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## Financial crisis as a catalyst of legal reforms: The case of Asia

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## **ADB Working Paper Series**

### **Financial Crisis as a Catalyst of Legal Reforms: The Case of Asia**

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Masahiro Kawai  
and Henrik Schmiegelow

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**Abstract**

This paper discusses how financial crises in emerging Asia and Japan worked as catalysts for legal reforms. The responses of six Asian countries with different legal histories to financial crises that posed similar challenges are of both legal and economic interest. We first provide a theoretical framework that focuses on law and economics. We then review the basic approaches adopted by the Asian countries affected by financial crises in 1997–1998 to bank and corporate restructuring and to legal and other reforms. Finally we examine indicators that measure the quality of legal institutions (regulatory quality, rule of law, and control of corruption) for the six countries to determine whether these indicators show improvement over time. We find that all six countries pursued significant legal and judicial reforms, but the indicators exhibit mixed results: the Republic of Korea shows clear improvements in all aspects, while the Philippines exhibits clear deterioration and Indonesia indicates a steep decline followed by remarkable improvement. We argue that reforms of the economic laws alone cannot improve the quality of entire legal and judicial systems of countries. What matters is the enforcement of substantive law by procedural law, the efficiency of the justice system, and other political and social factors. In the case of Indonesia, Malaysia, and the Philippines, the colonial “transplant effect” of Western legal systems may have made the implementation of laws a significant challenge. In Thailand, implementation was affected by the “yellow shirts” (anti-Thaksin) versus “red shirts” (pro-Thaksin) conflict. Long time lags, perhaps of several decades, may be needed to observe how *de jure* changes to substantive laws lead to *de facto* improvements of legal institutions.

**JEL Classification:** F65, G01, G28, G33, K40, O16, O43

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# 1. INTRODUCTION

The financial crisis in emerging Asian economies in 1997–1998 was triggered by massive capital outflows, which followed equally massive capital inflows that had taken place in the mid-1990s. These capital inflows had gone to domestic financial firms—mainly banks—and corporate sectors of the affected countries (Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand). The Japanese banking crisis of 1997–1998 was caused by the collapse of the real estate bubble, which affected banks that had extended excessive bank loans to the corporate sector with real estate as collateral.

The financial crises in emerging Asia and Japan adversely impacted banks and corporations in these economies. Most banks were heavily burdened with large nonperforming loans (NPLs). A large number of corporations had levels of debt they were unable to service and investment assets that were economically nonviable. The holes in the balance sheets of banks and corporations were huge, and it took many years to write off problem loans and failed investments.

Bank and corporate restructuring was an essential element of the strategy for sustainable recovery and growth in crisis-affected economies. Restoring a healthy banking system was necessary to ensure an adequate supply of credit to support economic recovery. Corporate debt and operational restructuring was the key part of this exercise as a healthy banking system required credit-worthy corporate borrowers. The crisis-affected countries learnt that bank restructuring and corporate restructuring needed to take place simultaneously as the banking crisis was rooted in systemic insolvency problems in the corporate sector.

One of the most significant impediments to bank and corporate restructuring in these crisis-affected countries was the lack of systematic—particularly legal and institutional—frameworks that would enable problem banks to be resolved quickly, weak banks to be rehabilitated, financial and operational sides of viable corporations to be restructured, and nonviable corporations to be put into insolvency procedures. Bank and corporate restructuring required reforms of substantive as well as procedural areas of law. Substantive legislation was needed in the areas of antimonopoly, banking, bankruptcy, insolvency, and commercial law. Judicial systems had to provide for credible enforcement of contract law in civil or commercial courts, effective bankruptcy courts, and the creation of procedures for out-of-court workouts. There was considerable variation in the six countries' paths toward crisis resolution, reflecting differences in their economic and legal development. Nonetheless, there was a remarkable commonality in the policy actions to create the enabling legal environment for both immediate crisis resolution and more sustained economic growth and development. The experience of the six Asian countries offers useful lessons for crisis resolution and legal reforms in other regions of the world.

One of the main objectives of this paper is to describe how the financial crises in emerging Asia and Japan worked as a catalyst for legal reforms in the crisis-affected countries in Asia. The responses of six Asian countries with different legal histories to financial crises that posed similar challenges are of both legal and economic interest. Another important objective is to examine whether the legal reforms have improved the quality of legal institutions in these six Asian countries. It would be expected that the reforms would have had a positive impact on the quality of legal institutions. From this perspective, we examine a few indicators that measure the quality of legal institutions—such as regulatory quality, rule of law, and control of corruption. This approach can help refocus the debate on the relationship between law and economics

as well as on methodologies for measuring the impact of legal change.

The paper is organized as follows. Section 2 provides a theoretical presentation on the debate on law and economics. Section 3 reviews the basic approaches adopted by the Asian countries affected by financial crises in 1997–1998 to bank and corporate restructuring and to legal and institutional reforms in economic and other areas. Section 4 considers these issues from country-specific perspectives. Section 5 analyzes indicators of the quality of legal institutions, examines whether the quality of such institutions has improved following reforms of substantive laws, and interprets the findings. Section 6 concludes the paper.

## **2. RELEVANCE FOR THE DEBATE ON LAW AND ECONOMICS**

Although the causes of the financial crises in the five emerging Asian countries and in Japan were different, they triggered simultaneous reforms in one or more areas of law: (i) business governance, (ii) credit and security interests, and (iii) dispute settlement. For scholars of comparative law, the similarity of these legal reforms is all the more remarkable in view of differences between the legal histories of the six countries. These countries were similarly affected by the financial crises, irrespective of their categorization as civil law or common law countries, which poses a challenge to legal origins theory. Empirical approaches to linking law and development might consider the financial crises as salutary external shocks forcing entrenched legal systems to open up to necessary change. In institutional economics, business governance, credit and security interests, and dispute settlement play important roles in supporting the legal environment for economic growth. Analysis of the catalytic nature of the financial crises that triggered reforms in these three areas can help deepen the understanding of the mutual relationship between legal reforms and long-term economic growth and development.

### **2.1 Comparative Law**

Apart from Malaysia, the countries examined have legal systems featuring civil codes, commercial codes and civil procedure codes, and are commonly, if not always entirely correctly, referred to as civil law countries. The three codes cover substantial parts of business governance, credit and security interests, and dispute settlement, unless legislation of business and banking sets special norms. Of these countries, three—Japan, the Republic of Korea, and Thailand—legislated their codes autonomously, although borrowing selectively from patterns of the European codification movement in the 19th century. Malaysia is the only common law country in our sample.

When Japan began its modernization in the second half of the 19th century, there was a prolonged struggle between Japanese scholars advocating French, English or German models. A composite of French, English, German, and traditional Japanese patterns prevailed (Tanaka and Smith 2000). With its civil code of 1896, its commercial code of 1897 and its civil procedure code of 1890, Japan became the leading example of the voluntary selection of elements of Western law from the perspective of comparative law. Berkowitz et al. (2003) emphasize that this type of voluntary adoption of foreign legal patterns, as opposed to colonial transplants of legal systems, correlates with a high degree of effectiveness of legal institutions. However, after World War II Japan's banking and corporate sectors were profoundly transformed by laws modeled on American statutes. The Antimonopoly Law and the Securities and Exchange Law

are the foremost examples of this transformation. While adjusting these new rules continuously to changing economic requirements, Japan has fared remarkably well with them. Rather than being governed completely by either civil law or American models of business laws, the spectacular growth of Japan's post-war economy was supported by what might be called strategic pragmatism (Schmiegelow and Schmiegelow 1989).

The Republic of Korea, which became independent in 1948, adopted a civil code in 1958, a commercial code in 1962 and a civil procedure code in 1960. All three codes were drafted by Korean legal scholars educated in the systematic foundations of the Japanese codes. But the result was distinctive in substance and style (S-Y Kim 2000; M. Kim 2008; Kozuka and Lee 2009). Thailand had a more protracted debate on the choice between continental European law and English law. It began in 1892, when English law had strong support, as many jurists had been trained in England. Nevertheless the legislature decided in favor of continental European patterns, except for the area of sales law, where English law exerted strong influence. The code of civil procedure was enacted first in 1908 (Boonyawan and Phetsiri 2011), and the civil code and commercial code followed in 1925 (Schwenzer, Hachem, and Kee 2012).

Indonesia and the Philippines received their civil law systems by colonial transplant, Indonesia from the Netherlands (Tabalujan 2002; Deguchi 2008) and the Philippines in the 16th century from Spain and then American common law principles after the American-Spanish war in 1898, transforming the Philippines into a "mixed jurisdiction" (Villanueva 1990; Sicat 2007). Berkowitz et al. (2003) attribute the slower pattern of historical per capita GDP evolution in Indonesia and the Philippines in comparison with that in Japan, the Republic of Korea and Thailand to the "transplant effect" of the imposition of a culturally foreign legal system on a nonreceptive country where local customary traditions had previously prevailed (Tabalujan 2002; Gamboa 1974).

Malaysia adopted the common law system through legislation on British Indian models (Hamzah and Bulan 1995) in contrast to prevailing perceptions of the English common law tradition as a legal system based on judge-made law. The entire common law was codified in the late 19th century as part of the British effort to accelerate its diffusion in the British Empire (Badami and Chandu 2013). Intellectually, this effort was guided by the perception of cultural incompatibility between English common law and "native" legal traditions (Wilson 2007). Just as in the cases of former colonies of civil law countries, the "transplant effect" may explain why Malaysia, despite rich natural resource endowments, did not develop as rapidly as countries with autonomous codifications, such as the Republic of Korea. The economically most important codifications of the common law under British rule were the Civil Law Act of 1937/1956, the Contracts Act of 1950, and the Subordinate Courts Act of 1948. After independence in 1957, Malaysia continued using the same technique of legal reforms with the Banking and Financial Institutions Act of 1989 and a series of civil procedure statutes.<sup>1</sup>

Hence, from the perspective of comparative law and legal history, there is a difference in the relevance of the legal reforms induced by financial crises for the affected countries. While legal reforms were undertaken in crucial areas in all six countries, such reforms were particularly relevant for the autonomous development of legal institutions in the three former Western-colonial countries (Indonesia, Malaysia, and the Philippines) as these countries moved away from transplanted legal systems.

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<sup>1</sup> These included the Courts of Judicature Act of 1964, the Subordinate Court Rules of 1980, the Rules for the High Court of 1980, the Rules of the Court of Appeal of 1994, and the Rules for the Federal Court of 1995 (Ahmad and Rajasingha 2001).



## 2.2 Legal Origins Theory

Legal origins theory argues that common law is economically superior to civil law.<sup>2</sup> Its most influential thesis is that common law encourages uninformed capital owners to trust professional insiders acting as agents in the best interests of their principals, whereas civil law is the expression of the will of the ruler rather than of free citizens wishing to protect their economic interests (La Porta et al. 1999). The most important contribution of legal origins theory, however, was to marshal impressive resources for cross-country econometric analysis relating the economic performance of more than 170 countries of the world to their legal origin in one of five categories: English, French, German, Scandinavian, and Socialist. This effort was unprecedented and remains unrivaled until today.

Having initially focused on substantive rules governing financial markets, such as shareholder protection in corporate law, authors supporting legal origin theory subsequently found common law to be superior to civil law in the procedural field as well. Assuming that common law was close to the ideal of two parties informally entrusting their dispute to their common neighbors' judgment while civil law was inefficiently formal, Djankov et al. (2002) constructed an index of procedural formalism. The authors collected responses from members of the Lex Mundi association of law firms on the duration of procedures of eviction of tenants for non-payment of rent and of collection of bounced checks in 106 countries and found the mean as well as median values of duration in common law countries lower than in civil law countries. Although the two cases of tenant eviction and check collection procedures do not qualify as crucial legal support for growth, and analyses of cost and time factors in civil procedures can reveal contrary findings (Langbein 1985; Jackson 2009; Reimann 2012; H. Schmiegelow 2013), the theory maintains that its conclusion in favor of common-law-based dispute settlement is consistent with the assumed high costs, long duration and low transparency of civil procedure in civil-law-based countries. In fact, leading American judges and scholars of comparative law as well as reformers of English civil procedure have lamented the time and cost inefficiency of common law procedure as compared with civil law procedure. The lower mean and median values of the duration of common law procedure are obtained only in large country samples with overwhelming majorities of economically struggling former colonies, more than half of which are coded as of French legal origin. These samples capture lagging development rather than the intrinsic qualities of common law and civil law.

