

**Document of
The World Bank**

Report No.: 35051

PROJECT PERFORMANCE ASSESSMENT REPORT

THE KINGDOM OF THAILAND

**FINANCE COMPANIES RESTRUCTURING LOAN
(LOAN NO. 4268-TH)**

**ECONOMIC AND FINANCIAL ADJUSTMENT LOAN
(LOAN NO. 4372-TH)**

**SECOND ECONOMIC AND FINANCIAL ADJUSTMENT LOAN
(LOAN NO. 4447-TH)**

January 31, 2006

*Country Evaluation and Regional Relations
Independent Evaluation Group*

Currency Equivalents (annual averages)

Currency Unit = USD to Thai Baht

1997	US\$1.00	\$31.40
1998	US\$1.00	\$41.40
1999	US\$1.00	\$37.80
2000	US\$1.00	\$40.10
2001	US\$1.00	\$44.40
2002	US\$1.00	\$43.00
2003	US\$1.00	\$41.50

Abbreviations and Acronyms

ICR	Implementation Completion Report	IEG	Independent Evaluation Group
OED	Operations Evaluation Department	IFI	International Financial Institution
PPAR	Project Performance Assessment Report	IFC	International Finance Corporation
ADB	Asian Development Bank	IMF	International Monetary Fund
AMCs	Asset Management Companies	KTB	Krung Thai Bank
AMCorp	Asset Management Corporation	KTT	Krung Thai Thanakit Finance Co.
ASEAN	Association of South East Asian Nations	LOI	Letter of Intent
BMB	Bangkok Metropolitan Bank	LODP	Letter of Development Policy
BOT	Bank of Thailand	LRC	Legal Reform Committee for Development of Thailand
BT	Bank Thai	MOF	Ministry of Finance
CB	Commercial Bank	NPL	Non-performing Loan
CDRAC	Corporate Debt Restructuring Advisory Committee	OED	Operation Evaluation Department*
EFAL I	First Economic and Financial Adjustment Loan	PPAR	Project Performance Assessment Report
EFAL II	Second Economic and Financial Adjustment Loan	RB	Radhanasin Bank
FC	Finance Company	ROSC	Review of Standards and Codes
FCRL	Finance Company Restructuring Loan	SAM	Sukumvit Asset Management Co.
FIDF	Financial Institutions Development Fund	SCIB	Siam City Bank
FI	Financial Institution	SET	Stock Exchange of Thailand
FRA	Financial Sector Restructuring Authority	SFO	Special Financial Operations (of the World Bank)
GDP	Gross Domestic Product	TAMC	Thai Asset Management Corporation
GOT	Government of Thailand	UB	Union Bank
ICAAT	Institute of Certified Accounts and Auditors of Thailand		

* OED has changed its official name to Independent Evaluation Group (IEG). The new designation "IEG" will be inserted in all IEG's publications, review forms, databases, and web sites in the next few weeks.

Fiscal Year

Government: October 1 – September 30

Director-General, Evaluation	:	Mr. Vinod Thomas
Director, Independent Evaluation Group (IEGWB)	:	Mr. Ajay Chhibber
Senior Manager, IEGCR	:	Mr. R. Kyle Peters *
Task Manager, IEGCR	:	Ms. Laurie Effron

* Because Mr. Peters was associated with one of the operations under review, he recused himself from all review and supervisory functions related to it.

FOREWORD

The Kingdom of Thailand: Project Performance Assessment Report Finance Companies Restructuring Loan; Economic and Financial Adjustment Loan; and Second Economic and Financial Adjustment Loan

Thailand's record of economic growth during much of the last quarter of the 20th century was very strong. Poverty declined significantly and overall welfare improved markedly. But in 1997, after more than a decade of exceptionally strong economic growth, Thailand experienced a major macroeconomic and financial crisis, which spread rapidly to neighboring countries. In spite of assistance from the international financial institutions (IFI) and a wide-ranging reform program, the Thai economy did not begin to recover for some year and a half after the crisis. The number of people living in poverty jumped dramatically following the crisis, from 6.8 million people in 1996 to 9.8 million in 1999. The last several years have witnessed robust growth of over 6 percent per annum in 2003 and 2004, which has helped to reduce poverty rates to their pre-crisis level, although the average per capita income in 2004 was still below its pre-crisis level. With the exception of Indonesia, Thailand's recovery has been slower than most other countries that suffered a crisis in the 1990s.

The country has made progress in a number of key areas, including supervision of financial institutions, corporate governance and disclosure, and development of the bond market. Nevertheless, considerable challenges remain, in the financial, corporate, and legal regimes. And some early actions, under advice from external agencies, which with the benefit of hindsight could have been avoided, may have deepened the crisis and affected the subsequent response. The attached report summarizes what happened and the outcomes in the reform areas supported by three Bank loans, comprising lessons of experience.

The main findings for stronger results from the review of these loans are:

- The significant cost of cleaning up financial crises can offset the progress made over many years in poverty alleviation and other social improvements, both of which are central to the Bank's mandate. Given this, the Bank must continue to play a role in client countries in both improving financial sector governance and soundness to reduce the probability of crisis and in post-crisis management and well-structured recovery.
- The severity of the crisis was initially underestimated by the Bank and others, as was the negative impact on the economy of the large scale closure of the finance companies (FCs) in the early phase of the reforms. Early underestimates of the severity of the crisis and the impact of the closure of the FCs on the economy raised concerns about the credibility of the International Financial Institutions' approach and, most important to Thailand's future, about the financial reform itself. This suggests that crises in other countries need to be approached more comprehensively, taking into account potential negative impacts of large scale closures.

- Short-term crisis management policies can compromise essential structural reforms. The failure to factor into the design of the reforms the inadequacies of the Thai legal and regulatory infrastructure led to approaches that may have increased the cost of cleanup. For example, traditional procedures in Thailand for corporate restructuring were notoriously slow and generally benefited the debtor; thus, the corporate reorganization procedures modeled after the United States (Chapter 11 style) were ill-suited to the situation and may have served to worsen it (longer-delays, reduced restructuring). A better approach would have been to simplify liquidation procedures, involving the stakeholders and a bankruptcy administrator, rather than the court system.
- The sequencing and timing of reforms are crucial. Too little early emphasis was placed on reforming bankruptcy and foreclosure laws, developing a deposit insurance scheme, and fostering development of capital and money markets. The government that came to power just after the crisis emerged was reform-minded, but the adverse macro-economic impact of the early policy changes gave reform an unfavorable image in Thailand.
- The allocation of pieces of the reform package among the three International Financial Institutions may have made sense, but only if it had been followed by better coordination. As it turned out, the division led to an absence of a clear guiding vision for the reform of the financial system. Thus, for example, commercial bank restructuring was carried out very differently from finance company restructuring, even when they suffered from the same problems. In addition, the division of labor broke down, as the Bank fairly quickly became involved in FI restructuring and capital market development.
- Succeeding loans with increasingly broader goals and a growing list of conditions diffused the focus of reform and meaningful monitoring. A better approach might have been a well-designed programmatic one now used (but not available at that time), which seeks to develop a set of priority reforms and sequences the steps for supporting those reforms through successive loans.

Vinod Thomas
Director-General
Independent Evaluation Group

IEG Mission: Enhancing development effectiveness through excellence and independence in evaluation.

About this Report

The Independent Evaluation Group assesses the programs and activities of the World Bank for two purposes: first, to ensure the integrity of the Bank's self-evaluation process and to verify that the Bank's work is producing the expected results, and second, to help develop improved directions, policies, and procedures through the dissemination of lessons drawn from experience. As part of this work, IEG annually assesses about 25 percent of the Bank's lending operations. In selecting operations for assessment, preference is given to those that are innovative, large, or complex; those that are relevant to upcoming studies or country evaluations; those for which Executive Directors or Bank management have requested assessments; and those that are likely to generate important lessons. The projects, topics, and analytical approaches selected for assessment support larger evaluation studies.

A Project Performance Assessment Report (PPAR) is based on a review of the Implementation Completion Report (a self-evaluation by the responsible Bank department) and fieldwork conducted by IEG. To prepare PPARs, IEG staff examine project files and other documents, interview operational staff, and in most cases visit the borrowing country for onsite discussions with project staff and beneficiaries. The PPAR thereby seeks to validate and augment the information provided in the ICR, as well as examine issues of special interest to broader IEG studies.

Each PPAR is subject to a peer review process and IEG management approval. Once cleared internally, the PPAR is reviewed by the responsible Bank department and amended as necessary. The completed PPAR is then sent to the borrower for review; the borrowers' comments are attached to the document that is sent to the Bank's Board of Executive Directors. After an assessment report has been sent to the Board, it is disclosed to the public.

About the IEG Rating System

The time-tested evaluation methods used by IEG are suited to the broad range of the World Bank's work. The methods offer both rigor and a necessary level of flexibility to adapt to lending instrument, project design, or sectoral approach. IEG evaluators all apply the same basic method to arrive at their project ratings. Following is the definition and rating scale used for each evaluation criterion (more information is available on the IEG website: <http://worldbank.org/IEG/eta-mainpage.html>).

Relevance of Objectives: The extent to which the project's objectives are consistent with the country's current development priorities and with current Bank country and sectoral assistance strategies and corporate goals (expressed in Poverty Reduction Strategy Papers, Country Assistance Strategies, Sector Strategy Papers, Operational Policies). *Possible ratings:* High, Substantial, Modest, Negligible.

Efficacy: The extent to which the project's objectives were achieved, or expected to be achieved, taking into account their relative importance. *Possible ratings:* High, Substantial, Modest, Negligible.

Efficiency: The extent to which the project achieved, or is expected to achieve, a return higher than the opportunity cost of capital and benefits at least cost compared to alternatives. *Possible ratings:* High, Substantial, Modest, Negligible. This rating is not generally applied to adjustment operations.

Sustainability: The resilience to risk of net benefits flows over time. *Possible ratings:* Highly Likely, Likely, Unlikely, Highly Unlikely, Not Evaluable.

Institutional Development Impact: The extent to which a project improves the ability of a country or region to make more efficient, equitable and sustainable use of its human, financial, and natural resources through: (a) better definition, stability, transparency, enforceability, and predictability of institutional arrangements and/or (b) better alignment of the mission and capacity of an organization with its mandate, which derives from these institutional arrangements. Institutional Development Impact includes both intended and unintended effects of a project. *Possible ratings:* High, Substantial, Modest, Negligible.

