($300 bil. to banks)

China

Bad bank loans: US$ 200 bil.

Four commercial banks control 75% of lending.

Japan

90% of listed firms have a main bank.

BANK VERSUS CAPITAL MARKET FINANCING

Funding from banks vs capital markets - early 90's:

Japan	$5.33 of bank funds	: $1 of cap. mkt. funds
Germany	4.20	: 1
US	0.85	: 1

Bank assets as % of GNP - 1993-94:

US	7% of GNP
German	36
Japan	39
Canada	55

Bank loans as % of GDP - 1997:

US	50%
Germany	170
Japan	150
Malaysia	100

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