Unfortunately, the theory's methodological problems are severe. Static cross-country analysis with large numbers of countries may have the advantage of econometric robustness, but cannot capture evolutionary change such as legal and economic development (H. Schmiegelow 2006; Armour et al. 2007; Boucekine et al. 2010, Deakin and Sarkar 2011; Docquier 2013). The classification of countries into one of the five categories is so inaccurate on the comparative law level of analysis that it may seriously undermine the value of theoretical conclusions for policy. The three most revealing examples of this problem are: (i) the categorization of the US as of English legal origin, although its business laws and financial regulations are essentially codified in civil law style rather than judge-made as in English common law (Dam 2006); (ii) the listing of Japan as of German legal origin, although its civil and commercial codes are syntheses of French, English, German, and domestic patterns, and its banking and

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<sup>2</sup> Authors advocating the theory focused on the comparative performance of financial markets in New York, London, Paris, and Frankfurt in the 1990s (La Porta et al. 1997, 1998). They looked for behavioral patterns and legal rules encouraging the provision of capital to financial markets (Shleifer and Vishny 1997; La Porta et al. 1997, 1998).

corporate laws are inspired by American models; and (iii) the classification of practically all Latin American countries as of French legal origin (Dam 2006; H. Schmiegelow 2006). The Philippines, with its hybrid Spanish and American legal system, is labeled as of French legal origin. So is Indonesia, arguably with more reason, as the older Dutch codes transplanted in the 19th century were inspired by the Napoleonic codes. But Thailand, which codified its civil, commercial, and procedural codes autonomously like Japan without being a colony, is categorized as of English legal origin (Djankov et al. 2002, Table 2A). Malaysia is the only country of the six countries considered in the paper, which is correctly categorized as of transplanted English legal origin.

Djankov et al. (2007) recognized the incapacity of static analysis to capture evolutionary change but still maintained the defective country codings of the 2002 paper. The authors examined the economically much more relevant issue of contract enforcement of unpaid debt worth 50% of GDP per capita and found that the average number of calendar days required to enforce such contracts was notably different from that for tenant eviction and collection of bounced checks. Using data reported by the authors, the average of the duration of enforcement (271 days) for the four countries of our sample coded as of civil law legal origin—Indonesia (570), Japan (60), Republic of Korea (75), and the Philippines (380)—is shorter than the average (345 days) for Malaysia (300) and Thailand (390), the two countries coded as common law legal origin.

Even though there are some grounds to support legal origins theory, its relevance for the analysis of bank and corporate restructuring in Asia is generally limited. Alternative dispute resolutions are clearly preferred whenever necessary and possible in countries with less than efficient judicial systems. The fact that both the impact of the financial crises on the economies of the six countries and their catalytic roles for legal reforms cut across the common law and civil law divide in Asia is one more methodological challenge to legal origins theory.

## 2.3 Law and Development

Debate on the relationship between law and development has gone through wide swings. Two waves of US and international efforts at legal reforms in developing or transition countries in the past five decades were each followed by protracted debates on the relative merits of top-down approaches working with governments and judiciaries of countries in need of legal reform versus bottom-up strategies relying on nongovernmental initiatives in favor of the rule of law, access to justice, and poverty reduction (Hammergren 2012). The first wave occurred in the “development decade” of the 1960s and was aimed at modernizing legal systems in developing countries. As described by Trubeck and Galanter (1974), it was based on the assumption that the American legal system was good and potent and thus should be exported to developing countries. The trough followed in the 1970s when American legal scholars, after exposure to more sustained contact with lawyers and scholars in developing countries, began to realize that their assumption was questionable in terms of foreign policy, economics and jurisprudence. The second wave was driven by the surge of optimism after the fall of the Berlin Wall. Again, large American resources were mobilized, this time directed at rewriting the legal systems of Russia, other former members of the Soviet Union and Eastern European countries. The trough came when prominent advisors, who had gone on their missions with great faith in the early 1990s, became appalled later in the decade by evidence of moral hazard in voucher privatization and the “kleptocracy” of prominent Russian entrepreneurs (Black et al. 2000).

A collection of empirical studies on the rule of law (Jensen and Heller 2003) analyses past failures of rule of law programs and highlights evidence of resistance of entrenched judicial sectors to structural reforms within and across legal systems. It concludes by advocating that structural reforms should rely on competition and incentives for altering existing legal practices and institutions, as they remain artifacts of the very system that is the object of reform. Perhaps this view does not sufficiently recognize the role of legal scholars, legislators and judges in the history of legal reforms since the transition from feudal societies to modern contract societies in the 19th century (Maine 1861). Japan's and Thailand's early autonomous modernizing codifications and the post-independence reforms in Indonesia, the Republic of Korea, Malaysia, and the Philippines are part of this history.

Heller (2003) is certainly right to draw attention to the importance of institutional competition and incentives for reform, especially in transnational and supranational integration processes and in functional interaction with multilateral organizations. He could have added one more type of incentive for legal reforms: financial crises such as those discussed here. Such crises are disruptive directly for the affected economies and potentially for entire societies. If the legal systems concerned rose to the challenge by adjusting through structural reforms, it would be a sign of at least some adaptive functionality of these systems. The crises would be used as catalyst of legal reforms and subsequent development.

## **2.4 Institutional economics**

The most compelling relationship between law and economics is observed if law reduces transaction costs as shown by Coase (1937, 1988) in his theory of the firm as a system of long-term contracts and by North (1981, 1990) in his studies of constitutions, property rights and other laws as frameworks providing order and safety to markets. For example, secure property rights are a necessary condition for the accumulation of physical and human capital, which played a crucial role in the “East Asian Miracle” (World Bank 1993). Boucekine et al. (2010) show how codified default rules for the economically most important contract types reduce transaction costs for incomplete contracts and correlate with economic growth for eight developed or newly industrialized economies, including Japan, the Republic of Korea, and Taipei, China since the time of codification.

Pistor and Wellons (1999) analyzed the same three areas of law that were challenged by the Asian financial crisis of 1997–1998, i.e., those related to business governance, credit and security interests, and dispute settlement. They retraced the relationship of these areas of law with three contributions to growth in Asia between 1960 and 1995: (i) capital formation, (ii) lending volume, and (iii) division of labor. They studied a set of six Asian countries different from the set concerned here, but overlapping with it partially as it included Japan, the Republic of Korea, and Malaysia. The relevance of analyzing the challenge of the same three legal areas posed by financial crises in the set of affected countries should be evident.

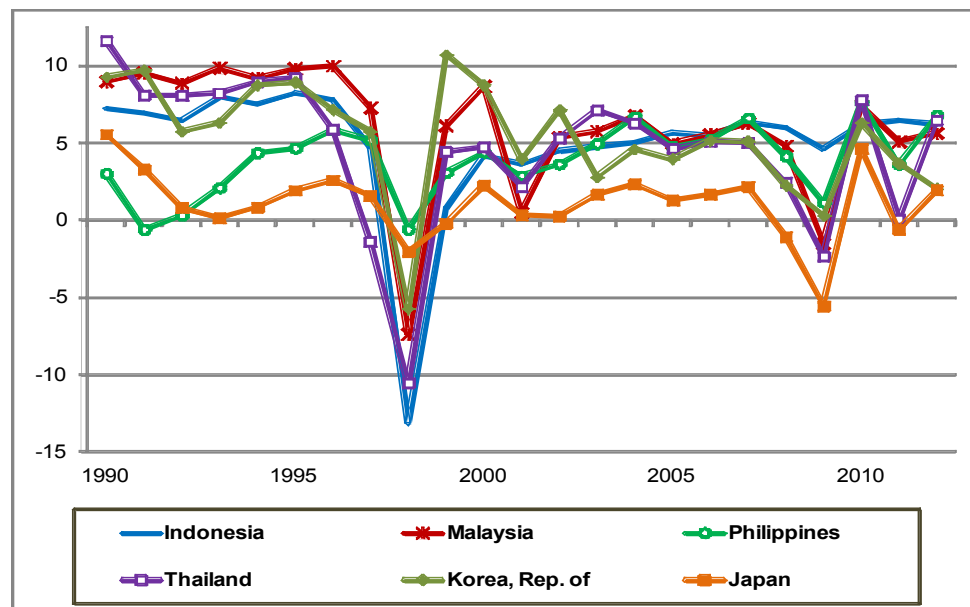
### **3. ISSUES IN BANK AND CORPORATE RESTRUCTURING**

#### **3.1 Impact of the Crisis on Growth**

The Asian financial crisis of 1997–1998 devastated the economies of Indonesia, the Republic of Korea, Malaysia, and Thailand and adversely affected several neighboring countries including the Philippines. The crisis—a combination of currency and banking crises—was driven by rapid capital inflows followed by equally rapid outflows. The banking sectors of the affected countries played a critical role in intermediating large amounts of domestic savings and external, foreign-currency-denominated short-term funds for long-term domestic lending of dubious quality, thereby creating the “double mismatch” problem and the potential for banking crises. The countries’ corporate sectors, which had expanded both debts (domestically and externally) and domestic investments, faced difficulties in repayment when the currency values began to decline sharply.

Japan’s banking crisis in 1997–1998 was domestically driven; it was a result of the collapse of the asset price bubble in the early 1990s and the lack of a decisive comprehensive strategy to address the banking sector problem at an early stage of the asset-price bust. The asset-price bubble in the late 1980s had been created by the optimistic expectations of ever-rising land prices in Japan, an overextension of bank loans to corporations with land as collateral, the absence of a credit culture to assess and price credit risks of borrowers rigorously, and weak macro-prudential supervisory frameworks. Slow policy responses allowed a systemic banking crisis to emerge in 1997–1998 and led to the resulting long-term stagnation.

The crisis-affected emerging Asian countries saw a sharp contraction of economic activity in 1998 (Figure 1). GDP growth in the five crisis-affected emerging economies of Asia—Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand—declined sharply from a pre-crisis average of positive 7.1% during 1990–1996 to negative 7.6% in 1998. The depth of the collapse in Indonesia, with GDP contracting by more than 13% in 1998, was among the largest peacetime contractions, excluding the experience of several transition economies in the early 1990s. Japan’s decline in GDP growth was more modest than those in emerging Asian economies—except the Philippines—but its GDP growth remained low afterwards. The concurrence of economic contractions in the affected economies in 1998 was remarkable.

**Figure 1: Real GDP Growth Performance for Crisis-Affected Asian Economies**

Source: IMF, World Economic Outlook database (October 2013)

The contractions were sharp but short-lived, with a solid V-shaped economic recovery in 1999 partly due to favorable global economic conditions, although post-crisis average growth rates were lower than in the pre-crisis period. The strength and pace of recovery varied significantly across countries; the Republic of Korea saw the fastest and strongest growth with only a temporary loss of output due to the crisis and returned quickly to the pre-crisis output trend, while Indonesia, Malaysia, and Thailand suffered large declines with semi-permanent loss of output. The impact of the crisis on the Philippines is less obvious as the country had been stagnant since the mid-1980s. Japan's economic recovery was slow and prolonged, resulting in the lost two decades.

The financial crises prompted the governments to implement aggressive policies to tackle the problem. Indonesia, the Republic of Korea, and Thailand invited the International Monetary Fund (IMF) to intervene and received liquidity support as well as policy advice on bank and corporate restructuring and on macroeconomic policy adjustments and structural reforms. Malaysia did not invite the IMF, but received quick-disbursing adjustment loans and policy advice from the World Bank, particularly on bank and corporate restructuring.