Outcome: The extent to which the project's major relevant objectives were achieved, or are expected to be achieved, efficiently. *Possible ratings:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

Bank Performance: The extent to which services provided by the Bank ensured quality at entry and supported implementation through appropriate supervision (including ensuring adequate transition arrangements for regular operation of the project). *Possible ratings:* Highly Satisfactory, Satisfactory, Unsatisfactory, Highly Unsatisfactory.

Borrower Performance: The extent to which the borrower assumed ownership and responsibility to ensure quality of preparation and implementation, and complied with covenants and agreements, towards the achievement of development objectives and sustainability. *Possible ratings:* Highly Satisfactory, Satisfactory, Unsatisfactory, Highly Unsatisfactory.

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Principal Ratings

	<i>EAP Region</i>		<i>IEG</i>
	<i>ICR*</i>	<i>ICR Review*</i>	<i>PPAR</i>
<i>Finance Companies Restructuring Loan (Ln. 4268-TH)</i>			
Outcome	Satisfactory	Satisfactory	Moderately Unsatisfactory
Sustainability	Likely	Likely	Non-evaluable
Institutional Development Impact	Partial	Substantial	Modest
Bank Performance	Satisfactory	Satisfactory	Unsatisfactory
Borrower Performance	Satisfactory	Satisfactory	Satisfactory
<i>Economic and Financial Adjustment Loan (Ln. 4372-TH)</i>			
Outcome	Satisfactory	Satisfactory	Moderately Unsatisfactory
Sustainability	Likely	Likely	Likely
Institutional Development Impact	Substantial	Substantial	Modest
Bank Performance	Satisfactory	Satisfactory	Satisfactory
Borrower Performance	Satisfactory	Satisfactory	Unsatisfactory
<i>Second Economic and Financial Adjustment Loan (Ln. 4447-TH)</i>			
Outcome	Satisfactory	Moderately Satisfactory	Moderately Unsatisfactory
Sustainability	Likely	Likely	Likely
Institutional Development Impact	Substantial	Modest	Substantial
Bank Performance	Satisfactory	Satisfactory	Satisfactory
Borrower Performance	Satisfactory	Satisfactory	Unsatisfactory

* The Implementation Completion Report (ICR) is a self-evaluation by the responsible operational division of the Bank. The ICR Review is an intermediate Independent Evaluation Group (IEG) product that seeks to independently verify the findings of the ICR.

Key Staff Responsible

<i>Project</i>	<i>Task Manager</i>	<i>Sector Manager</i>	<i>Country Director</i>
Finance Companies Restructuring Loan (Ln. 4268-TH)			
Appraisal	Ijaz Nabi	Hoon Mok Chung	Jayasankar Shivakumar
Completion	Ijaz Nabi	Homi Kharas (Acting)	Jayasankar Shivakumar
Economic and Financial Adjustment Loan (Ln. 4372-TH)			
Appraisal	Ijaz Nabi	Masahiro Kawai	Jayasankar Shivakumar
Completion	Ijaz Nabi	Homi Kharas	Jayasankar Shivakumar
Second Economic and Financial Adjustment Loan (Ln. 4447-TH)			
Appraisal	Ijaz Nabi	R. Kyle Peters (Acting)	Jayasankar Shivakumar
Completion	Ejaz Ghani	Homi Kharas	Jayasankar Shivakumar

Preface

This is a Project Performance Assessment Report (PPAR) on Thailand: *Finance Companies and Restructuring Loan* (FCRL) for US\$350 million equivalent; *Economic and Financial Adjustment Loan* (EFAL) for US\$400 million equivalent; and *Second Economic and Financial Adjustment Loan* (EFAL II) US\$600 million equivalent. This report is based on the President's Reports for the projects, legal documents, project files, related to economic and sector work, and implementation completion reports (ICRs) for the projects (prepared by the East Asia and Pacific Region). In addition, discussions with Thai officials, other donors, other stakeholders, and World Bank Group staff were valuable inputs to the report. This report examines information for the period 1997 through 2003 or 2004, depending on data availability, to arrive at an assessment of the outcomes of these operations.

An Independent Evaluation Group (IEG) mission visited Thailand in 2004 to discuss the effectiveness of Bank assistance with government officials, donors and other stakeholders. Their cooperation and assistance in preparing this report is gratefully acknowledged.

Comments from the Bank's Regional Management have been incorporated in the report.

A draft report was sent to the Government of Thailand for comment. The Securities and Exchange Commission of Thailand sent comments suggesting changes in wording and some figures, which have been incorporated into the text of the report. The comments from the Ministry of Finance are attached as Annex B.

This report was prepared by two consultants: Professor Richard Herring and Professor Carol Leisenring, under the supervision of Ms. Laurie Efron (Task Manager). Roziah Baba provided administrative support.

Summary

1. Attached is the Project Performance Assessment Report (PPAR) on three loans to the Kingdom of Thailand: *Finance Companies Restructuring Loan* (FCRL) for US\$350 million; *Economic and Financial Adjustment Loan I* (EFAL I) for US\$400 million; and *Second Economic and Financial Adjustment Loan II* (EFAL II) for US\$600 million. FCRL was approved in December 1997, EFAL I in July 1998, and EFAL II in March 1999 and were all single tranche operations. A fourth loan, *Financial Sector Implementation Assistance*, was under implementation at the time this PPAR was planned. These loans constituted part of a coordinated effort, along with the International Monetary Fund (IMF) and Asian Development Bank (ADB), to help stabilize the Thai economy after the financial markets crisis of 1997. The Bank assumed primary responsibility for actions related to Finance Companies (FCs) and helping to improve the regulatory and supervisory framework.

2. The objectives of all three loans were related to long-term processes, and were therefore similar. The loans sought to support: (i) fiscal and macroeconomic stability; (ii) FC suspension and closure and disposal of FC assets; (iii) treatment of depositors and creditors; (iv) restructuring and recapitalization of core financial institutions (FIs); (v) restructuring of corporations; (vi) improving corporate governance and disclosure; (vii) strengthening the supervision and regulatory environment; and (viii) developing the bond market. EFAL I placed a greater emphasis on corporate restructuring, while EFAL II initiated the reforms in the government bond market.

Context

3. After more than a decade of exceptionally strong economic growth, Thailand experienced a major macroeconomic and financial crisis, which spread rapidly to neighboring countries. In spite of assistance from the international financial community and the implementation of many reforms, it took well over a year after the onset of the crisis before the Thai economy began to recover. In 2003 and 2004, strong growth rates of over 6 percent per year have helped to reduce poverty rates to their pre-crisis level, although the 2004 per capita income was still below its pre-crisis level. With the exception of Indonesia, Thailand's recovery has been slower than most other countries that suffered a crisis in the 1990s.

4. While there has been substantial progress in the corporate and financial sectors in a number of dimensions, large challenges still remain in these areas. This report summarizes outcomes in the reform areas supported by three Bank loans.

Fiscal Policy and Macroeconomic Stability

5. While the Government of Thailand (GOT) was able to tighten fiscal policy in 1997 in response to conditionality on achieving a *fiscal surplus* for that year, it was initially unable to fully meet the subsequent targets which reversed direction and called for *fiscal deficits* under EFAL I and II. Considerable debate exists over whether the fiscal targets set in the early phases of the crisis were appropriate, in both an *ex ante* sense,

given what was known and anticipated at the time in terms of the magnitude of the crisis, and ex post, in terms of whether the early stringent fiscal target helped or hindered economic recovery. On balance, IEG holds the view that the impact of the fiscal stance in 1997 and early 1998 may have contributed to sluggish economic recovery in the aftermath of the crisis; the cumulative fall in GDP was higher in Thailand than in other crisis-affected countries (except for Indonesia) and GDP growth in Thailand took longer to rebound than in these other crisis affected countries. Although the Bank was not the lead agency in setting fiscal targets nor were the targets a major focus of the loans, conditionality under all three loans adopted the fiscal targets set by the IMF, and thus the three Bank loans under review here are associated with these macroeconomic outcomes.

Finance Companies suspension and closure

6. Prior to the July 1997 depreciation of the baht, the Thai authorities had suspended 16 FCs, and in August 1997, the Bank of Thailand (BOT) suspended another 42 FCs (almost the entire FC sub-sector), and later closed these 56 FCs. The closure of the 56 FCs, which represented at the time some 14 percent of assets of the financial sector, had considerable impact on the economy: even healthy companies were unable to access financial services, and this added strain to an already fragile corporate sector. The impact of the closed FCs spilled over to unsuspected financial institutions both through the corporate sector and through the direct equity claims of other financial institutions in the FCs, and added downward pressure on an already contracting economy. Rather than closure of the FCs, establishing a bridge bank very early on might have been more effective in isolating insolvent FCs from healthy ones; the performing assets of the FCs could then have been serviced by the bridge bank, and performing debtors would have continued to have access to additional credit and other financial services. A bridge bank was eventually established in Thailand, but came too late: the good assets of the intervened financial institutions had turned bad and the bridge bank was no longer useful. The outcome of the FC suspension and closure is therefore considered unsatisfactory.

Disposal of Finance Companies assets

7. By contrast, given the decisions on closing the FCs, the disposal of FC assets was carried out by the responsible Thai agency (the FRA) as well as possible under the circumstances. The magnitude of the task was huge, as some 869 billion baht (about US\$25 billion, depending on the exchange rate used) were transferred to the FRA, the quality of the assets was poor, and the economic situation in the country and the region was dismal, with neighboring countries also trying to dispose of financial sector assets. Given these factors as well as other constraints, the fact that the FRA was able to dispose of some 86 percent of assets by end 2000, at an average recovery rate of 35.3 percent of face value, through open and fair actions is highly commendable. Nevertheless, one unanticipated outcome of the process was a strongly negative perception of it by the public once it learned that most of the successful bidders on these assets were foreigners, many of whom were suspected of flipping the loans back to the original borrowers at substantial profit. Many of those interviewed by IEG noted that the public reaction to the asset disposal affected the momentum of the reform program and made reform-minded leaders reluctant to pursue a similar approach to corporate restructuring. Taking into account the satisfactory achievement of the basic objective of asset disposal but the

unanticipated negative public perception, IEG rates the outcome of *the disposal of FC assets as moderately satisfactory*.

Treatment of creditors and depositors

8. The blanket creditor and deposit guarantees may have been needed early in the crisis to stabilize the system, and may have been politically expedient, but it was, and remains, detrimental to long-term structural reform; it is also contrary to well-disseminated Bank guidance for deposit insurance. In contrast to the IMF's advice and to the Bank's subsequent efforts to support a limited deposit insurance system, the blanket guarantees were not temporary; the creditor guarantee was phased out only in November 2003, and the blanket deposit guarantee remained in place even longer, for at least seven years after the crisis. *The outcome of this aspect is considered highly unsatisfactory*.