### 3.2 Bank Restructuring

Bank restructuring was one of the most important policy foci for crisis management and response in Asian crisis-affected economies. It was only at later stages that corporate restructuring became prominent in the policy agenda. It was then learned that strategies for bank and corporate restructuring needed to be closely linked. Bank restructuring had to be done in tandem with corporate restructuring, particularly when the scale of corporate insolvency was huge and the size of NPLs large. One reason was that owners of failed or weak banks had no incentive to restructure their borrowers' debt (or their NPLs) because, if they had realized losses, the resulting write-down of capital would have brought on government intervention and they would have lost control of their banks. Another was that if solvent but illiquid corporations, along with assets of insolvent corporations, had not been restructured to put them back into

operation, distress in the banking sector would have continued and the costs of debt restructuring would have risen as assets lost value and recovery rates fell.

Bank restructuring had several stages (Table 1A): (i) stabilization of the banking system by restoring the confidence of depositors and creditors through the establishment of a deposit insurance system and the provision of liquidity support to troubled banks; (ii) stoppage of the bleeding by way of intervening in clearly nonviable and insolvent banks, through liquidation (closures), mergers with healthier banks, or temporary nationalization of nonviable banks, which often required a clear legal and operational groundwork; (iii) recapitalization and rehabilitation of weak but viable financial institutions, which required recognition of losses on NPLs, costs to existing owners to avoid a future moral hazard such as changes in ownership and management, and renewed incentives to restructure NPLs of viable borrowers; (iv) effective prudential regulation and supervision, which enforced capital adequacy, loan classification, provisioning rules, and improvements in accounting and disclosure rules to bring them into line with international standards; and (v) strengthening of bank credit cultures and management by introducing more competition and risk management practices.

**Table 1: Agendas for Bank and Corporate Restructuring**

A. Bank Restructuring	B. Corporate Restructuring
<b>1. Establish institutional framework</b> <ul style="list-style-type: none"> <li>• Deposit insurance</li> <li>• Liquidity support</li> </ul>	<b>1. Create enabling environment</b> <ul style="list-style-type: none"> <li>• Removing obstacles for mergers (legal)</li> <li>• Ease of debt equity swaps (legal)</li> <li>• Security interests (legal)</li> <li>• Tax incentives</li> <li>• Foreign ownership liberalization</li> <li>• Labor market flexibility</li> </ul>
<b>2. Resolve nonviable banks</b> <ul style="list-style-type: none"> <li>• Liquidate</li> <li>• Nationalize or absorb into other banks</li> </ul>	
<b>3. Recapitalize viable banks</b> <ul style="list-style-type: none"> <li>• Capital support programs from government</li> <li>• Foreign bank or strategic buyers</li> <li>• Stop-loss, put-back for strategic buyers</li> <li>• Foreign or domestic equity capital markets</li> </ul>	
<b>4. Resolve or restructure NPLs</b> <ul style="list-style-type: none"> <li>• Recognize full extent of NPLs</li> <li>• System-wide carve-out of NPLs</li> <li>• Restructuring of viable NPLs</li> <li>• Tax &amp; other incentives for NPL restructuring</li> <li>• Foreclosure of nonviable NPLs</li> <li>• Sale of NPLs in the secondary market</li> </ul>	<b>2. Establish out-of-court mechanisms</b> <ul style="list-style-type: none"> <li>• Basic voluntary framework in place</li> <li>• Adequate incentives to participate</li> </ul>
<b>5. Revamp regulatory frameworks for banking sector</b> <ul style="list-style-type: none"> <li>• Stronger prudential norms</li> <li>• Effective bank supervision and examination</li> <li>• Enforcement of bank regulation</li> </ul>	<b>3. Strengthen bankruptcy and foreclosure systems</b> <ul style="list-style-type: none"> <li>• Quality of bankruptcy law</li> <li>• Enforcement and judicial capacity in bankruptcy system</li> <li>• Foreclosure and insolvency procedures</li> </ul>
<b>6. Strengthen bank credit cultures and management</b> <ul style="list-style-type: none"> <li>• Bank consolidation</li> <li>• Foreign bank buy-ins</li> <li>• CAMELS rating for banks</li> <li>• Proper NPL definition, interest accrual, provisioning norms</li> <li>• Credit risk rating, scoring and monitoring systems</li> </ul>	
<b>4. Improve corporate governance</b> <ul style="list-style-type: none"> <li>• Effectiveness of ownership oversight and boards of directors</li> <li>• Shareholder rights and protection</li> <li>• International accounting, auditing and disclosure standards</li> </ul>	

CAMELS = capital adequacy, asset quality, management quality, earnings, liquidity, sensitivity to market risk;

NPL= nonperforming loan,  
Source: Kawai (2000)

An important principle of bank restructuring was that the longer it took, the larger the eventual economic costs. Weak banks would have continued to accumulate assets that were likely to go bad, or bank owners would have lent to connected enterprises in the optimistic expectation that the loans would be repaid sometime in the future. The restoration of banking system health helped resume creditflows and economic activity in crisis-affected countries, although economic recovery took much longer in Japan than in emerging Asian economies.

### 3.3 Corporate restructuring

The phrase “corporate restructuring” is used to refer to both corporate debt and operational restructuring. Corporate debt restructuring may include debt rescheduling (an agreed-on rollover of loan principal and interest payments), debt-for-equity swaps, foreclosure, and forgiveness of principal and/or interest. Corporate operational restructuring may include asset sales to reduce debt levels, reductions in employment and production capacity, changes in the line of business, and closure of production facilities.

The governments of Asian crisis-affected countries implemented a broad, complex agenda for corporate restructuring (Table 1B). This included several steps: (i) creating the enabling environment for corporate restructuring by way of eliminating legal, tax, and regulatory obstacles (such as tax policies that impeded corporate reorganizations, mergers, debt-for-equity swaps, and debt forgiveness; restrictions on the participation of foreigners as holders of domestic equity and investors in domestic banks; and labor laws and other existing laws and regulations that hindered debt restructuring); (ii) establishing a policy framework to facilitate out-of-court settlements, which were considered more efficient than court resolutions, and the facilitation of an orderly voluntary restructuring of debts—referred to as the “London approach” of the International Federation of Insolvency Professionals (INSOL);<sup>3</sup> (iii) strengthening or introducing effective bankruptcy and foreclosure procedures to create appropriate incentives and “threats” for creditors and debtors to reach out-of-court settlements; and (iv) improving corporate governance by increasing the extent of disclosure, curbing the power of large inside shareholders, putting in place a sizable number of outside shareholders, and making the financial system competitive and efficient.

Bankruptcy procedures had to be strengthened as part of debt resolution strategies to ensure that nonviable firms would not continue to absorb credit and that a creditor bank could recover the maximum value of the claims submitted to the insolvent debtor corporation. Although informal out-of-court settlements were considered more efficient than court settlements, an effective bankruptcy system was considered necessary and enforcement of bankruptcy procedures had to become a credible threat as an alternative to out-of-court settlements (see Kawai 2000; Kawai, Lieberman, and Mako 2000).

Better corporate governance was expected to attract investment, improve management efficiency, and stimulate longer-term growth. The introduction of a sizable number of

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<sup>3</sup> There was a strong consensus that corporations had a better chance of survival under the London approach or provisions similar to Chapter 11 of the US bankruptcy code. In much of Europe, debt restructuring is negotiated out of court to avoid formal insolvency proceedings, which are often seen as unpredictable and lengthy, without any formal binding rules of engagement. The court-based procedure, including Chapter 11, has the advantage of being transparent in comparison to out-of-court settlements.

outside (often foreign) shareholders was complemented by reforms in board composition, structure and responsibility, as well as by improvements in minority shareholder rights in order to ensure effective board oversight of management. Legislative changes were needed and made to pursue these reforms.

### 3.4 Coordinated Approach to Bank and Corporate Resolution

To resolve the troubled assets of banks, it was necessary to work on the underlying problem of bad loans to the corporate sector. For this purpose, the governments of crisis-affected economies forged strong links between bank and corporate restructuring. The governments and central banks had to find a credible mechanism that would encourage banks to recognize losses and restructure failing corporations, as an individual bank might not have sufficient incentive to adopt drastic measures such as write-downs and debt–equity swaps, thus leaving “zombie” borrowers intact.<sup>4</sup> Without well-functioning bankruptcy courts, registries of security interests and foreclosure procedures, creditor banks would have no incentive to make concessions to debtors. Nor would corporate debtors have incentives to negotiate with creditor banks without new funds coming in. Without credible court enforcement of contract law or trusted out-of-court mechanisms, corporate debtors might resort to strategic defaulting. In a sense this was a “prisoner’s dilemma” because of the lack of mechanisms to support creditor–debtor coordination.

Recognizing this, the authorities of crisis-affected countries introduced a host of measures to help coordinate policy and to carry out institutional and legal actions for bank and corporate restructuring. Table 2 summarizes the institutional designs created by these governments and central banks to coordinate bank and corporate restructuring, so that a socially optimum outcome would be reached. The authorities identified major support institutions for restructuring and created or nominated agencies for bank recapitalization, asset purchases and management, and corporate debt restructuring. A bank in trouble because of nonperforming loans on its books could sell them to an asset management company. If the bank remained in financial trouble and was unable to raise sufficient capital from shareholders and the market, it could seek assistance from a recapitalization agency for public recapitalization. Meanwhile, a debt restructuring agency acted as an informal mediator, often adopting the London rules approach, and facilitated voluntary negotiations between borrowers and their creditors to achieve voluntary restructuring schemes. These agencies attempted to link their efforts as much as possible.

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<sup>4</sup> Caballero, Hoshi, and Kashyap (2008) discuss the problem of “zombie” corporations. They propose a model that highlights the implications of the zombie problem for restructuring. The congestion created by “zombie” corporations reduces the profits of healthy firms, discouraging their entry and investment. In the presence of zombie firms, economic recovery is delayed significantly.



**Table 2. Institutional Frameworks for Bank and Corporate Restructuring in Asia**

Country	Major Support Institution	Agency for Bank Recapitalization	Asset Management Company	Agency for Voluntary Corporate Restructuring
<b>Indonesia</b>	Indonesian Bank Restructuring Agency (IBRA)	Direct from Bank Indonesia (BI) or via IBRA	IBRA	Jakarta Initiative Task Force (JITF)
<b>Malaysia</b>	Bank Negara Malaysia (BNM)	Danamodal	Danaharta	Corporate Debt Restructuring Committee (CDRC)
<b>Thailand</b>	Bank of Thailand (BOT)	Financial Restructuring Advisory Committee (funded by the Financial Institutions Development Fund)	FRA to take assets of closed finance companies; unsold assets moved to AMC and good assets to RAB. TAMC for commercial banks	Corporate Debt Restructuring Advisory Committee (CDRAC)
<b>Republic of Korea</b>	Financial Supervisory Service (FSS)	Korea Deposit Insurance Corporation (KDIC)	Korea Asset Management Corporation (KAMCO)	Corporate Restructuring Coordination Committee (CRCC)
<b>Japan</b>	Financial Services Agency (FSA)	Deposit Insurance Corporation (DICJ)	RCC and IRC	None. Oversight by FSA

FRA = Financial Sector Restructuring Authority; AMC = Asset Management Corporation; RAB = Radanasin Bank; TAMC = Thai Asset Management Corporation; RCC = Resolution and Collection Corporation; IRC = Industrial Revitalization Corporation.

Source: Kawai (2000, 2005)

These institutional designs were backed up by revamped legal frameworks for corporate insolvency, establishment of bankruptcy courts, and the creation of procedures for out-of-court workouts.