Restructuring and Recapitalization of Core Financial Institutions (FIs)

9. The Thai authorities intervened in six commercial banks (accounting for some 24 percent of total loans in the financial sector), and subsequently merged a number of closed FCs and an FI into a state owned bank. As of 2004, three FIs, including one which the government agreed to privatize under EFAL II by mid-2001, were still state owned. EFAL II also supported the recapitalization of several intervened FIs, which occurred mainly through the transfer of non-performing loans, rather than through an increase in equity, and the recapitalized state owned banks continue to be characterized by political interference, allegations of corruption, management turnover, and inadequate business plans. The outcome of the recapitalization and restructuring of the core FIs is rated as *unsatisfactory*.

Strengthening Supervision and Regulatory Environment

10. The outcomes on improving supervision and prudential regulation have been good, although the modernization, even some seven years after the crisis, has not been complete and delays have been long. Nevertheless, new provisioning guidelines are in place (although BOT engaged in forbearance, at least through 2002), the BOT has better legal authority for intervening, licensing standards have been improved, the BOT has upgraded their skill base, and on-site examinations occur regularly. *Outcomes under this component are considered satisfactory*.

Corporate Restructuring

11. Progress in corporate restructuring has been slow and incomplete. Both EFAL I and EFAL II contained conditions pertaining to this component, but the GOT met fierce resistance in Parliament to proposed bankruptcy and foreclosure reforms. Progress on these reforms remains unsatisfactory, with the result that the framework for bankruptcy and other aspects of corporate restructuring remains weak. The process of restructuring corporations has relied on voluntary, out of court procedures, and has focused on financial relief through restructuring debts through an extension of the maturity, extension of the grace period, or reduction of the interest rate. In addition, there has been little operational restructuring, and a significant portion of these restructurings have been unsuccessful: in 2002, for example, about 30 percent of the debt restructured reverted to

nonperforming status within a few months and by the first half of 2003, two-thirds of the corporate loans restructured by private banks had reverted to non-performing loan (NPL) status. Finally, the process was far from complete some six years after the onset of the crisis. By mid-2003, only 48 percent of corporate debt cases had been restructured in out-of-court programs (compared to 95 percent in Korea, 77 percent in Malaysia, and 56 percent in Indonesia by mid-2003). Overall, *the outcome of corporate restructuring is considered moderately unsatisfactory.*

Improving Corporate Governance and Disclosure

12. The improvements in corporate governance and disclosure are demonstrable and recognized by international surveys, which show progress in standards of companies listed on the Thai stock exchange, and favorable comparison of corporate governance practices in Thailand with some neighboring countries. New accounting standards have been introduced and implemented, and although further improvements are still needed to improve oversight of the accounting practices, and enhance oversight of corporate directors, *the outcome of this component is considered satisfactory.*

Developing the Bond Market

13. The improved infrastructure and organization of the government bond market are impressive. The BOT succeeded in developing a yield curve for government bonds with a maturity range from less than a year to fifteen years and made improvements to the regulatory framework. It also introduced an efficient clearing and settlement system. Over time this may contribute to the development of a robust corporate bond market, although to date the contribution to the raising of capital by the private sector is not evident. Nevertheless, *the outcome of this component is considered highly satisfactory.*

Rating the Loans: FCRL

14. Although the disposal of FC assets was a primary focus of the FCRL, which this assessment finds to have had a *moderately satisfactory* outcome, the FCRL was also predicated on the suspension and closure of the FCs, which had a negative impact on the economy, and an unsatisfactory outcome. In addition, the FCRL explicitly supported the fiscal surplus, which may have contributed to the economic contraction. The remaining components of the FCRL had more mixed outcomes: improving supervision and prudential regulation (moderately satisfactory under this loan because of forbearance by BOT) and amendments to the bankruptcy law (not done). Finally, although developing a strategy for phasing out the blanket guarantee was discussed in FCRL and included in a matrix of conditions, no specific agreement was sought to take any actions and the blanket guarantee for both depositors and creditors continued. On balance, *the outcome of the FCRL is considered moderately unsatisfactory.*

15. The concept of *sustainability* is difficult to apply to the FCRL, mainly because much of the focus of the loan was on short-term emergency measures, such as the closure of FCs, which had a detrimental impact on the economy (and therefore the concept of sustainability does not apply) and disposal of FC assets, which was carried out well, but whose benefits are not easily thought of in terms of resilience to risk (the definition of

sustainability). While the improvements to supervision and prudential regulation begun under the loan are considered sustainable, the blanket guarantees for creditors, which lasted for six years (until November 2003), and for depositors are detrimental to the development of prudent financial intermediation, and thus work against sustainability. Given all these considerations, IEG has not rated the sustainability of FCRL.

16. In terms of the *institutional development impact* (IDI) of FCRL, the closing and disposing of assets of FC involved the acquisition of expertise by Thai professionals associated with the process, and thus may have put the country in a better position to deal with another crisis should one occur in the near future; in this sense, IDI was substantial. On the other hand, an unintended impact of the FC process was the public perception of the process, which was so negative that it detracted from public support of the longer-term reform agenda. While the strengthening of banking supervision and prudential regulatory policies has been substantial, the failure to address the blanket guarantee of creditors and depositors was detrimental to longer term institutional development. Given these quite different impacts on institutions under the FCRL, *IDI is considered modest*.

17. *Bank performance is mixed under FCRL*. The Bank supported two policies – fiscal tightening, and suspension and closure of the FCs, which may have contributed to the contraction of the economy and exacerbated the crisis. Although the Bank played a supporting, rather than a leading, role in these policy decisions, the FCRL provided reinforcement for them. On the suspension and closure of the FCs, these decisions were technically made by the Thai authorities before this loan was approved, but they were part of a larger program for restructuring the financial sector which the Bank supported prior to going forward with the first adjustment loan. During the formulation of this restructuring program, in the immediate aftermath of the onset of the crisis, the Bank provided technical assistance to the authorities and participated in IMF missions that also provided assistance to the authorities to articulate the restructuring program, which included dealing with the FCs. Even if the Bank did not take the lead in the discussions, and even if there were Bank staff who disagreed with the approach, much of the focus of the FCRL was on implementing the fundamental decision to close the FCs, so the loan was implicitly fully supportive of the decision. In this aspect, Bank performance is considered unsatisfactory. By contrast, Bank performance is considered satisfactory in its support for the disposal of FC assets. On balance, *Bank performance under FCRL is considered unsatisfactory*.

18. Thai authorities and agencies did a good job of implementing the policies agreed with the Bank, closing the FCs and, in particular, disposing of FC assets under difficult circumstances; the agency involved hired appropriate consultants, and carried out its difficult mandate as efficiently as possible; their performance on this aspect is considered highly satisfactory. Against this should be set Borrower performance on creditor and depositor guarantees, considered highly unsatisfactory. While the authorities made progress on strengthening prudential regulations, considerable BOT forbearance meant that there was little enforcement of the new standards. *On balance, however, Borrower performance under FCRL is considered satisfactory*.

Rating the Loans: EFAL I

19. The *policy objectives of EFAL I* was better designed than under FCRL, but achievement of the objectives was mixed, with significant weaknesses. EFAL I incorporated a change in the direction of fiscal policy, from a surplus target under FCRL to a fiscal deficit target, but the Government was unable to increase expenditures enough to reach the deficit (the actual fiscal deficit for FY98 was lower than the target). To deal with the FCs, it included the establishment of the bridge bank to manage the assets of the FCs, although it was too late in the process of FC closure to be useful. It placed greater emphasis on starting the process of restructuring core FIs (not just the FCs), which was begun but not carried out satisfactorily, and of defining the longer term strategy for the FIs, which was done. But EFAL I did not successfully address the blanket guarantee on depositors and creditors, which remained in effect. EFAL I continued the process of strengthening FI supervision and regulation, although BOT forbearance continued; focused on establishing the framework for bankruptcy and strengthening other commercial legislation, whose progress has been limited; and focused improving corporate governance and disclosure practices, whose outcome is considered satisfactory. On balance, *the outcome of EFAL I is considered moderately unsatisfactory.*

20. The *sustainability of the benefits achieved under EFAL I is considered likely.* Although some of the benefits under EFAL I, such as the start of FI restructuring, may not be resilient to risks, most other benefits achieved under the loan are considered sustainable. These include continued progress on strengthening prudential regulation and supervision, and improvements in corporate governance and disclosure, where external pressures involving international reviews of standards and codes and private sector surveys of the business climate and accounting standards are likely to sustain the momentum to work toward international standards.

21. On institutional development, the impact in some areas supported by EFAL I was substantial – strengthened FI prudential regulation, for example, as well as improvements to corporate governance and disclosure. In corporate restructuring, although progress achieved was not as rapid or as substantial as hoped, the emphasis on civil court procedures and the development of a specialized bankruptcy court should lead to an improved process and better performance over time. In other significant areas, however, such as restructuring FIs, and continued BOT forbearance in enforcing the strengthened prudential regulations, *IDI is considered modest*, and this is the overall rating under EFAL I.

22. *Bank performance is considered satisfactory under EFAL I.* EFAL I placed greater emphasis on restructuring the whole financial sector, in spite of the earlier agreement on the division of responsibilities among the international financial institutions (IFI), and focused on longer term issues for the sector, all of which were appropriate. It also focused on the critical area of corporate restructuring and reforms, and provided substantial technical assistance in this area to help the Government deal with corporate restructuring. The Bank thus addressed important weaknesses in the overall environment for effective financial intermediation and took a pro-active approach to implementing the broader set of reforms.

23. In contrast, *Borrower performance is rated unsatisfactory* under EFAL I. Although the Borrower continued satisfactory disposal of FC assets and it strengthened its regulation and supervision of FIs, it did not enforce the stricter prudential regulations, and it allowed the blanket guarantee to persist. It carried out reforms in the framework for corporate governance, but its performance on restructuring and recapitalization of FIs and on restructuring corporations is considered weak, and progress with the corporate bankruptcy law was unsatisfactory, due in part to stiff resistance from Parliament.

Rating the Loans: EFAL II

24. The objectives of EFAL II appropriately shifted the emphasis for the treatment of depositors to developing a deposit insurance scheme with limited protection; it also appropriately included for the first time the development of the government bond market. Although there was some progress toward putting in place the limited deposit insurance scheme, which was to have occurred by end-1998, it was not completed at the time of this writing. The outcome of the development of the government bond market is considered to have been highly satisfactory. As noted in paragraph 8, banking supervision continued to be strengthened and the outcome of this component is considered satisfactory. The other objectives which received particular emphasis under EFAL II were achieved to a much more limited extent, in some cases with significant shortcomings; these include core FI restructuring, strengthening the legal framework for corporate restructuring, and improving progress on corporate restructuring, as discussed in paragraphs 7 and 9. As a result, *the outcome of EFAL II is considered moderately unsatisfactory*.

25. *EFAL II receives a sustainability rating of likely*, because the benefits such as strengthened supervision and regulation and improved corporate governance and disclosure are likely to be resilient to risks for reasons noted in paragraph 18. Although one aspect, FI restructuring, is not considered sustainable, the sustainability of the development of the bond market is considered highly likely, as the probability is high that the benefits will continue to grow under most economic scenarios.

26. *IDI for EFAL II is rated as substantial*, because in addition to the factors mentioned in paragraph 19 under EFAL I, the development of the government bond market represents a significant contribution to the institutional development of the financial sector. It permits the establishment of a benchmark yield curve, a crucial element for further capital market development. These achievements will facilitate the development of the corporate bond market, trading in derivative instruments and more efficient pricing of equities. Thus the institutional contribution of EFAL II to capital market development is considered high.

27. *Bank performance is rated satisfactory*. As in the case of EFAL I, the design of EFAL II was appropriately focused on broader and longer-term issues than was the case under FCRL. EFAL II design also added an objective of capital market development, which was highly relevant to longer term financial market development and stability. The Bank worked effectively with government and relevant private sector entities to develop an sound plan for corporate governance and disclosure. And although the division of responsibilities following the crisis allocated capital market development to

the Asian Development Bank, the Bank took the lead under EFAL II in a first step in this process of supporting improvements to the government bond market.

28. *Borrower performance under EFAL II is rated, on balance, unsatisfactory.* Although performance was strong in certain key objectives of EFAL II, it was weak in others. On the positive side, the Borrower's performance was highly satisfactory with respect to improvements in corporate governance and disclosure and development of the government bond market. On the negative side, however, while it may be argued that the blanket creditor and depositor guarantee initially put in place was the joint responsibility of the IFI and Thai authorities, the failure over a sustained period of time to phase out the deposit guarantee and replace it with a limited deposit insurance program, supported under EFAL II, was the responsibility of the government. In addition, there was considerable political opposition to legislative proposals that would have served to strengthen the legal and institutional infrastructure for corporate restructuring, and as noted in paragraph 9, some of the legislative proposals have served to weaken the framework for bankruptcy and other aspects of corporate restructuring, and there has been insufficient progress on both corporate restructuring and FI restructuring and strengthening.

Summary of different performance ratings under the loans

29. At the time the first of these three loans, the FCRL, was approved, the Bank supported policies (fiscal tightening and closure of FCs) which may have contributed to a deepening and prolongation of the crisis. In addition, partly as a result of the agreement with the other IFIs on the division of labor, the FCRL focused mainly on the FCs and to a more limited extent on larger sectoral issues, such as developing a limited deposit insurance scheme, stronger financial sector supervision; corporate restructuring; corporate governance. By contrast, in subsequent loans, the Bank appropriately broadened its approach to focus more on these areas and to support relevant reforms. Primarily for these reasons, Bank performance is considered *unsatisfactory* under the first loan and *satisfactory* under the subsequent EFAL I and II.

30. The Thai authorities did a good job of implementing most of the policies agreed under the FCRL, under very difficult conditions. They also made a good start at undertaking the reforms agreed, such as strengthening prudential requirements and proposing amendments to the bankruptcy act. For these reasons, IEG rates their performance as *satisfactory* under FCRL. Under EFAL I and II, by contrast, progress was much slower on both the reforms (bankruptcy and foreclosure laws, deposit insurance, continued forbearance – at least up to 2002 – on implementing prudential regulations) and on restructuring FIs and corporations. IEG therefore rates Borrower performance *unsatisfactory* under both EFAL I and EFAL II.

Findings and recommendations

31. The main findings from the review of these loans are:

- The impact financial crises can offset progress made over many years in poverty alleviation and other social improvements, both of which are central to the Bank's mandate. Given this, the Bank should continue to play a role in client countries in

both improving financial sector governance and soundness to reduce the probability of crisis and in post-crisis management and well-structured recovery.

- The severity of the crisis was initially underestimated by the Bank and other International Financial Institutions (IFIs), as was the negative impact on the economy of the large scale closure of the FCs. This in turn created problems for the credibility of the IFIs' approach and, most important to Thailand's future, about the financial reform itself. This suggests that crises in other countries should be approached more comprehensively, taking into account potential negative impacts of large scale closures.
- The nature of the short-term response to crisis can affect longer-term structural reforms. For example, traditional procedures in Thailand for corporate restructuring were slow and generally benefited the debtor; thus, the corporate reorganization procedures initially adopted that were modeled after the United States (Chapter 11 style) were not well suited to the situation and may have worsened it (longer-delays, reduced restructuring). A better approach would have been to simplify liquidation procedures, involving the stakeholders and a bankruptcy administrator, rather than the court system.
- The sequencing and timing of reforms is critical. Too little early emphasis was placed on reforming bankruptcy and foreclosure laws, developing a deposit insurance scheme, and fostering development of capital and money markets. The adverse macro-economic impact of the initial measures to contain the crisis made subsequent reforms politically difficult.
- The allocation of reforms among the three IFIs may have been appropriate, but could only work if it had been followed by good coordination. As it turned out, the division resulted in an absence of a clear guiding vision for the reforms. For example, commercial bank restructuring was carried out very differently from finance company restructuring, even when they suffered from the same problems. In addition, the division of labor among the IFIs did not hold, as the Bank quickly became involved in FI restructuring and capital market development.
- Each succeeding Bank loan had broader goals and a wider list of conditions than the previous one. This approach diffused the focus of reform and made monitoring difficult. A programmatic approach, now used widely in the Bank, would have been better, although it was not available at that time.

1. Introduction

1.1 After more than a decade of strong economic growth, Thailand experienced a major macroeconomic and financial crisis in mid-1997, which spread rapidly to neighboring countries. Its impact lasted for a number of years, resulting in large capital outflows (totaling some 60 percent of GDP over the following five years), negative economic growth, and a drop of some 40 percent in per capita GDP, which has still not fully recovered. The number of people living in poverty jumped dramatically following the crisis, from 6.8 million people in 1996 to 9.8 million in 1999. The last several years have witnessed robust growth of over 6 per cent per annum in 2003 and 2004, which has helped to reduce poverty rates to their pre-crisis level, although the average per capita income in 2004 was still below its pre-crisis level.

1.2 In the first half of the 1990's, the assets of the Thai banking system (including Finance Companies (FCs)) quadrupled. This high-growth environment generated both internal and external optimism about the Thai economy. As a result, investment boomed, the market capitalization of stocks traded on the Thai exchange doubled, and the real estate prices and new construction soared. Much of this continued investment and growth was financed by inflows of foreign capital, largely short-term money.

1.3 The rapid expansion of financial institutions during the early 1990's masked, and may even have exacerbated, fundamental weaknesses in the Thai financial sector. Prudential regulation of financial institutions was weak and uneven across types of institutions. Regulatory practices were not always well-defined or standardized, regulatory forbearance was common and the Bank of Thailand (BOT) lacked adequate, skilled supervisory personnel. In addition, substandard accounting and weak disclosure practices clouded regulators' understanding of the underlying weaknesses in the system and impeded monitoring by the private sector.

1.4 Financial institutions had accumulated excessive risk in their loan portfolios due to high exposures to the real estate sector, small companies, insider lending and connected lending. Their balance sheets also contained considerable unhedged foreign exchange and interest rate risk. The problems were even more serious within the FCs, which accounted for about 20 percent of the assets of Thai financial institutions (FIs). The Thai financial system was (and remains) heavily bank-centered. The year before the crisis, bank lending (including FCs) accounted for nearly all the external funding of Thai corporations.¹

1.5 The Thai economy has heavily concentrated corporate ownership with the top 15 families dominating more than half the corporations² and a small number of family groups owning both banks and corporations. In the absence of effective bank regulatory and

¹ During 1996, bank lending financed about 31.3 percent of gross fixed capital formation, while net issues of bonds financed some 1.9 percent. Part of the reason that Thailand had such an underdeveloped bond market is that the government had an enviable record of fiscal rectitude, with little government debt outstanding and no new issues of government bonds from June 1990 to 1998.

² Claessens, Djankov and Klingebiel (p. 29) report that only the Philippines (55.1) and Indonesia (61.7) had a heavier concentration of ownership than Thailand (53.5), where the numbers in parentheses indicate the percentage of ownership control among the top 15 families.

supervisory constraints on connected lending, this kind of institutional framework resulted in weak credit monitoring and discipline and enabled some Thai firms to obtain an excessive amount of leverage despite low profitability. This environment permitted family groups to retain control and maintain high growth rates, but left them especially vulnerable to economic shocks. More broadly, leverage was high in the corporate sector, both in absolute terms and relative to averages in other emerging markets and most developed countries. With inadequate capital to buffer against loss, corporations quickly passed financial stresses to their lenders once difficulties in the real economy emerged.

1.6 Prior to the 1997 crisis, the Government of Thailand (GOT) took a number of destabilizing policy actions. On the macroeconomic front, interest rates were rising, the current account deficit was growing and the baht was under considerable pressure in international markets. The IMF had advised government officials to allow greater exchange rate flexibility and/or to devalue the baht. Instead, Thai officials tried to suppress the growing foreign exchange crisis: BOT intervened, massively and secretly, in the foreign exchange market to support the baht. This policy rapidly depleted foreign exchange reserves and caused foreign exchange traders to be suspicious about the stability of the Thai economy and banking system.

1.7 In addition, the BOT continued policies of forbearance with regard to bad loans and extended huge amounts of liquidity to FIs, through the Financial Institutions Development Fund (FIDF). Despite these actions to disguise or postpone recognition of the fragility of financial institutions, public concern about the financial sector grew.

1.8 At the same time, evidence of an economic slowdown in Thailand and the region was emerging by the spring of 1997. Thai exports were declining. The stock market declined dramatically. The real estate market collapsed. Interest rates rose to double digits. And downward pressure on the baht continued. These developments further weakened the condition of FIs, leading quickly to capital adequacy problems.