For example, the Indonesian authorities' strategy for corporate restructuring included several elements: (i) establishment of the Indonesian Bank Restructuring Agency (IBRA) as a major support agency for bank and corporate restructuring and as an asset management company; (ii) introduction of the Jakarta Initiative and the Jakarta Initiative Task Force (JITF) to facilitate voluntary negotiations between debtors and creditors for corporate restructuring and to provide a regulatory "one-stop shop" for administrative procedures pertaining to debt resolution; (iii) introduction of a new and improved bankruptcy system and a special commercial court to provide a credible threat (out-of-court settlements); and (iv) establishment of the Indonesian Debt Restructuring Agency under the Frankfurt Agreement to provide foreign exchange cover for Indonesian corporations with foreign currency-denominated debt once they reached debt restructuring agreements.

The government took several steps to accelerate corporate debt restructuring and asset recovery. First, an interagency committee, comprising representatives from Bank Indonesia, IBRA, and the Ministry of Finance, was formed to implement and monitor the restructuring and asset recovery process. Second, the names of debtors were made public to induce corporate debtors to begin settlement negotiations. Many of these corporate debtors signed letters of commitment indicating a willingness to negotiate a settlement as the government said it would take legal actions against uncooperative corporations that failed to reach a restructuring agreement with IBRA. Third, commercial courts were established to offer credible bankruptcy procedures to induce corporate debtors to negotiate voluntarily. Disclosure rules were strengthened to discourage strategic defaulting of solvent debtors. A new Secured Transactions Law encouraged creditors to provide new working capital.

Malaysia established a solid institutional framework for tackling bank and corporate restructuring in unison. The authorities created three agencies—Danaharta, Danamodal, and the Corporate Debt Restructuring Committee (CDRC)—to carry out a comprehensive restructuring of the banking and corporate sectors.<sup>5</sup> A bank in trouble could transfer its NPLs to Danaharta and have it sell them. If the bank was unable to raise sufficient capital from shareholders, it could seek assistance from Danamodal for recapitalization, diluting the original shareholders. In exchange, Danamodal could facilitate consolidation of the banking sector by selling its stake to a stronger bank and thereby fostering bank mergers. Meanwhile, the CDRC acted as an informal mediator, facilitating dialogue between borrowers and their creditors to achieve voluntary restructuring schemes. When the CDRC could achieve this, NPLs were resolved voluntarily. When it could not, Danaharta would take over the bad loans, disposing of them over the long term.

The Thai government established the Financial Sector Restructuring Agency to take assets of closed finance companies and the Asset Management Corporation to absorb unsold assets. It also established the Corporate Debt Restructuring Advisory Committee (CDRAC) to coordinate debt restructuring and developed the Framework for Corporate Debt Restructuring, an adaptation of the London rules approach. This permitted debtors to negotiate with multiple creditors to reach voluntary agreements. Relative to the magnitude of the problem, corporate debt restructuring through this framework slowly began to yield results. In contrast to the situation in other crisis-affected countries, small and medium-sized enterprises (SMEs) in Thailand accounted for more than two-thirds of aggregate corporate debt; therefore, restructuring required far more effort. The Thai judicial system slowly began to demonstrate its determination to enforce the revised bankruptcy and foreclosure procedures to prompt strategic defaulters to resume paying their debts.

The Philippines did not experience systemic crises in the banking or corporate sector and, as a result, did not face the urgent need to develop a systemic approach to banking and corporate sector crisis resolution. However, realizing the economy's structural weaknesses, the government acted to strengthen the banking sector and the supervisory and regulatory framework. Debt restructuring was carried out on an informal or formal basis according to procedures dictated by the existing legal framework for insolvency. When informal debt resolution proved impossible, a distressed corporation could petition the Securities and Exchange Commission (SEC) for protection from its creditors. The SEC then had the power to: (i) impose stays of actions by creditors against corporate debtors, (ii) permit debtors to suspend payments to their creditors, (iii) decide whether a debtor should be liquidated or be permitted to attempt rehabilitation, and (iv) liquidate debtors and appoint receivers, members of management committees, and liquidators.

The Korean government created an independent agency, the Financial Supervisory Commission (FSC), in 1997 to supervise and restructure all banks and nonbank financial institutions. This agency was later expanded into the Financial Supervisory Service (FSS) in 1999 by merging four financial supervisory agencies (banks, nonbanks, securities, and insurance). The government set up a special fund within the Korea Asset Management Corporation (KAMCO) in 1997 to which banks were allowed to sell their NPLs. Later in the year, KAMCO was moved from the Ministry of Finance

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<sup>5</sup> Danaharta was an asset management company with functions similar to those of the US Resolution Trust Corporation; Danamodal Nasional Berhad was established to recapitalize the banking sector, especially to assist banks whose capital base had been eroded by losses; and CDRC was established to reduce stress on the banking system and to repair the finances and operations of corporate borrowers.

and Economy to the control and supervision of FSC as a public agency, or a bad bank, to manage nonperforming assets. As 64 *chaebols* (conglomerates) accounted for the bulk of corporate debt in the Republic of Korea, the government had to take decisive measures to: (i) reduce corporate debt-to-equity ratios; (ii) remove cross-guarantees between subsidiaries within a *chaebol*; and (iii) enforce business swaps (“Big Deals”) among largest *chaebols*.<sup>6</sup> The five largest *chaebols* agreed to Capital Structure Improvement Plans (CSIPs) to undertake (i) and (ii) above. Although creditor banks accepted the CSIPs of the top five *chaebols*, they did not play a role in the restructuring process, at least until a later stage. The “6–64” *chaebols* also agreed on CSIPs with their creditor banks and pursued corporate restructuring. Other companies applied to the formal workout program within the Corporate Restructuring Coordination Committee framework.<sup>7</sup>

The Japanese government introduced a framework for voluntary, multi-creditor out-of-court negotiations for corporate restructuring—using the London rules of the INSOL International. This was based on the recognition that, while legal insolvency procedures would secure transparency, they lacked the speed and flexibility needed for efficient corporate debt restructuring. However, the major focus of this voluntary framework was on setting guidelines for debt forgiveness, rather than on a comprehensive debt restructuring negotiation process.

The government established two asset management companies, the Resolution and Collection Corporation (RCC) and the Industrial Revitalization Corporation of Japan (IRCJ). These were designed to accelerate corporate restructuring and the disposal of NPLs through purchases of such loans from banks, while each targeting different types of loans and corporations. The RCC was essentially a collection company that purchased and sold collateralized NPLs from firms classified as “in danger of bankruptcy” or “bankrupt,” focusing on smaller, nonviable firms.<sup>8</sup> The IRCJ, in contrast, focused on higher-quality NPLs—classified as “need special attention”—for larger firms.<sup>9</sup> The objective was to promote restructuring of relatively large, troubled but viable firms by purchasing their loans from secondary banks, leaving the main bank and the IRCJ as the only major creditors.

### 3.5 Broader Reforms in Substantive and Procedural Law

In crisis-affected countries, the revamping of legal frameworks for bank and corporate restructuring may have raised awareness of the need for legal reforms and of efforts to increase the effectiveness and efficiency of justice in subsequent years. Even legislators or judges whose institutional environments may not have predestined them to become legal reformers were found leading legal reform initiatives for economic

<sup>6</sup> The top five *chaebols* implemented “Big Deals” involving key business areas—such as automobiles and semi-conductors—with the objectives of reducing overcapacity and high leverage and focusing on core competency. By the end of 2000, business swaps in the four industries of oil refinery, semiconductors, vessel engines, and power plant equipment were completed, followed by aerospace, petrochemical, and rolling stock. The top *chaebols*’ restructuring through “Big Deals” and mergers of firms that competed in the same industries began to realize economies of scale and enhance the global competitiveness of Korean firms.

<sup>7</sup> Corporations classified as financially weak but viable began bank-led rehabilitation, referred to as “workout programs.” Workout programs were implemented through debt-to-equity swaps among companies that were still viable and competitive but suffered from a temporary liquidity shortage.

<sup>8</sup> Its function was subsequently strengthened by allowing it greater flexibility to decide the purchase price—i.e., at fair value—and to buy NPLs from healthy institutions.

<sup>9</sup> It purchased loans for two years and disposed of them within three years of purchase.

development. Indonesian legislators took advantage of the end of the Suharto regime to pass new laws governing finance and competition. Malaysia's and Thailand's judiciaries initiated efforts to reduce court backlogs and the duration of civil procedures. In Japan, the Koizumi government took the unprecedented step in 2002 to force banks to write down the remaining NPLs on their balance sheets.

Interestingly, all these countries adopted similar approaches to bank and corporate restructuring and legal reforms, despite the considerable variation in the six countries' legal systems and stages of economic and legal development. The countries underwent similar experiences of crisis response, resolution and legal reforms. This is partly explained by the fact that the same international financial institutions (IFIs)—the IMF, the World Bank, and the Asian Development Bank—intervened in Indonesia, the Republic of Korea, and Thailand, and assisted them in bank and corporate restructuring by recommending international best practices for bank and corporate restructuring and legal and judiciary reforms. Malaysia was not subjected to IMF programs but did receive adjustment loans and policy advice from the World Bank which led to an approach similar to those employed in other countries. Japan was the only country that was not subject to intervention or assisted by these IFIs, but nonetheless it quickly adopted similar best practices for legal reforms. Thus, there was a remarkable commonality in the actions taken to create the enabling legal environment for both immediate crisis resolution through bank and corporate restructuring and more sustained economic growth and development through fundamental legal reforms.

## **4. COUNTRY EXPERIENCES OF INSTITUTIONAL AND LEGAL REFORMS**

### **4.1 Indonesia's Legal Reforms**

When the financial crisis erupted, Indonesia's Bankruptcy Law, which had been introduced in 1905 during the Dutch colonial rule, was dysfunctional. Facing the need to support resolution of systemic corporate insolvencies, the Bankruptcy Law was amended in 1998 to promote prompt and fair resolution of commercial disputes and provide a framework to encourage debtors and creditors to seek out-of-court settlements. To expedite dispute resolution, the authorities also established the Commercial Court (Pengadilan Niaga) in 1998. Initially, the Commercial Court was intended to handle only bankruptcy and insolvency applications, but its jurisdiction was extended to other commercial matters. Appeals from the Commercial Court proceed directly to the Supreme Court. Due to inadequacies in the amendments and fundamental problems in the judiciary system, a completely new Indonesian Bankruptcy Law (Law Number 37 of 2004 on Bankruptcy and Suspension of Payment) was introduced in 2004.

**Table 3: Legal and institutional changes to facilitate corporate restructuring: Indonesia**

Year Changed	Laws, Procedures, and Institutions	Contents
January 1998	Establishment of the Indonesia Bank Restructuring Agency (IBRA)	Oversight of financial sector rehabilitation
February 1998	Amendment to Corporate Annual Financial Information (No.24, 1998)	Obligations for companies to submit financial report
July 1998	Establishment of Indonesia Debt Restructuring Agency (INDRA)	Enabling debtors to eliminate exchange rate risk on future debt service payments
September 1998	Establishment of Jakarta Initiative Task Force (JITF)	Facilitating out-of-court workout procedures and negotiations to restructure corporate debt (until December 2003)
September 1998	Amendment to Bankruptcy Law (No.4, 1998)	Promotion of prompt and fair resolution of commercial disputes; provision of a framework to encourage debtors and creditors to seek out-of-court settlements.
September 1998	Establishment of Commercial Courts	Processing petitions for declaration of bankruptcy and moratorium of debt repayment
March 1999	Prohibition of Monopolistic Practices and Unfair Business Competition (No.5, 1999)	Provision of a comprehensive legal framework for business competition policies.
1999	Establishment of the National Committee on Corporate Governance (NCCG)	Publication of the Code for Good Corporate Governance
2003	State-Owned Enterprises Law (No.19, 2003)	Comprehensive legislation governing state-owned enterprises
2004	Law on Bankruptcy and Suspension of Payment (No.37, 2004)	Provision of clarity to details such as time frames, the rights of the various parties to enhance the efficiency of bankruptcy processes

Source: Lek&Co Lawyers, Indonesian Bankruptcy Law Blog, various posts, [www.indonesiabankruptcylaw.com](http://www.indonesiabankruptcylaw.com); Maarif (2001); Sato (2005); and Booth (2009).