1.9 In June 1997, sixteen FCs were suspended. After months of delay in addressing the situation, these actions were undertaken partly to assure the Thai public that the authorities stood behind the remaining FCs and that deposits would be protected and partly to demonstrate to the international community that tough actions were being taken. While the desire to shore up public confidence was understandable, the actions themselves had perverse consequences.

1.10 On July 2, the exchange rate was allowed to float and the baht depreciated by over 50 percent by end 1997. Thailand experienced huge capital outflows as the inflow of short term money that had helped finance economic expansion was reversed. GDP declined 1.4 percent in 1997. On August 5, another 42 FCs were suspended by the BOT.

1.11 During the latter half of 1997, corporations were caught between rising debt service costs³ and collapsing revenues, exacerbated by the austerity measures negotiated

³ The substantial depreciation of the exchange rate roughly doubled the cost of servicing unhedged foreign currency-denominated debt and the sharply higher interest rates increased the cost of servicing baht-denominated debt.

with the IMF.⁴ The impact of the closure of the FCs, in combination with a deteriorating macro-economy, caused borrowers to default on loans from other FIs. Because Thailand's bankruptcy and foreclosure laws were weak and highly inefficient, they were unable to deal with this flood of non-performing loans.

2. Post-Crisis World Bank Assistance

Context

2.1 On August 14, 1997, GOT and the International Monetary Fund (IMF) agreed on a 34-month stand-by facility valued at US\$3.9 billion. Other prospective donors agreed to fill the gap between the IMF facility and the US\$17.2 billion that Thailand was expected to need to fund a successful stabilization program.⁵ In addition, the International Financial Institutions (IFIs) agreed to a division of responsibilities for dealing with the Thailand's financial sector. The IMF assumed responsibility for commercial banks, the Bank had responsibility for FCs and improving the regulatory and supervisory framework, and the Asian Development Bank (ADB) had primary responsibility for capital markets development. In the event, however, this division of labor broke down as the Bank supported reforms affecting both commercial banks and the capital market (see, for example, paragraphs 2.7, 2.11, and 2.28).

Loan Objectives and Design

Description of Loans

2.2 The Bank's program for Thailand consisted of four loans, of which three are assessed here.⁶ The Finance Company Restructuring Loan (FCRL) was approved in December 1997 for US\$350 million; the second, Economic and Financial Adjustment Loan (EFAL I), in June 1998 for US\$400 million; and the third, Second Economic and Financial Adjustment Loan (EFAL II), in March 1999, for US\$600 million. A timeline of agreements with the Bank and the IMF is in Table 2.1 below.

⁴ Although views vary on the extent to which the IMF's approach in the early part of the crisis contributed to deepening the crisis, most agree that fiscal tightening in the early period did not help the country to emerge from its crisis. Radelet and Sachs (1998) note: "...mistakes by both the Asian governments and the IMF contributed to the panic and unnecessarily deepened the crisis." pp 3-4, while Berg (1999) in an IMF working paper notes that the restrictive fiscal policy may have played some role in exacerbating the output declines (p. 44), and Lane et al (1999) in another IMF publication notes that fiscal policies should have been more expansionary from the start, but that in any case there is a limit to the impact that expansionary fiscal policy could have had under the circumstances (p. 64).

⁵ Japan contributed US\$4 billion, the Bank, US\$1.5 billion and the Asian Development Bank, US\$1.2 billion. In addition, the governments of Australia, China, Hong Kong, Malaysia and Singapore all pledged US\$1 billion each. Indonesia and Korea each pledged US\$0.5 billion.

⁶ The fourth loan, Financial Sector Implementation Assistance, was under implementation at the time this PPAR was planned.

2.3 To varying degrees, all three loans addressed nine policy areas: (1) fiscal policy and macroeconomic stability; (2) FC restructuring; (3) disposition of FC assets; (4) deposit insurance (or treatment of depositors and creditors); (5) restructuring and recapitalization of core institutions; (6) strengthening supervision and prudential regulation; (7) corporate restructuring; (8) corporate governance and disclosure; and (9) bond market development. A detailed matrix of the Board conditions for the Bank loans is in Annex C.

Table 2.1: Timeline of the Thai Agreements with IMF/WB

Date	Item
August 14, 1997	First IMF Letter of Intent signed
November 25, 1997	Second IMF Letter of Intent signed
December 24, 1997	Finance Companies Restructuring Loan (Loan number 4268-TH)
February 24, 1998	Third IMF Letter of Intent
May 26, 1998	Fourth IMF Letter of Intent
July 13, 1998	Economic and Financial Adjustment Loan (Loan number 4372-TH)
August 25, 1998	Fifth IMF Letter of Intent
December 1, 1998	Sixth IMF Letter of Intent
March 23, 1999	Seventh IMF Letter of Intent
March 26, 1999	Second Economic and Financial Adjustment Loan (Loan number 4447-TH)
September 21, 1999	Eight IMF Letter of Intent

Finance Company Restructuring Loan (FCRL)

2.4 *Key decisions and actions with respect to macroeconomic and fiscal policy and FC suspension and closure had been undertaken by the GOT/BOT during the summer and fall of 1997 under the guidance of the IFIs.* The IMF appears to have dominated these crucial policy decisions, but the Bank provided technical assistance to the Thai authorities in the summer and fall of 1997 and participated in IMF missions related to these policy decisions. Much of the focus of the FCRL was on implementing these policies, particularly in relation to the FCs. In addition, the FCRL also focused on strengthening the supervision and prudential regulation of FIs, and had elements of corporate restructuring and corporate governance and disclosure.

2.5 The Board Condition for the FCRL with respect to *macroeconomic and fiscal policy* called for a shift from a fiscal *deficit* of 1.6 percent of GDP in 1996/97 to a *surplus* of 1 percent of GDP in 1997/98.

2.6 With respect to *restructuring the FCs*, FCRL supported decisions and activities already underway. With 58 FCs suspended and a process for reviewing their viability already in motion, a GOT decree in October 1997 had initiated most of the actions in the Board Conditions. The FCRL defined institutional details and timing.⁷

⁷ These included: the establishment of the Financial Sector Restructuring Authority (FRA) and the Asset Management Corporation (AMCorp), definition of the rehabilitation/resolution process of suspended FCs, provision of financial support by GOT to FRA and AMCorp and the fiscal arrangements to properly reflect the cost of restructuring, definition of treatment of depositors and creditors of FIs, and conditions for liquidity support from FIDF.

2.7 For *strengthening the supervision and regulatory environment*, the process was defined by which the BOT would address open, weak FIs. In addition, loan classification, income recognition and provisioning requirements were to be made consistent with international standards and a time line was set for phasing in these changes. Finally, the BOT was to establish procedures for prompt corrective action, strengthening licensing requirements, prudential regulation, and the supervisory regime (in spite of the agreed division of labor in which the IMF was to deal with the banks – see paragraph 2.1).

2.8 With respect to *corporate restructuring* (called strengthening market discipline), GOT was to improve the legal and regulatory framework for corporate workouts. In particular, GOT was to submit legislative proposals for corporate reorganization, facilitate financing to companies under reorganization, and speed collateral foreclosure.

2.9 On *strengthening corporate governance and disclosure* (also under strengthening market discipline), GOT pledged to upgrade to world standards its generally accepted accounting principles, disclosures on portfolio quality, income recognition practices, ownership structures, and auditing standards.

Economic and Financial Adjustment Loan (EFAL I)

2.10 EFAL I addressed the same areas as FCRL, with greater emphasis on corporate restructuring. On *macroeconomic and fiscal policies*, EFAL I required that GOT reverse direction from contraction (under the FCRL – para 2.5) to expansion and make satisfactory progress toward a public sector *deficit* target for 1997/98 of 3 percent of GDP.

2.11 On *financial restructuring*, measures to address the closed FCs were reiterated, specifically progress on FRA sales and establishment of AMC; establishment of a bridge bank, Radhanasin Bank (RB) was an added objective. Rather than focusing exclusively on FCs, as had been the case under the FCRL, greater emphasis was put on restructuring the entire financial sector. Looking more to the future, EFAL I set the objectives of redefining the role of FIs in a modern financial sector and developing a comprehensive framework for supervision. It also addressed the restructuring of banks that had been taken over by the BOT (again, in spite of the agreed division of labor with the IMF – see paragraph 2.1). EFAL I reiterated the regulatory/supervisory objectives of improving legal provisions and regulations and strengthening the capacity of the supervisory agencies.

2.12 With regard to *corporate restructuring*, EFAL I retained the goal of developing appropriate legal and institutional frameworks for bankruptcy and reorganization and added goals for providing a legislative and institutional framework for secured lending and improving the process of enforcing commercial contracts and other commercial legislation. EFAL I also included (under the heading *fiscal objectives*) tax reforms to remove the bias in favor of debt over equity financing, to promote debt rescheduling and encourage cash-free asset transfers, share acquisitions, and mergers as methods of corporate restructuring. In addition, GOT pledged to remove tax obstacles to the formation of special purpose vehicles in order to facilitate securitization of bank assets.

2.13 On *corporate governance and disclosure*, GOT promised to rationalize the institutional framework for setting accounting standards and regulating accounting and auditing practices. The Institute of Certified Accountants and Auditors of Thailand (ICAAAT) was to become an independent self-regulatory professional body by the end of 1998. Corporate governance was to be strengthened by a series of measures, including enhancing the financial oversight role of the board of directors, the establishment of audit committees, legal and regulatory changes to enhance protection of minority shareholder rights and strengthen the accountability of corporate officers and directors, and strengthening enforcement of laws and regulations for public companies.

Second Economic and Financial Adjustment Loan (EFAL II)

2.14 The third loan continued the focus on macroeconomic and fiscal conditions, financial sector restructuring, and corporate restructuring.⁸ EFAL II reiterated the commitment in EFAL I to fiscal stimulus, in contrast to the fiscal tightening required in FCRL. Explicit goals were set for government spending and a program for easing the credit crunch was called for.

2.15 With regard to *financial sector restructuring*, the only new theme in EFAL II was development of a deposit insurance system. EFAL II placed greater emphasis than the previous two loans on *corporate restructuring*. The GOT was to strengthen the legal and institutional framework for: (i) corporate insolvency, to facilitate the reorganization of companies and the recovery of distressed assets; and (ii) secured lending, by expanding the types of assets that could be used by debtors to secure loans and by speeding up the procedures for the realization of secured interests. Finally, a credit bureau was to be established that would be open to all FIs and trade creditors, facilitating the establishment and operation of private asset management companies and eliminating the remaining tax disincentives to corporate restructurings.

2.16 With regard to *corporate governance and disclosure*, EFAL II repeated most of the same objectives as EFAL I.

2.17 The main new initiative in EFAL II was *capital market development*. The GOT was to deepen the government bond market to ensure the successful placement of new issues and lay the foundation of a broader bond market with sufficient breadth and depth to facilitate raising capital by the private sector and the conduct of monetary policy.

Relevance of Objectives

2.18 Because most of the objectives of the three loans related to long-term processes, there was considerable overlap among them. This is not a criticism of the loans, but an explanation for the discussion below, which is organized around themes rather than loans.

⁸ Competitiveness, poverty, and social protection were also loan objectives. These not covered by this assessment, which is focused on financial sector issues.

Macroeconomic and Fiscal Policy

2.19 With the benefit of hindsight, the fiscal objectives in the FCRL were too restrictive, based on an underestimation of the full scope of the macroeconomic consequences of the large-scale financial system restructuring and on over-optimism about the speed and magnitude of the expected recovery of the Thai economy. The fiscal austerity may have been damaging to the Thai economy: the cumulative fall in GDP was higher in Thailand than in other crisis-affected countries (except for Indonesia) and GDP growth in Thailand took longer to rebound than in these other crisis affected countries (see paragraph 3.2 and Tables 3.1-3.3) and most observers interviewed by the IEG mission were sharply critical of the IFIs for this initial position.⁹ The subsequent easing of fiscal targets under the later loans proved difficult for the Thai authorities to meet and did not result in an economic rebound.

Finance Company Restructuring

2.20 The precipitous suspension and subsequent closure of the FCs and the rapid disposition of their assets through FRA were decisions made prior to the approval of the FCRL. Nevertheless, the Bank was present during the discussions leading up to these decisions and much of the focus of the FCRL was on implementing the policies. The objectives for FC restructuring contained in FCRL and EFAL I and II were largely administrative in nature, and were generally practical and appropriate requirements for the required restructuring, although some proved to be important. For example, the tight deadline for FRA's disposition of assets subsequently became controversial.

2.21 EFAL I added the objective of establishing Radhanasin Bank (RB) as a bridge bank to manage the assets of the closed FCs. This was a very good objective, but it was already too late in the process, because by the time EFAL I was approved in July 1998, one year after the onset of the crisis, the assets that had been good had turned bad, so there was little for the bridge bank to do. Both EFAL I and EFAL II included objectives to restructure and recapitalize the banks that had been intervened by the BOT, which were also relevant for rehabilitating the financial sector.

Strengthening the Supervision and Regulatory Environment

2.22 All of the objectives under FCRL that related to strengthening supervision of banks and FCs, as well as to FI accounting, disclosure, and prudential regulation are relevant and important to the restructuring of the Thai financial system. While specific regulatory changes were defined in FCRL, both EFAL I and II contained broader objectives to improve legal provisions and regulations for supervision of FIs and to strengthen the capacity of the supervisory agencies. These were badly needed and very relevant goals.

⁹ Although the initial conditions on fiscal restraint were set by the IMF in its LOI, the Bank's FCRL reiterated these conditions – see Annex C, Matrix of Board conditions.

2.23 Nevertheless, there should have been early and stronger emphasis on limiting the depositor guarantee and on introducing a limited deposit insurance scheme (a strategy for phasing out the blanket guarantee was in the FCRL matrix, but no specific condition tied to it, and the development of a deposit insurance scheme to replace the blanket guarantee was in the Letter of Development Policy in EFAL I and became a Board condition in EFAL II). By contrast, arguably less emphasis should have been placed on broader and longer-term objectives, such as defining the future role of FIs and developing a comprehensive framework for supervision of a modernized system, which were introduced in EFAL I and repeated in EFAL II. Although relevant, emphasis on these issues while still in a crisis seems to be a questionable use of scarce regulatory resources.

Corporate Restructuring

2.24 The objective of corporate restructuring was highly relevant, and deserved greater emphasis than it got in the first two loans. Had GOT achieved greater success in getting legislative approval for and implementing essential reforms in bankruptcy and foreclosure laws earlier in the crisis, these reforms would have made it easier to restructure the financial sector and less costly to dispose of the FRA assets.

2.25 The success of bank restructuring ultimately depended on the successful work-out of non-performing loans. But the willingness of banks to restructure existing loans and extend new loans depended on their confidence that corporate borrowers would undertake credible restructuring measures to repay and could be compelled to repay should they prove unwilling to do so. The deterioration in Thailand's credit culture that was associated with the closure and disposition of assets of FCs made FIs much more reluctant to restructure existing loans meaningfully or advance new loans.

2.26 In addition, Thailand needed an insolvency framework that would reduce legal and financial uncertainty, promote efficiency and provide fair and equitable treatment of stakeholders in insolvent firms. Traditional procedures were notoriously slow and gave the debtor enormous scope for delay; thus, reorganization procedures essentially adopted from the United States ("Chapter 11 style") were probably the wrong model, as they were likely to exacerbate delays, which in turn increase uncertainty, reduce efficiency and may even worsen equity, especially when small creditors are trapped in a moratorium. Moreover, such procedures require a highly specialized judiciary, which Thailand lacked. It would have been preferable to focus on improving simple liquidation procedures which emphasize the involvement of stakeholders rather than the court in business decisions.¹⁰

Corporate Governance and Disclosure

2.27 Weaknesses in corporate governance – ineffective boards of directors, weak internal controls, unreliable financial reporting, inadequate audits and weak market discipline – have been implicated as underlying causes of the Thai financial crisis.

¹⁰ For example, a general creditor could apply for the court to appoint a bankruptcy administrator when the corporation has defaulted on its debt to the general creditor. The court would then choose an administrator from a list of licensed administrators and creditors would have the right to request a replacement only on the narrow grounds of fraudulent or malicious behavior.

Neither bank lenders nor their corporate borrowers were subject to effective market discipline and so the objective of strengthening corporate governance, accounting, auditing, and disclosure standards was highly relevant.

Government Bond Market Development

2.28 The objective of bond market development was also highly relevant because the Thai economy was heavily dependent on banks for external finance. Since banks were the dominant financial institutions in Thailand and were highly leveraged, the economy was more vulnerable to crisis than it would have been if there had been a well developed capital market. When the banking crisis occurred, the damage to the real economy was much greater than if borrowers had had access to a well-functioning bond market. Moreover, the financial restructuring process was more difficult than it would have been if Thailand had had a robust capital market to facilitate securitization.

3. Implementation Experience

Macroeconomic and Fiscal Policy

3.1 The GOT managed to *meet the stringent fiscal target for a surplus* in 1997, but it had more difficulty in meeting *targeted fiscal deficits*. Throughout fiscal 1997/98 and 1998/99, the GOT substantially undershot its target fiscal deficits – that is, its deficits were lower than the targets (Table 3.1). The reason for this apparent paradox is that it was easier for GOT to stop expenditures than to start them. Once expenditures were stopped, it was often necessary to start a new bidding process and renegotiate contracts before expenditures could be resumed. In addition, the credit crunch in the financial sector meant that suppliers were often unable to submit new bids.

Table 3.1: Macro Indicators, 1998-2004

Fiscal year		1998	1999	2000	2001	2002	2003e	2004p
GDP growth	planned	-4 to -5.5	1					
	actual	-10.5	4.4	4.8	2.1	5.4	6.8	6.5
Fiscal deficit*	planned	+1/-3	-5	n/a	n/a			
	actual	-2.4%	-3.1%	-2.5%	-1.2%	-1.7	1.5	1.1
Inflation (headline CPI)		8.1	0.3	1.6	1.6	0.7	1.8	2.7

*by fiscal year
Source: IMF

3.2 This fiscal performance, however, may have contributed to poor economic performance in the immediate aftermath of the shock (Table 3.2). Economic growth was considerably lower than projected in the year following the crisis, although growth resumed in 1999, and since 2002, overall economic performance has been very strong in terms not only of growth, but also fiscal performance and low inflation. Nevertheless, the cumulative fall in GDP was higher in Thailand than in other crisis-affected countries (except for Indonesia); GDP growth in Thailand took longer to rebound than in these other crisis affected countries; and GDP in both Thailand and Indonesia took longer to reach

their pre-recession peaks (Table 3.2). To the extent that the early fiscal targets were too stringent and that the shift from a fiscal surplus to a deficit target was difficult to attain for the GOT, the fiscal targets in the three Bank loans should have called for higher deficits.

Table 3.2: Post-Crisis Economic Trends

	Year of Crisis	Quarters of GDP Decline	Cumulative % Fall in GDP	Quarters to Recover Former Peak	Average growth in 2 Years After Trough	Fiscal Cost (% of GDP)
Indonesia	1997	3	-19.4	Not Yet*	4.1	50
Thailand	1997	5	-14.8	Not Yet*	4.9	32.8
Mexico	1994	2	-8.9	6	7.3	19.3
Korea	1997	2	-8.0	4	10.2	26.5
Argentina	1994	3	-5.7	3	8.3	0.5
Brazil	1999	2	-1.9	4	3.4	13.2
Median		2-3	-8.5	4-6	6.1	

*As of March 2001

Source: "Lessons for Turkey from Recent Emerging Market Crises," World Bank note, March 2001: World Bank data, seasonally adjusted by authors. Honohan and Klingebiel, 2000 for fiscal costs of the crisis.

Finance Company Suspension and Closure

3.3 After the FRA completed its evaluation of the viability of each suspended FC, 56 were closed and their assets were transferred to the FRA. Over 80 percent of the liabilities of these institutions were loans from the FIDF, so the ultimate cost of the FC closure had already, implicitly, been shifted to the Thai public. These actions were in place before the first Bank loan was approved. The actions taken by the Thai officials in the summer of 1997, with the urging and support of the IFIs, did stem deposit outflows somewhat, but aggravated the negative effects on other FIs and the macro-economy.