Although there had been a movement in favor of "healthy business competition" in the early 1990s among Indonesian scholars, political parties and some government institutions, the financial crisis became the proximate cause of such legislation in 1999. Following a letter of Intent to the IMF, the Indonesian government submitted a draft antimonopoly law to the parliament, which enacted it in March 1999. The basic structural purpose of the law was to deconstruct the patron–client social structure that had been part of Indonesian business culture through the pre-colonial, colonial and post-independence periods (Maarif 2001). This was a big step toward improving the quality of Indonesia's legal system.

After the end of the authoritarian Suharto era in 1998, the first task for the reform of the judiciary was to bring it into line with the process of democratization. In a country characterized by regional, ethnic and religious diversity, democratization also meant decentralization, or what Hill (2013) calls the transformation of Indonesia into "a federal state" in all but name. These two imperatives dictated two priorities for the judiciary: ending the control of the courts by the military (Ricklefs 2001) and establishing new courts in newly created provinces and districts. The first priority meant rapidly recruiting

new judges untainted by the legacy of corruption of the old regime, and the second allocating fiscal resources for a massive expansion of judicial infrastructures. Neither was easy or fast. Each of the 260 new districts required a new (first instance) district court and each of the eight new provinces a new (appellate) high court. A new Constitutional Court was created, in addition to the existing Supreme Court. The recruitment of judges and investments in court infrastructure were enormous and posed significant challenges to the implementation of laws.

Not surprisingly, decentralization was a source of uncertainty for post-crisis recovery in Indonesia. Given the magnitude of the fundamental reforms to be undertaken, Indonesia's legal transformation has faced conflicting interests, involved high costs, and required a long time horizon.

## **4.2 Malaysia's Approach**

Malaysia's bankruptcy law is governed by the Bankruptcy Act of 1967, derived from the English Bankruptcy Act of 1883, which governed trade and commerce in England. Although English common law and legislation was a colonial transplant to Malaysia, the Bankruptcy Act had been adapted in accordance with local needs and had thus evolved into a distinct insolvency law. The Bankruptcy Act was amended a few times, including in 1988 and 2000 (which came into force in 2003). The objective of the most recent amendment was to keep abreast with international changes in the law relating to insolvency. The amended act adopted a unitary approach to the administration of insolvency, under the Insolvency Department headed by the Director General of Insolvency.

The corporate restructuring framework—comprising Danaharta, Danamodal, and the Corporate Debt Restructuring Committee—worked reasonably well, with a few amendments to the Bankruptcy Act, although the judicial side remained a challenge.

**Table 4: Legal and Institutional Changes to Facilitate Corporate Restructuring: Malaysia**

Year Changed	Laws, Procedures and Institutions	Contents
June 1998	Creation of Danaharta (national asset management company)	Removal of nonperforming loans from the banking system to assist corporate restructuring (until December 2005)
July 1998	Creation of Danamodal	Recapitalization of viable banks
July 1998	Creation of the Corporate Debt Restructuring Committee	Mediation of voluntary out-of-court debt restructuring
March 2000	Code on Corporate Governance	Regulations governing the board of directors, supply of information, accountability and audit, shareholders' rights and protection, evaluation, disclosure and transparency
March 2001	Financial Sector Masterplan	Reform recommendations on banking sector, insurance sector, Islamic banking and <i>takaful</i> (Islamic insurance), development of financial institutions and offshore finance market
October 2003	Amendment to the Bankruptcy Act of 1967 in force	Adoption of a unitary approach to the administration of insolvency
July 2005	Malaysia Deposit Insurance Corporation Act of 2005	Facilitating execution of bank resolution processes
September 2008	Establishment of New Commercial Courts	Improving the efficiency of enforcing contracts

Source: Law Business Research (2013), Malaysia entry (pp. 308–319); Booth (2009); Cooper (2009); Khoo (2013).

A World Bank report (World Bank 2011) requested by the Malaysian judiciary on progress of reforms initiated in 2008 revealed that, since the 1980s, the judiciary as a whole had gone through a period of declining performance and public confidence. Malaysia's ratio of judges per 100,000 inhabitants ranged between 1.5 and 2.4 (depending on whether members of the Judicial and Legal Service assigned to the courts were included). This was very low compared with ratios in other countries at a comparable level of development within and outside Asia. Hence, cases commonly took unpredictable periods of time to resolve, depending on the disposition of the judge and the actions exercised by the lawyers. Each judge operated in relative isolation, leading to considerable variations in how cases were processed, and an often disorganized management of internal administration.

A first significant step to reduce case backlog and procedural delay was the introduction of pre-trial case management into the Rules of the High Court in 2000. This move was intended to take control of the progress of a case out of the hands of the attorneys and to give it to the court, thereby reducing a good deal of unnecessary delay. To allow the High Court divisions in charge of civil and commercial law to reduce their backlog of cases, New Commercial Courts and New Civil Courts were created as part of the 2008 reform program. These were to receive only new cases filed after their establishment. In April 2010, the judiciary introduced the possibility of court-annexed mediation for commercial, family, and other civil cases. By September 2010, the number of pending cases had been reduced by two-thirds, from 3,759 to 1,228. But, of course, reducing the backlog does not mean shorter disposition times and higher clearance rates for newly filed cases. The World Bank recommended that better trained judges, especially in first-instance courts, should take the pace of procedures out of the hands of attorneys and enable cases to be managed more actively and efficiently than in the past (World Bank 2011).

Judging by the time that had passed since Malaysia's independence without major legal reforms, a catalytic effect such as the financial crisis was clearly needed to open the prospect of a much more ambitious judicial reform in line with the World Bank's suggestions. Malaysia's judiciary has recognized the problem; it will have to allocate bigger budgets for legal education and training of future generations of first instance judges.

### **4.3 Thailand's Legal Reforms**

The Thai Bankruptcy Act of 1940 was patterned after the English Bankruptcy Act of 1914. There was no rehabilitation or reorganization mechanism for business entities. The main purpose of the crisis-induced amendments in 1998 and 1999 was to add such provisions. The result was a hybrid of the US pattern of reorganization under Chapter 11 and the English pattern of rehabilitation modeled on English insolvency law (Wisitsora-At 2005). Whereas previously bankruptcy cases fell into civil court competence, the urgency of the financial crisis required them to be dealt with quickly without being held up by the backlog of other civil law cases, and the Bankruptcy Court was established in 1999. The sustained numbers of new reorganization cases filed with the court as well as of bankruptcy filings since 1999 suggests that the reform was accepted and effective.



**Table 5: Legal and institutional changes to facilitate corporate restructuring: Thailand**

<b>Year Changed</b>	<b>Laws, Procedures, and Institutions</b>	<b>Contents</b>
October 1997	Establishment of Financial Sector Restructuring Authority (FRA)	Processing early disposal of NPLs held by finance companies to reconstruct the financial system.
October 1997	Establishment of Asset Management Corporation (AMC)	Facilitating early disposal of NPLs held by finance companies
April 1998	Amendment to the Bankruptcy Act of 1940 (No.4, 1998)	Adding a new chapter to the act to enable reorganization of potentially viable corporations
June 1998	Establishment of the Corporate Debt Restructuring Advisory Committee (CDRAC)	Facilitating informal workouts and voluntary processed of corporate restructuring (based on the London Approach)
September 1999	Establishment of Central Information Services Co., Ltd.*	Gathering of loan data from financial institution members
March 1999	Further amendment to the Bankruptcy Act (No.5, 1999)	Strengthening the principal provisions of the 1998 amendment
June 1999	Establishment of Bankruptcy Courts (Central Bankruptcy Court, Regional Bankruptcy Court, and Bankruptcy Division, Supreme Court)	Jurisdiction over all bankruptcy cases and all civil matters pertaining to bankruptcy cases
June 2001	Establishment of Thai Asset Management Corporation (TAMC)	Resolving NPL problems of state-owned and private financial institutions (until 2013)
November 2002	Credit Information Business Act	Regulation of the credit information business, including the operators, their rights and obligations, and privacy protections of credit information
2002	Establishment of National Corporate Governance Committee (NCGC)	Setting policies, measures, and schemes to upgrade the level of corporate governance among institutions, associations, corporations and government agencies in the capital market.
2006	Regulations for bankruptcy cases	Major new regulations and amendments to the Bankruptcy Act to deal with bankruptcy and reorganization procedural matters

\* The name changed to the National Credit Bureau, Co., Ltd. from May 2005.

Source: Law Business Research, Thailand entry, pp. 486–492 (2013); Dasri (2004); Booth (2009); Cooper (2009).

The caseload in Thai civil courts has dramatically increased since the early 1990s. This has resulted in case backlogs and delays in court proceedings. To promote access to justice and to address increasing delays in court proceedings, the Thai judiciary recognized the need to implement measures to increase procedural efficiency. Chief among these were the introduction of case management—such as pre-trial conferences and a fast track/regular track division of cases—and court-annexed mediation. In 2000, the Civil Court started providing an option for parties to refer cases to mediation before the first hearing day. This has helped parties settle their cases before the onset of costly and time-consuming litigation (Phitaiyaporn 2003).

#### **4.4 The Philippines' Legal and Judicial Reforms**

In the Philippines, the Insolvency Act of 1909 was the principal legislation on corporate insolvencies, addressing suspension of payment, voluntary insolvency, and involuntary insolvency. Under this act, the judicial courts had jurisdiction over these proceedings. Presidential Decree (902–A) of 1976 expressly established the concept of rehabilitation (not insolvency), which applied only to corporations, and allowed the corporation to recover and to continue as a going concern. However, the decree lacked rules that would provide for an effective corporate recovery system. The Philippines Securities and Exchange Commission (SEC) adopted the first major set of rules and procedures on corporate recovery in 1999. In 2001, the Congress began to work on reviewing and updating the Insolvency Act, including the introduction of a fast track mechanism for informal workouts. In 2010, the Financial Rehabilitation and Insolvency Act was finally introduced and enacted to consolidate and codify scattered provisions on rehabilitation and liquidation into one comprehensive law.

**Table 6: Legal and Institutional Changes to Facilitate Corporate Restructuring: The Philippines**

Year Changed	Laws, Procedures and Institutions	Contents
November 1999	Rules and Procedures on Corporate Recovery	First major set of rules and procedures on corporate recovery adopted by Philippine SEC
April 2000	Amendment to the General Banking Law (R.A. 8791)	Promotion and maintenance of a stable and efficient banking and financial system; Foreign banks allowed to acquire up to 100% of the voting stock (effective within 7 years)
July 2000	Securities Regulation Code (R.A. 8799)	SEC's jurisdiction over the speedy resolution of disputes and complaints
2001	Review and beginning of the overhaul of the Insolvency Act of 1909 (Act No. 1956, 1909)	Work begun by Congress to update insolvency laws that deals with suspension of payments, voluntary insolvency, and involuntary insolvency
April 2002	Code of Corporate Governance	Regulations on the board of directors, supply of financial information, accountability and audit, shareholders' rights and protection, evaluation, disclosure and transparency
April 2004	Introduction of Alternative Dispute Resolution (R.A. 9285)	Encouraging and regulating arbitration, mediation, conciliation, mini-trial and early neutral evaluation
2007	Proposal for fast track mechanism for informal work-outs introduced	Special chapter in draft Corporate Recovery and Insolvency Act introduces idea of fast-track approach
September 2008	Credit Information System Act (R.A. 9510)	Establishment of a centralized credit information system
December 2008	Detailed rules of procedure governing rehabilitation issues	Supreme Court uses its rule-making power to create Rehabilitation Rules in 2000 & 2008
January 2009	Supreme Court Rules of Procedure on Corporate Rehabilitation (No. 00-8-10-SC)	Whole body of corporate rehabilitation developed, including procedural rules and key provisions that bordered on substantive laws
February 2010	Financial Rehabilitation and Insolvency Act	Enacted to consolidate and codify scattered provisions on rehabilitation and liquidation into one comprehensive law, through the establishment of a systematic framework for insolvency proceedings and provision of equitable treatment to all parties.

Source: Booth (2009); Cooper (2009); Lim (2013).

Sicat (2007) notes that the growth of the Philippine economy in the early years of independence, although significant (averaging 5.5% per year), was not at the same level as that of other "East Asian Miracle" countries, mainly because of restrictive policies towards foreign direct investment. These were inspired by the country's development strategy enshrined first in the Constitution of 1935 and retained ever since through successive constitutional changes. He also describes structural weaknesses in the legal system of the Philippines which are similar to those in Malaysia before the 2008 reforms, such as the small number of professional judges, case backlogs, and delays. Given the weaknesses of the formal legal system, the enactment of the law on Alternative Dispute Resolution (ADR) in 2004 is significant,

with an impact on the number of court cases dealing with commercial disputes (Sicat 2007).

Delays in court proceedings, expensive litigation fees, and the rigid and inflexible system of courts have encouraged parties to disputes to resort to several forms of other dispute resolution procedures. Considered to be an alternative to litigation, ADR procedures include arbitration, mediation, conciliation, mini-trials and early neutral evaluation. ADR methods are encouraged by the Philippine Supreme Court and were held to be valid and constitutional even before laws were enacted to regulate these procedures. It may be noted however, that the Supreme Court has in recent years begun pursuing various judicial reform projects to decongest courts and jails, improve case management, and increase access to justice. These projects include: (i) the Efficient Use of Paper Rule which promotes a paper-less system in the judiciary; (ii) Enhanced Justice on Wheels which uses mobile courts to provide legal aid to detainees as well as legal information in the local community; (iii) Small Claims Project which provides for an inexpensive, informal, and simple procedure for small money claims; and (iv) other projects to enhance the information technology capabilities of courts. All of these initiatives scope all cases brought before it including corporate recovery cases.

#### **4.5 Republic of Korea's Legal Reforms**

Major aspects of corporate restructuring in the Republic of Korea included exits or bankruptcy of non-viable companies, rehabilitation through workout programs for viable companies, and business swaps among *chaebols*. The principles of bankruptcy were adopted from the German legal system, which was introduced via Japan. The principles of rehabilitation were largely modeled on US federal law, such as Chapter 11 protections.

In June 1998 almost all Korean financial firms entered into the Financial Institutions Arrangement for Facilitating Corporate Restructuring (known as the Master Workout Arrangement), introducing an informal workout system into the Korean insolvency regime. The government subsequently enacted the Corporate Restructuring Promotion Act (effective from September 2001 until the end of 2005), which replaced the Master Workout Arrangement with the aim of facilitating and expediting informal workouts. This became the basic law governing out-of-court informal corporate rescue procedures.

**Table 7: Legal and Institutional Changes to Facilitate Corporate Restructuring: Republic of Korea**

<b>Year Changed</b>	<b>Laws, Procedures and Institutions</b>	<b>Contents</b>
1996	Revision of Supreme Court Rule on Corporate Reorganization Procedure of 1992 revision	Courts now able to exclude incumbent management from reorganization process and to disregard controlling shareholders responsible for mismanagement
June 1997	Creation of Financial Supervisory Commission (FSC)	Agency to supervise and restructure all banks and nonbank financial institutions
August 1997	Special fund set up in Korea Asset Management Corporation (KAMCO)	Banks allowed to sell their NPLs to KAMCO
November 1997	KAMCO reorganized under the supervision of FSC	KAMCO disposes of NPLs and assists with corporate restructuring
June 1998	Financial Institutions Arrangement for Facilitating Corporate Restructuring; creation of the Corporate Restructuring Coordination Committee (CRCC)	Introduction of voluntary procedures for corporate debt restructuring. FSC in charge of implementing major and voluntary work-outs (London approach)
December 1998	Revision of Commercial Law	Procedures for corporate splits introduced
January 1999	Establishment of Financial Supervisory Service (FSS)	An integrated financial supervisory authority over banks, nonbanks, securities, insurance
April 1999	Revision of KAMCO Law	Provision of bad bank function to KAMCO
October 2000	Financial Holding Company Law	Establishment of financial holding companies allowed
October 2000	Corporate Restructuring Investment Companies Act	Establishment of a corporate restructuring vehicle
February 2001	Rules on Regular Assessment of Corporate Credit Risk	Continuous corporate restructuring based on regular assessment results
March 2001	Revision of Corporate Reorganization Act	Shorten corporate restructuring procedures by introducing prepackaged bankruptcy
March 2001	Revision of Securities Investment Company Act	Establishment of mergers and acquisitions (M&A) fund
September 2001	Corporate Restructuring Promotion Act	Out-of-court informal workout program to help ailing firms and later financial institutions; reenacted in August 2007
December 2004	Revision of Indirect Investment Asset Management Act	Private equity fund for M&A purposes allowed
April 2006	Debtor Rehabilitation and Bankruptcy Act (DRBA)	New insolvency law governing all bankruptcy and reorganization proceedings in Korea in integrated fashion

Source: Law Business Research (2013), Korea entry (pp. 278–284); Oh (2007); Financial Supervisory Service.

In response to difficulties in reaching agreement between creditors and a lack of professionals in the management of insolvent firms, the government used KAMCO to promote corporate restructuring of insolvent firms and to address financial institutions' NPLs. The government also introduced a corporate restructuring vehicle through the Corporate Restructuring Investment Companies Act in October 2000.

In April 2006 the government introduced the Debtor Rehabilitation and Bankruptcy Act, also known as the Unified Insolvency Law. The act consolidated the Corporate Reorganization Act, the Composition Act, the Bankruptcy Act, and the Act on

Rehabilitation of Individual Debtors to establish systematic procedures for the rehabilitation and liquidation of insolvent firms and individuals. The act also established a rehabilitation procedure to modify and improve the previous reorganization procedure. As a result, the act provided for two corporate insolvency procedures: bankruptcy and rehabilitation.

## 4.6 Japan's Progress on Insolvency Reforms

Before recent reforms, the Japanese insolvency system consisted of two liquidation procedures—liquidation (*hasan*) and special liquidation (*tokubetsu seisan*)—and three reorganization procedures—corporate restructuring (*kaisha kosei*), civil rehabilitation (*minji saisei*) and corporate reorganization (*kaisha seiri*). Because these insolvency procedures were legislated separately long ago, the system was incoherent and outdated. To help accelerate corporate restructuring, more flexible procedures had to be introduced (Table 8). As a result, the Japanese legal system is no longer regarded as an impediment to corporate restructuring.

**Table 8: Legal and Institutional Changes to Facilitate Corporate Restructuring: Japan**

Year Changed	Laws, Procedures and Institutions	Contents
1997	Commercial Code	Procedures for corporate mergers rationalized
December 1997	Anti-Monopoly Law	Establishment of pure holding companies allowed
March 1998	Financial Holding Company Law	Establishment of financial holding companies allowed
July 1998	Financial Supervisory Agency created	To take over the functions of supervision and inspection of the financial system from MOF, with the policy planning function left with MOF
December 1998	Financial Reconstruction Commission (FRC) established	A parent body of the Financial Supervisory Agency, with oversight of the financial industry
1999	Commercial Code	Share swaps introduced; procedures related to parent and subsidiary companies rationalized
April 1999	Resolution and Collection Corporation (RCC)	A collection company to purchase and sell collateral-based NPLs—"in danger of bankruptcy" or blow
April 2000	Civil Rehabilitation Law ( <i>Minji Saisei Ho</i> )	Facilitates filings and decisions for large number of firms
July 2000	Financial Services Agency (FSA) newly established	To merge the Financial Supervisory Agency and the policy planning function of MOF
2000	Commercial code	Procedures for corporate splits introduced
September 2001	Voluntary procedures for corporate debt restructuring based on the London rules (by INSOL)	Guidelines for debt forgiveness agreed
April 2003	Corporate Restructuring Law ( <i>Kaisha Kosei Ho</i> )	Restructuring provisions eased and some flexibility allowed in the restructuring measures in line with those of the Civil Rehabilitation Law
April 2003	Industrial Revitalization Corporation of Japan (IRCJ)	Restructuring of large firms made easier through purchase of NPLs from all non-main bank creditors (until 2007)

Sources: Japan's Financial Services Agency; Japan's Ministry of Finance; OECD.

Japan's debate on how to remove the burden of NPLs on the balance sheets of banks was protracted and the balance sheet problems of commercial banks were effectively

addressed only in October 2002. The Financial Services Agency (FSA) enforced a fair value repricing of bank assets and rigorous write-downs of NPLs combined with recapitalization and restructuring of the banking sector. Only then did Japan's banks recover the ability to carry out financial intermediation and the Japanese economy to bounce back, although this bounce was not sufficient to reverse losses of the "lost decade" since the bursting of the bubble.

Japan has had a good record of procedural efficiency. However, in 1999, the Cabinet-level Justice System Reform Council was created for the achievement, among others, "of a legal profession as it should be." The ratio of lawyers practicing as *bengoshi* at court was only 19 per 100,000 inhabitants in 2004 (Lubbers 2010), compared with 388 in the US (2011), 265 in England and Wales (2006), and 168 in Germany (2006) (H. Schmiegelow 2013). Although the low density of professional lawyers could be seen as in keeping with Japan's low litigation rate, there has been a movement toward adopting American patterns both in financial crisis resolution and in the legal profession. As a result, 74 new law schools opened in 2004 and 2005. While more than 35,000 candidates took the nationwide law school admission test in 2003, their numbers dropped every year thereafter to about 10,000 in 2009 (Lubbers 2010). The unexpectedly high number of law schools and candidates was not matched by a corresponding rise in the capacity of the combined classes for trainees of judges, prosecutors and lawyers at the Legal Training and Research Institute of Japan. In addition, just like the American Bar Association, the Japan Federation of Bar Associations does not appear too eager to let competition between lawyers increase to the point of reducing their income (Lubbers 2010).

## 5. QUALITY OF LEGAL INSTITUTIONS

### 5.1 Indicators of the Quality of Legal Institutions

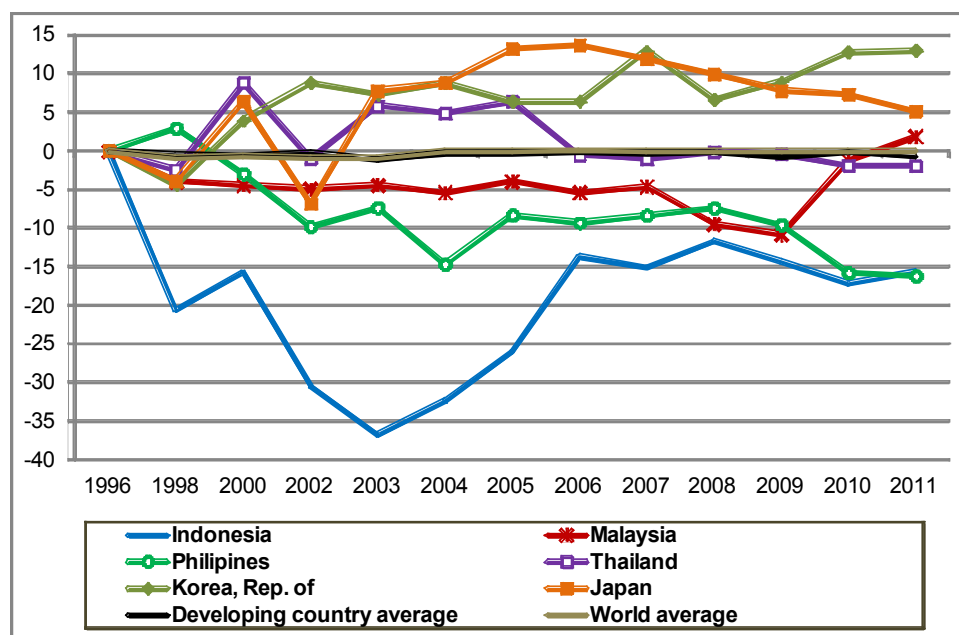
We next examine whether the legal and judicial reforms undertaken by each of the six crisis-affected countries have actually led to improvements in the quality of legal institutions. Measuring the quality of legal institutions is not an easy task. In this section, we examine three indicators published by the World Bank as part of its Worldwide Governance Indicators: (i) regulatory quality, (ii) rule of law, and (iii) control of corruption. These indicators measure the quality of legal institutions beyond those for bank and corporate restructuring needed to resolve financial crises. They cover much wider and more diverse areas, from regulatory quality (including agricultural, environmental, industrial, and consumer regulations), to the extremely broad concept of the rule of law (including constitutional law, human rights, criminal law, international law, administrative law, public order, military laws), and to specific laws on corruption control. But we assume they can serve as suggestive proxy indicators for the general quality of legal institutions.