3.4 Although the FCs technically remained "open" in their suspended status, the Thai regulatory authorities lacked the experienced personnel to perform even the most basic functions. As a result, normal banking procedures broke down and documents were not safeguarded. The regulatory agencies also lacked the authority, the procedures, and the resources to undertake closure of the 56 FCs, and in any case, inadequate record-keeping and accounting practices complicated the audits of these institutions. Finally, the absence of deposit insurance complicated the situation in terms of public confidence.¹¹

¹¹ It is doubtful that any regulatory agency, even one experienced in the closure of FIs, could take on 56 FIs at once. Rather than suspension and closure, establishing a "bridge" bank facility would have been more effective in separating the good assets of insolvent FCs from the bad and isolating insolvent FCs from healthy ones. The performing assets of FCs could have been transferred to the bridge bank facility where they would have continued to be serviced; performing debtors would have continued to have access to additional credit and other financial services. This approach would have had a number of advantages: (1) by isolating nonperforming assets early in the process, more FCs would likely have survived; (2) the credit contraction associated with closure and the adverse macroeconomic impact would have been smaller; and (3) the asset quality of closed institutions would have been better protected to minimize the ultimate public cost of resolution. Although not a panacea, a bridge bank facility, supported with assistance from IFIs and private sector experts, and combined with other restructuring measures, would likely have had a better outcome, compared to the large scale closure and disposition of assets that amounted to 15 percent of GDP.

3.5 The government that came to power in November 1997 established the bridge bank RB (an objective in EFAL I), but this was already too late. By the time it was established in February 1998, approximately 80 percent of the commercial loans of closed FCs were non-performing.¹² RB was expected to be a bidder in FRA auctions, but was never adequately capitalized.

Finance Company Asset Disposition

3.6 With the closure of 56 FCs, 869 billion baht, or 14 percent of the assets of the financial sector, was transferred to the FRA for disposition. An asset disposition of this magnitude would be a daunting task under any circumstances and the dismal economic situation in Thailand and the region created additional challenges. In formulating the sale process, FRA officials' biggest concern was whether there would be sufficient bidders from either within Thailand or externally, given the economic uncertainty, and the perceived inadequacies of Thai bankruptcy and foreclosure laws and practices. In addition, other countries in the region were experiencing similar problems and also trying to sell their non-performing loans.

3.7 The emergency decree that created the FRA gave it the authority to dispose of the assets through methods they deemed appropriate for each type of asset. It also indicated that the preferred method was an open auction. The FRA did not have authority to restructure or renegotiate loans. At the same time AMCorp was set up to act as the bidder-of-last-resort in FRA auctions. Assets that could not be sold for a higher price were transferred to the AMCorp which then worked to restructure the loans to recover as much as possible. Initially the FRA was required to complete its task by end 1998, only a year after the closure of the FCs. Later, this deadline was extended a year.

3.8 There was no expertise in Thailand to undertake such a complicated process. FRA officials hired a foreign investment bank to help structure the sales and prepare and package the loans for sale. The FRA held its first auction of core assets¹³ in June 1998, six months after the closure of the FCs. By end 2000, 86 percent of FRA assets had been sold with an average recovery rate of 35.3 percent of face value. Most of the remaining assets were involved in litigation. By the second quarter of 2001, the FRA distributed its recovered funds, 218 billion baht, to the creditors of the FCs and the FIDF. The Ministry of Finance (MOF) had taken the position that debtors could not bid on their own loans¹⁴ and the IFIs generally agreed with this policy. Of the 600 billion baht in core assets auctioned, about 50 percent were purchased by a few foreign, institutional bidders. In

¹² Veerathai Santiprabhob, p. 25.

¹³ Core assets exclude items such as real estate, autos, and artwork.

¹⁴ In addition to collusion among debtors, MOF and FRA officials were concerned about "strategic default". If debtors could buy their own debt at below face value, there would be an incentive for debtors to stop paying on loans in the expectation that they could be bought later at a substantial discount. Widespread strategic defaults would have further eroded asset quality in an already fragile financial system and might have done long-term damage to the credit culture by undermining the expectation and cultural norm that debt is repaid.

addition, one of the winning bidders was the investment banking firm that had been hired to advise the FRA.¹⁵

3.9 These results were widely criticized after the public learned that most of the successful bidders were foreigners, many of whom were suspected of “flipping” the loans back to the original borrowers at substantial profit, and that one of the successful bidders was the advisor to the FRA. There is no evidence, however, that particular bidders were favored, foreign or otherwise. All parties had access to the same information and that information is now available to the public in the national library. It is possible that if the FRA had offered smaller lots of assets, more Thai bidders could have come forward, but large packages of the loans were needed to diversify the risk enough to attract large bidders and, in any case, small lots would have made collusion among debtors easier.

3.10 Second, the prohibition of debtors bidding became controversial in Thailand. Since some of the winning foreign bidders later resold loans to the original debtors, the public believed that the cost of the asset disposition and the loss of wealth to foreigners would have been less if debtors had participated in the auctions directly. Although foreign buyers “flipping” the assets back to the debtors at a profit looks suspicious, given the prohibition on direct sales to debtors there is little else the FRA could have done. FRA officials were concerned about attracting enough qualified bidders and any attempt to discourage large, institutional foreign bidders would have been counterproductive. In effect, institutional buyers acted as debt restructurers for Thailand and took considerable risk, given the uncertain quality of the assets. Profits from “flipping” can be considered compensation for restructuring the loans and the risk assumed in doing so. Moreover, letting debtors buy their own debt at a discount is fraught with moral hazard problems (see footnote 14).

3.11 Third, the speed with which the assets were sold also raised public concerns. Since the economy was at its nadir at the time of the auctions, the common view is that better prices would have been received if the assets had been warehoused longer. But the assets had already deteriorated considerably and, with ongoing uncertainty about the economy, further delays would likely have reduced asset quality more. Since the rapid disposition of assets helped recycle the assets and clear the real estate market, it is likely that the disposition effort helped the economy recover sooner. Holding the assets longer could well have postponed economic recovery.

3.12 The deadline decreed for the FRA to sell its assets was onerous given the work involved to hold such auctions.¹⁶ But FRA officials reported to IEG that they were determined to demonstrate that they could resolve the problem and did not feel hampered

¹⁵ Allowing the foreign firm that was advising the FRA to bid was a politically bad decision. In principle, such potential conflicts of interest can be managed by erecting Chinese walls between the two different lines of business. The FRA was assured by the firm that appropriate practices were being followed and there is no reason to believe that the process was compromised. But the perception of it by the Thai public was predictably very negative.

¹⁶ It is also a tight deadline relative to similar operations in developed countries. The US Resolution Trust Corporation, for example, took five years to dispose of a much smaller stock of non-performing assets relative to GDP, with more experienced and expert staff, and under much less troubled economic conditions.

by the short deadline. The FRA's results might have been better if they had had the power to restructure or renegotiate the loans transferred to them, but FRA was denied this authority, on the grounds of enhancing transparency and minimizing the opportunity for corruption. Restructuring would have likely recycled some loans more quickly and released collateral, hastening the rehabilitation of viable debtors and might have allowed the FRA to avoid some of the most negative public reaction to the whole cleanup process.

3.13 The deficiencies in the bankruptcy laws and other restructuring infrastructure were an important deterrent to attracting more bidders. If bankruptcy procedures had been in place, the asset sales would have likely attracted more bidders and better prices. In addition, the public cost of the asset disposition would have been less if the FRA had partnered with an experienced investment banker or debt restructurer and entered into an incentive agreement based on recovery. The FRA did attempt such an approach on a small scale, and the recovery rate was somewhat better, but the arrangement faced heavy public criticism because of the image of turning the process over to a foreign company that would profit from the arrangement.

3.14 Given the size and complexity of the task, the FRA performed its role well, and in a timely way. The process involved open and fair auctions in which all interested bidders had equal access. The auctions returned to productive use assets that amounted to about 15 percent of 2001 GDP. The recovery rate was less than the pre-auction estimate (made by independent auditors in 1997) of 42 percent, but several years of worse-than-expected economic performance had intervened.

Treatment of Depositors and Creditors

3.15 The FCRL supported a blanket guarantee for both depositors and creditors. Depositors of suspended FCs could exchange deposits for notes of Krung Thai Thanakit Finance Company (KTT – paragraph 3.19), the maturity of which depended on the size of the deposit. Although depositors in suspended FCs lost the liquidity of their deposits, they eventually (in some cases over a year later) received full face value. At the time of the second FC suspension in August 1997, a blanket guarantee was extended to all depositors and creditors of all FIs in the system, not just those that had been suspended. The guarantee may have been needed early in the crisis to stabilize the system, and may have been politically expedient, but it was, and remains, detrimental to long-term structural reform; it is also contrary to well-disseminated Bank guidance for deposit insurance (see paragraphs 4.10-4.12 for discussion).

Restructuring and Recapitalizing Core FIs (banks)

3.16 The GOT began the crisis owning two FIs, and by 1998, four were state-owned. After combining two, three institutions were still state-owned as of 2004. Under EFAL II, these institutions were to be privatized by mid-2001. The GOT/BOT maintains that it is committed to privatizing these institutions, but no further progress has been made.

3.17 Over the year and a half beginning in the fall of 1997, the BOT intervened in six commercial banks (constituting 24 percent of total loans of the FI system) and 12 FCs. The management and boards of directors of most of the intervened banks were removed

and replaced. Working on a case-by-case basis, the authorities addressed the intervened banks using a combination of merger, consolidation, closure and sale to foreign interests.

3.18 In contrast to the treatment of the FCs, the intervention approach by the BOT was in many ways preferable. Public concerns were calmed when it was clear that depositors were protected and the system became more stable. The interventions and subsequent mergers have helped consolidate a system that consisted of too many, small, uncompetitive FIs. The authorities' out-of-pocket costs have been contained, compared to a payout under the deposit guarantee.

3.19 The authorities merged five FCs into a state-owned FC, KTT; subsequently, seven more FCs and one intervened FI were combined with KTT to form Bank Thai (BT). One intervened bank was merged into state-owned Krung Thai Bank (KTB). The outstanding loans from FIDF on these merged institutions' balance sheets were converted to equity so the mergers were a means of recapitalizing the state-owned institutions. In addition, KTB's non-performing loans (NPLs) were transferred to a government-owned Asset Management Company (AMC) in 2000. The assets were transferred, through some creative accounting, at enhanced prices (relative to market) to further recapitalize KTB, and the transfer allowed KTB's NPL ratio to fall from 58 percent to 8.4 percent and its risk-adjusted tier one capital ratio to rise to 9.5 percent. Assets were paid for with FIDF bonds, structured to help KTB meet its interest obligations.

3.20 BT and the other three state-owned banks at the time were treated similarly. In the case of BT, NPLs were transferred to a covered asset pool that remained in house, rather than a state-owned AMC. Its losses, however, were to be covered by the FIDF and therefore had no impact on BT earnings. BT was given a yield maintenance agreement by the FIDF to support servicing of deposits.