All indicators are standardized with a value of 0 in 1996, one year before the eruption of the banking crisis. An increase in indicator values means improvement while a decline means deterioration. In each figure, both the world average and the developing country average are also plotted for comparison.

Figure 2A plots changes in regulatory quality indicators. It shows that the Republic of Korea and Japan are the only countries to have experienced improvements in regulatory equality, achieving +13 points and +5 points, respectively in 2011. Indonesia's deterioration until 2003, down to -37 points relative to 1996, is remarkable, although the indicator improved significantly afterwards until 2006. The initial

deterioration is not surprising, because the period up to 2003 includes both the last years of the authoritarian rule of Suharto, when much decision making was governed by ad hoc decrees rather than by democratically legitimized regulations, and the period of trial and error typical of the discovery process of post-Suharto democratization. The eventual improvement appears consistent with increasing consolidation of democracy in Indonesia. The Philippines experienced persistent declines over time. Indonesia and the Philippines converged to a similar level in 2011, recording –16 points. Thailand experienced moderate improvement in early years but later saw modest deterioration. In contrast, Malaysia experienced deterioration until 2009 but began to improve afterwards, particularly during 2010–2011. These two countries recorded values close to zero (+2 points for Malaysia, –2 points for Thailand) in 2011, in line with the world and developing country averages. The focused reforms of the banking and corporate sectors in the emerging Southeast Asian countries in response to the Asian financial crisis may have been too specific to impact the broadly defined spectrum of the regulatory quality index more strongly.

**Figure 2A: Changes in Regulatory Quality Indicators (1996=0)**



Source: World Bank, *Worldwide Governance Indicators*, 2012.

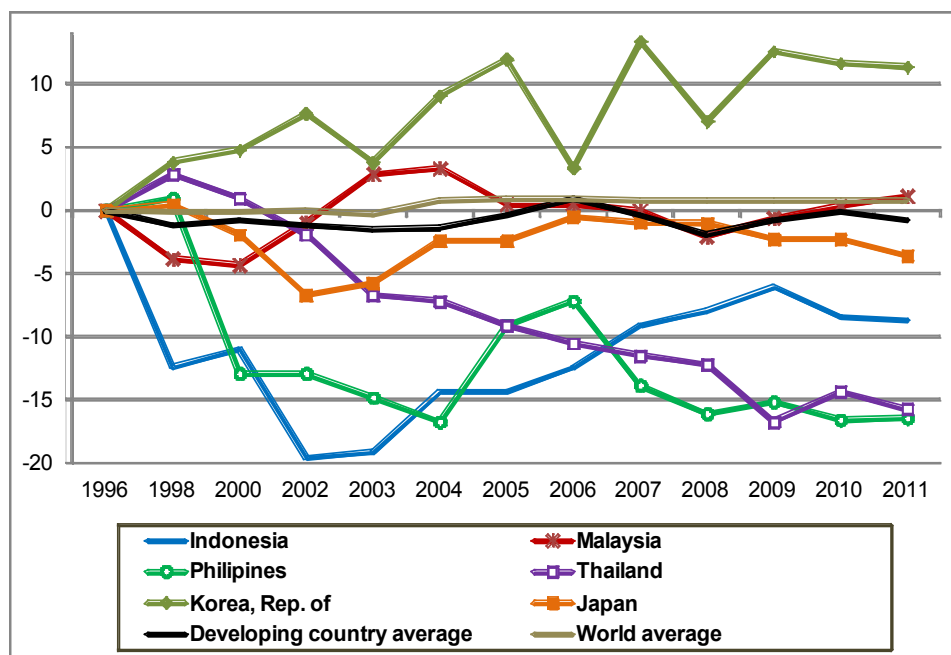
Figure 2B plots changes in rule of law indicators. The figure shows that only the Republic of Korea experienced significant improvement over time, recording +11 points in 2011. Surprisingly, Japan saw modest deterioration, recording –4 points in 2011. Malaysia saw modest deterioration up to 2000, modest improvements until 2004, and then modest deterioration afterwards, reaching +1 in 2011, a better performance than the world and developing country averages. Indonesia, the Philippines, and Thailand experienced significant deteriorations in rule of law indicators. As in the case of regulatory quality, Indonesia saw remarkable deterioration up to 2002–2003, reaching almost –20 points, and substantial improvements in subsequent years, recording –9 points in 2011. The Philippines saw deterioration in 2000 and did not recover much afterwards, while Thailand experienced steady deterioration over time. In 2011, these last two countries recorded the same level of –16 points.

Given the wide spectrum of the rule of law concept, changes in the indicators may well have been impacted by political and social events, such as the repression of political and social upheavals in Indonesia in 2002–2003 (in Timor–Leste until its independence



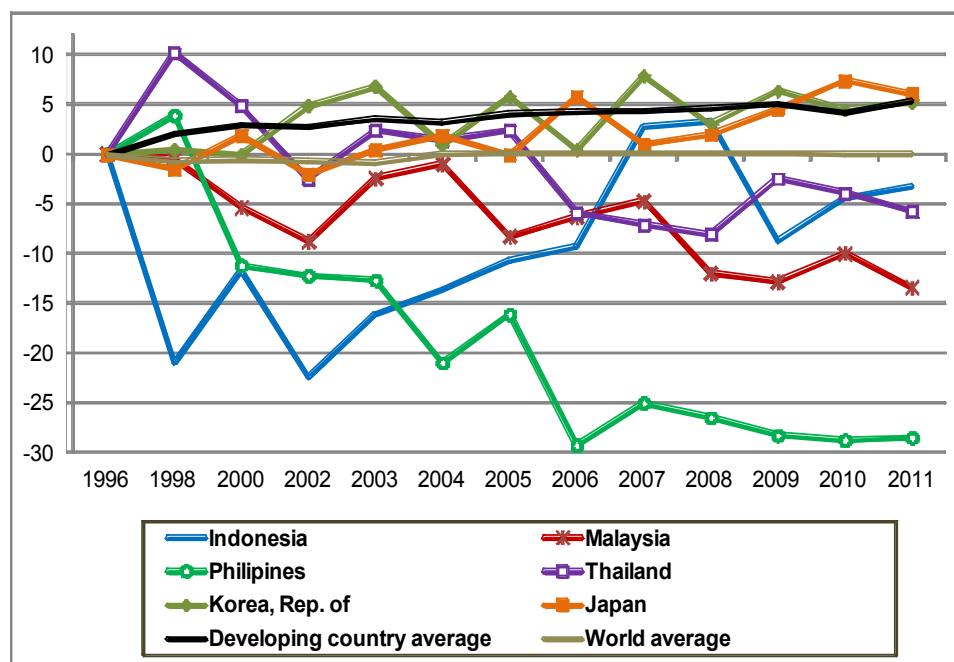
in 2002 and in Sulawesi, Aceh, South Kalimantan until 2003): unrest in the Philippines (Mindanao) since 2000 until today; and in Thailand the violent eruption of long-simmering social tensions between yellow shirts (anti-Thaksin forces) and red shirts (pro-Thaksin forces) that started in 2006. As the rule of law indicator covers an even broader spectrum of legal areas at a much higher level of generalization than the regulatory quality indicator, it is not surprising that banking and corporate sector reforms in response to a financial crisis are crowded out by the overriding political and social developments just mentioned. The reforms of civil procedure and of judicial structures in the Southeast Asian countries discussed in section 4 affect the broadly defined rule of law index, as they have an impact on access to justice. However, as we have seen, these reforms require much higher public investments and longer time horizons than regulatory reforms. Hence, it is too early for the indicator to pick up their effects.

**Figure 2B: Changes in Rule of Law Indicators (1996=0)**



Source: World Bank, *Worldwide Governance Indicators*, 2012.

Figure 2C plots changes in control of corruption indicators. The figure shows that Japan and the Republic of Korea made improvements over time, recording +6 points and +5 points, respectively. In contrast, Southeast Asian economies experienced deterioration, particularly relative to the developing world average, which made a steady improvement over time. The Philippines is the worst performer recording -29 points in 2011, followed by Malaysia (-13 points), Thailand (-6 points) and Indonesia (-3 points). In the case of Indonesia it is noteworthy that there appears to be a significant degree of covariance between consolidation of democracy reflected in the rule of law indicator (Figure 2B) and the control of corruption indicator.

**Figure 2C: Changes in Control of Corruption indicators (1996=0)**

Source: World Bank, *Worldwide Governance Indicators*, 2012.

To summarize, the Republic of Korea stands out by exhibiting consistent improvements in all three categories of regulatory quality, rule of law and control of corruption. Japan shows improvements in regulatory quality and corruption control, but not in rule of law. Malaysia demonstrates slight improvements in regulatory quality and rule of law, but a significant deterioration in corruption control. In contrast, Indonesia, the Philippines, and Thailand show significant worsening in all the categories, although the Indonesian case signals a positive trend—after experiencing remarkable deterioration—possibly reflecting the progress of democratization. The Philippines is the worst performer, followed by Indonesia.

The hypothesis of the paper is that the quality of legal institutions in the areas of banking, corporate and bankruptcy law as well as civil and commercial law has improved following the legal and judicial reforms achieved in the period after 1998 to resolve the financial crises. However, the mixed results for the six countries based on the three Worldwide Governance Indicators do not appear to support the hypothesis at first sight. Only when we take account of the different levels of analysis and time horizons of the legal reforms induced by financial crises and of the nature of the Worldwide Governance Indicators can we better understand the mixed findings.

## 5.2 Interpretation of the Mixed Findings

The six crisis-affected countries went through significant and similar legal and judicial reforms important for financial, commercial and civil transactions. There are several conceivable explanations as to why the three Worldwide Governance Indicators show improvements in some countries and not in others. These include: (i) the indicators with their large variety of data inputs cannot fully capture the impact of the type of legal reforms triggered by the financial crises; (ii) the reforms were not comprehensive and effective enough—particularly in Southeast Asian countries—to impact those countries' performance; (iii) the reforms were so fundamental that longer time horizons would be needed in most Southeast Asian countries; and (iv) intervening political and social

disruptions affected the results more than the legal and judicial reforms in some countries.

The strong achievements observed for the Republic of Korea and Japan can be attributed both to the quality of their codified substantive contract law (Boucekkine et al. 2010) and to the procedural efficiency of their judiciaries. As explained in section 2, the Republic of Korea codified its civil law system autonomously half a century ago. Japan has benefited from a similar system for seven decades longer. In both countries, civil procedure is managed by highly educated and trained judges who provide their knowledge as a public good. Judges and lawyers are trained together as in Germany and Switzerland (H. Schmiegelow 2013) and maintain high standards of independence, integrity and public trust (Haley 2007). These are the essential factors behind the strong performance of these two countries. The average disposition time for claims of unpaid debt worth 50% of GDP per capita in Japan (60 days) and the Republic of Korea (75 days) is the shortest in Asia (Djankov et al. 2007).

Among developed countries, Japan's litigation rate is very low. This may be partly due to the adoption of the American and French rule on court costs and on the allocation of lawyers' fees between the litigating parties, which leaves each party with its own lawyers' fees. The American rule has been criticized as a serious impediment to access to justice for seekers of judicial relief with justified cases (Reimann 2012; Maxeiner 2012). The reluctance of Japanese lenders and borrowers to jeopardize their relationship by going to court over NPLs may also have been one of the reasons for the slow recovery from the banking crisis in the previous years. One of the reasons why Japan lags behind the Republic of Korea in improving the regulatory quality indicator may be because of Japan's slower pace of economic deregulation, as the Republic of Korea made substantial progress following the 1997–1998 financial crisis.

Even though substantial legal reforms in financial, commercial, and civil areas were pursued in Indonesia and the Philippines, their positive effect seems likely to have been crowded out by negative data inputs in areas of constitutional law and human rights violations (Timor-Leste, Aceh, Sulawesi, and South Kalimantan in Indonesia and Mindanao in the Philippines). At the same time, these two countries do have serious problems in the area of judicial enforcement of law, which is a critical determinant of the quality of legal institutions.

Reforms in economically crucial areas of substantive law will remain mere “law on the books” without efficient enforcement through procedural law and effective judicial supply (H. Schmiegelow 2013).<sup>10</sup> The effectiveness of reforms in substantive law depends on procedural efficiency. Seen from the point of view of the effectiveness of the judiciary, this is a particular challenge for the Philippines and Indonesia as well as, to a lesser extent, for Thailand and Malaysia. These countries continue to be plagued by procedural inefficiencies such as low density and funding of subordinate courts, long disposition times and clearance rates resulting in sizable case backlogs.

The cross-country study of the duration of civil procedure (Djankov et al. 2007) suggests that the Philippines and Indonesia have a long way to go in developing their respective judicial supply. The enforcement of a contract of unpaid debt worth 50% of GDP per capita takes an average of 570 days in Indonesia, which is the worst of the six Asian countries studied here, and 380 days in the Philippines, in contrast with record

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<sup>10</sup> H. Schmiegelow (2013) focused on civil procedure and judicial structures in eight high-income economies (France, Germany, Japan, Republic of Korea, Switzerland, Taipei, China, UK, and US). As illustrated by the case of India in the five decades since independence, changes in *de facto* judicial supply involve much higher costs and take more time than *de jure* legislative changes of substantive law (Badami and Chandu forthcoming; Deakin and Sarkar 2011).

low numbers in the Republic of Korea (75 days) and Japan (60 days). All four countries have judicial systems based with civil law origins. Just as in the overwhelming majority of former colonies of Western powers, Indonesia, Malaysia, and the Philippines may still be suffering from the “transplant effect” of the imposition of a culturally foreign legal system on non-receptive countries which had previously had local customary traditions (H. Schmiegelow 2013). The three countries (as well as Thailand) clearly need to improve the functioning of their court systems and civil procedure further.

That Indonesia is one of the worst performers in terms of changes in the quality of legal institutions should come as no surprise. As noted above, the catalytic effects of the financial crisis were overtaken and magnified by the much more fundamental process of democratization and decentralization after the end of the Suharto regime in 1998. The expansion of the judiciary required by the decentralization process involves public investments in judicial infrastructure, recruitment, and training that far exceed those faced by Malaysia and Thailand. The rule of law indicator may not fully capture the initial complexities of such processes of simultaneous democratization and decentralization. Nonetheless, significant improvements in Indonesia’s indicators since 2003–04 appear to reflect the gradual consolidation of democratization and decentralization.

Malaysia’s performance was the best among the Southeast Asian countries in raising the quality of legal institutions, although it still faces the challenge of improving the efficiency of its justice system. In 2007, it still took an average of 300 days to enforce a contract of unpaid debt worth 50% of GDP per capita in Malaysia, far longer than in Japan and the Republic of Korea (Djankov et al. 2007). As explained in section 4, taking control of the progress of a case out of the hands of attorneys and giving it to the court was suggested by the World Bank (2011), but this would entail a fundamental change from the traditionally lawyer-dominated common law procedure to the traditionally judge-managed civil law procedure (Kaplan et al. 1956; Langbein 1985; Schmiegelow 2013). An essential requirement for such a change would be for the judges to develop their function from that of an arbiter of the contest between lawyers presenting unlimited arguments of fact and law to that of a manager of procedure, narrowing issues, separating relevant from irrelevant facts, and supplying legal knowledge as a public good according to the principle *iura novit curia*—“the court understands the law” (Schmiegelow 2013). To do this, an entirely new system of education, training and remuneration of judges, especially at the first instance level, would be needed. The legislative branch will have to contribute the budgets as well as the basic principles of legal education and training of future generations of first instance judges. Japan and the Republic of Korea offer excellent models of joint training of judges and lawyers.

As explained in sections 2 and 4, Thailand autonomously began developing its own civil law system by legislating a code of civil procedure in 1908. Hence its procedural efficiency should be less of a fundamental challenge than in Malaysia. However, like many other developing countries including Malaysia, Thailand has also suffered from the neglect of subordinate courts in the sense of insufficient public investments in education and training, as well as in status and pay, of first instance judges. The average disposition time for claims of enforcement of a contract of unpaid debt worth 50% of GDP per capita is 390 days (Djankov et al. 2007). As reported in section 4.3, the Thai judiciary has recognized the need to improve procedural efficiency, but the emergence of partisan divisions in Thai society and politics between “yellow shirts” and “red shirts” (Charoensin-o-larn 2013) has made such structural reforms more difficult in the short term. This remains an undertaking for the long term.

To summarize, what matters for improvements to be made to the quality of legal institutions is not only the reform of substantive law related to economically crucial areas but also the enforcement of law, procedural efficiency, and other political and social developments that may affect the results. Japan and the Republic of Korea stand out as countries with highly developed judiciaries, although they are known for widely diverging litigation propensities: Japan has an unusually low level of litigation (often interpreted as a cultural abhorrence of jeopardizing established relationships) while the Republic of Korea has a high level of litigation (Lee 2010). Indonesia, Malaysia, the Philippines, and Thailand are challenged by procedural inefficiencies that have been aggravated by fundamental political transformation or political and social cleavages. As emphasized by Pistor and Wellons (1999), legal reforms have not been adequately supported by training, status and pay for judges and other legal professionals in these poorly performing countries as in most developing countries. Moreover, reforms of *de facto* judicial structures take much longer than legislative changes to *de jure* substantive laws. Long time lags, perhaps in the order of several decades, may be needed to observe the tangible contribution of legal reforms.

## 6. CONCLUSIONS

This paper has examined the experience of legal reforms to facilitate bank and corporate restructuring in six crisis-affected Asian countries. Legal and other related reforms were pursued to resolve the financial crises and put their economies back to sustained growth paths. Bank and corporate restructuring was the first priority for these economies.

Restructuring of banks and their balance sheets required restructuring of their corporate clients as the banks' difficulties were due to NPLs to their corporate borrowers. Banks had to have adequate capital to set the stage for aggressive restructuring of NPLs on their balance sheets and thus corporate restructuring. Government recapitalization programs, conditional on some costs falling on bank owners but without jeopardizing their willingness to recognize losses, played critical roles. At the same time, corporate restructuring required creditors (such as domestic banks and international creditors) and debtors (corporate borrowers) to have the right incentives to preserve their assets and to manage their businesses efficiently. With such incentives, creditors were then able to judge whether, when, and how to restructure their debt claims so that corporate borrowers would operate their businesses efficiently and repay what they owed. Although agreements were encouraged to be voluntary, a credible threat of bankruptcy had to be introduced in order for a voluntary process of corporate restructuring to work. The alternatives to an agreement had to be made clear and credible so that creditors could enforce their legal claims through formal, court-based bankruptcy procedures. Mechanisms were introduced to provide borrowers with incentives to agree to a restructuring by subsequently making working capital financing available. Thus, legislative, judiciary, and executive branches of government played a proactive role in resolving systemic financial crises by strengthening, or establishing if necessary, the legal and institutional frameworks supporting corporate restructuring and policies to improve corporate governance.

Legislators, judges and government ministries in the six crisis-affected countries utilized the crisis as an opportunity to undertake legal, judicial and other reforms and to improve the overall legal environment of the countries. Except in the Republic of Korea and, to some extent, Japan and Malaysia, there is as yet no reliable evidence that these reform efforts actually led to improvements to the legal and judicial institutions in these countries. The four Southeast Asian countries faced the challenge of enforcing

new laws and judicial practices under various conditions of fundamental political transformation, separatist political upheavals, supervening social cleavages, or structural lack of capacity, incentives and oversight. But the fact remains that the six countries did embark on ambitious reforms in remarkably similar ways in response to their financial crises. That their economies recovered from the crises quickly (except in Japan) means that at least the reforms of their immediately concerned economic laws were not a wasted attempt.

That the six countries underwent similar experiences of crisis response, resolution and legal reforms can be partly explained by the fact that the same IFIs—the IMF, the World Bank, and the Asian Development Bank—assisted most of them in bank and corporate restructuring. They provided not only loans but also advice on international best practices of bank and corporate restructuring and legal, judicial, and institutional reforms. Japan was the only country that was not assisted by these IFIs, but it quickly adopted similar best practices of legal reforms.

We have argued that reforming substantive law alone cannot improve the quality of *de facto* legal institutions. What matters is the effective enforcement of law with procedural efficiency and easy access to justice. In the cases of Indonesia, the Philippines and Malaysia, the “transplant effect” of Western legal systems may have made the implementation of laws a significant challenge. In Indonesia, the supervening democratization and decentralization since 1998 have enormously magnified the task of improving the judiciary. In Thailand, political conflict has created social cleavages, which has resulted in additional burdens for a judiciary in the midst of very fundamental reforms. Such political and social transformations pose challenges in designing the rule of law indicator. Long time lags, perhaps in the order of several decades, may be needed to observe the transmission of legislative change of substantive laws “on the books”—through efficient civil procedure or alternative dispute resolution—into applied, practiced law, which can serve as a reliable framework for markets.

These experiences suggest several conclusions.

First, the financial crisis accelerated the process of convergence of legal systems between civil law countries and common law countries. Scholars of comparative law have recognized this for a long time, finding ever more legislation in common law countries and ever more judge-made laws in civil law countries. But so far, they have barely focused on the ways in which economic factors can promote such convergence.

Second, the similarity of crisis responses in countries with very different legal origins is a challenge to legal origins theory, which works with simplified codings of countries as either common law or civil law and would have predicted superior outcomes in common law countries compared with civil law countries. Moreover, this theory did not envisage financial crises in common law countries and would not have recommended proactive government policies for crisis resolution.

Third, the debate on the relationship between law and economic development can draw comfort from the interest and proactive responses of legal scholars and judiciaries in developing countries affected by financial crises. This would not have been anticipated from skeptical views of the readiness of entrenched legal systems of developing countries for reform.

Finally, leading cross-country indicators of regulatory quality, rule of law, and corruption control are certainly suggestive guides for problem detection. But questions remain as to whether they accurately capture the transmission from substantive law through civil procedure to applied, practiced law in different areas. A careful and transparent weighting of the relative importance of various areas of law may be needed for global

governance indicators. Strategies for legal reforms and measures of their success can only be provided by detailed analysis of the evolution of both substantive and procedural laws as well as of judicial structures. Data for the four Southeast Asian countries support the view that changes in *de facto* judicial supply involve much higher costs and take much more time than *de jure* legislative changes of substantive law or executive measures of bank and corporate restructuring.

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