3.21 The BOT attempted to sell their majority share in the four remaining intervened banks. Due to the large number of NPLs, the BOT had to offer yield maintenance or gain/loss sharing agreements to potential buyers. With many Asian banks trying to privatize or looking for strategic partners, few bidders came forward, although two of the four intervened banks were successfully sold.

3.22 The recapitalization of the four state-owned banks resulted in nearly a trillion baht of NPLs transferred to state-owned or state-supported AMCs. These recapitalization efforts resulted in three "good" state-owned banks and a fourth with its NPLs effectively isolated from its ongoing business. The accounting techniques employed in recapitalizing these institutions, however, do not constitute effective restructuring. The recapitalized state-owned banks are still burdened with political interference, allegations of corruption, management turnover, inadequate business plans, and for several of them, issues related to their merger.

Improving Supervision and Regulation

3.23 The BOT set new provisioning guidelines early in the crisis, but stopped short of bringing them to international standards. They were fully phased in at end 2000, but

forbearance still occurred, at least through 2002,¹⁷ in an attempt to reduce the stress on weak institutions and/or to increase lending to stimulate the economy. Forms of forbearance included allowing the loan loss provision to be calculated net of collateral without critical assessment of its value. The effect of this was to lengthen the period of time over which loan losses would be realized. Other forms of forbearance included weakening standards on classification of loans, including restructured loans, and weakening rules for types of collateral and collateral valuations. A phase-out of some of these forbearance tactics was scheduled for end 2003, but international standards are still not met. The forbearance has many negative consequences for the health of the financial system.¹⁸

3.24 Other regulatory and legal changes have been achieved, though with some delay compared to the timeline agreed upon the Bank. The BOT has acquired the authority to intervene in an illiquid or insolvent institution, and has promulgated the standards and guidelines for doing so. Legal authority to bring a prompt corrective action against an institution has been given (though over four years late) and the procedures defined. Regulation has been standardized across banks and FCs, foreign ownership rules have been liberalized somewhat, and licensing standards have been reviewed and improved.

3.25 The BOT has reengineered their supervisory function, upgraded their skill base significantly, and trained bank examiners. On-site exams now occur regularly. The BOT is building the capacity to begin risk-based examinations, in accordance with international standards.

3.26 In EFAL I and II, the BOT was urged to develop a longer-term framework for the future of Thai financial services in order to bring it to internationally accepted standards to be able to compete in a global industry. A task force was appointed which developed the Financial Sector Master Plan, publicly released in early 2004. The Master Plan has been reviewed by industry representatives and professional groups and forwarded to the Cabinet. The Master Plan addresses a wide range of topics from licensing of various types of FIs, to initiatives to improve financial services to the poor and for consumer protection. The document attempts to define a more level competitive arena for foreign institutions in terms of branching and business scope.

Corporate Restructuring

3.27 The GOT pursued a private-sector led, voluntary solution to the mounting volume of NPLs, which required a number of changes to the enabling environment, including

¹⁷ *Thailand: Economic Monitor*, July, 2001, p.17 and May, 2002, p.40.

¹⁸ First, it postpones, but does not eliminate, the need to realize losses. Second, it impedes appropriate FI restructuring by supporting the existence of weak FIs and industry overcapacity at the expense of stronger institutions. Third, FIs continue to operate with too little actual capital and have less competitive pressure to restructure or raise more capital. Fourth, since outsiders cannot accurately understand capital positions, assess losses or make valuations, raising capital from private investors or attracting a foreign partner (as the GOT has encouraged) is more difficult. Finally, in absence of the blanket guarantee, depositors and creditors would have had incentives to distinguish among FIs that remain in business because of regulatory forbearance, and those that manage and disclose risk based on accepted standards

most importantly, modernized bankruptcy and foreclosure laws and enhanced enforcement capacity.¹⁹

3.28 The GOT met fierce resistance in Parliament to its proposed bankruptcy and foreclosure reforms, particularly in the Senate where a number of Senators were themselves strategic defaulters.²⁰ Debtors feared that the proposed amendments would reduce their bargaining power and waged a major campaign in opposition, stirring up fears that Thai firms would be driven into bankruptcy and taken over by foreigners at bargain prices. As a result, the foreclosure reforms under EFAL I were carried out in two phases. The first phase was approved by Parliament according to the original timetable, but the second phase was delayed and ultimately passed in greatly watered-down form (paragraphs 3.37-3.38).

3.29 After the politically damaging experience with the FRA (paragraphs 3.9-3.12), GOT avoided reliance on a centralized government asset resolution agency, in contrast to Korea, Malaysia, and Indonesia. Instead the GOT emphasized decentralized, less transparent, less politically vulnerable ways of resolving NPLs. To encourage banks to recognize the losses implicit in their NPLs, GOT offered a public support scheme to ensure that banks had enough capital to withstand losses in restructuring troubled corporate debt.²¹

3.30 The Corporate Debt Restructuring Advisory Committee (CDRAC) was launched in June 1998 to coordinate the renegotiation of corporate debt and the Bangkok Approach was devised to provide a voluntary, out-of-court framework for restructuring NPLs. CDRAC first targeted the 350 largest NPL borrowers. Progress was slow through the end of 1998 and so EFAL II placed special emphasis on speeding up the process. The quantity of cases resolved under the auspices of CDRAC increased markedly thereafter, but the quality of the restructuring agreements left much to be desired.

3.31 More than three-quarters of the cases involved no reduction in the book value of the lender's claim on the borrower, relying instead on an extension of maturity, the provision of a grace period, or a reduction in the contractual interest rate.²² This would have been appropriate if borrowers faced liquidity problems rather than solvency issues. It is likely that banks favored this "cosmetic restructuring" to protect their fragile capital

¹⁹ Other changes that were required involved establishing guidelines for the accounting treatment of restructured debt and the regulatory treatment of NPLs; changes to the tax law; and providing training in corporate bankruptcies and formal corporate reorganizations for judges and receivers as well as trustees-in-bankruptcies, company managers, lawyers, accountants and others.

²⁰ See Annex C for a chronology detailing how one senator, who controlled the largest corporate debtor in Thailand, managed to evade creditors for at least seven years.

²¹ With two exceptions, banks not subject to intervention avoided participation in the recapitalization offer, preferring instead to engage in cosmetic restructuring that would defer the recognition of loss and, if economic conditions improved markedly so that borrowers could resume servicing their debts, perhaps avoid recognition of a loss.

²² Less than a quarter of the cases involved a forgiveness of principal or accrued interest, a swap of debt for assets or debt for equity or other restructuring techniques. This inference is based on Table 8.1s, in Veerathai Santiprabhob, (p. 85).

positions, avoid dilution of control, and to maintain the option of borrowers' repayment of the principal if the economy and borrowers should recover.²³ The inadequacy of this approach to corporate restructuring contributed to the very slow reduction in NPLs.

3.32 With lagging economic recovery and continued delays in corporate restructuring, NPLs continued to grow through the first quarter of 1999. As of January 1999, NPLs accounted for nearly half the loans at Thai commercial banks.²⁴ During 2001 and 2002, the "reentry" of NPLs that had been restructured under CDRAC exceeded new NPLs; in 2002 alone, for example, some 30 percent of the debt restructured reverted to NPLs within a few months.²⁵ By the first half of 2003, two-thirds of the loans restructured by private banks had reverted to NPL status.²⁶

3.33 The progress in NPL restructuring under CDRAC was largely among private FIs. The restructuring of NPLs at state-owned FIs (and at private FIs where state owned banks were involved) proved to be much slower. They had less capital capacity to accept a loss and they lacked sufficient legal immunity for their employees and directors, who faced potential criminal liability for incurring losses to the state even if a reduction in the book value of a loan enhanced its economic value. These restraints on the involvement of state-owned banks were later eased.

3.34 By mid-2003, after five years of operation, the CDRAC process had completed 49 percent (by face value) of its US\$67 billion (2.9 trillion baht) target cases. The remaining cases failed the CDRAC process and were transferred to the Civil Courts for resolution (US\$31 billion) or to the Thai Asset Management Corporation (TAMC) (US\$4 billion).²⁷

3.35 Established in June 2001, TAMC has become the largest public AMC in Thailand. By the second quarter of 2003, the TAMC had acquired nearly 18,000 loans with aggregate book value of 784 billion baht (US\$19.8 billion),²⁸ and had approved resolution plans or undertaken legal enforcement measures for over 70 percent of the transferred assets. By the second quarter of 2003, however, fewer than half of the cases under the heading of "Debt/Business Restructuring" had been signed, with the remainder awaiting final agreement. The overall implementation of the out of court corporate restructuring does not compare well to neighboring Asian countries that experienced crisis, as shown in Table 3.3.

²³ The BOT's policy on classification of restructured loans may also have encouraged this approach. Originally, the BOT permitted restructured loans to be reclassified to normal status and their provisions reduced only if the borrower had fulfilled payment obligations for at least three payment periods or three months, whichever was longer. In March 1999, however, the BOT relaxed the NPL graduation standard to encourage a faster reduction in NPLs. See Veerathai Santiprabhob, p. 78.

²⁴ *Thailand: Economic Monitor*, April 1999, p. 20.

²⁵ Claessens (2005), p. 19.

²⁶ *Thailand: Economic Monitor*, October 2003, p. 23.

²⁷ *Thailand: Economic Monitor*, April 2004, p. 37.

²⁸ Ernst & Young, Global Nonperforming Loan Report, 2004, p. 18.

Table 3.3 Corporate Restructuring in four East Asian Countries

<i>Indicator</i>	<i>Indonesia</i>	<i>Korea, Rep. of</i>	<i>Malaysia</i>	<i>Thailand</i>
Number of registered cases				
Mid-1999	157	83	27	430
Mid-2003	n.a.	83	54	14,917
Number of restructured cases				
Mid-1999	22	46	10	167
Mid-2003	n.a.	68	46	6,345
Ratio of restructured debt to total debt (in percent)				
Mid-1999	13	40	32	22
Mid-2003	56	95	77	48

n.a.— not available

Source: Claessens: "Policy Approaches to Corporate Restructuring around the World: What Worked, What Failed", in Pomerleano and Shaw, eds. (2005), p. 18.

3.36 In addition, concerns have been raised about the transparency of the process, particularly the need for more information about actual and projected cash recoveries from all types of resolution procedures. Although TAMC projects a recovery rate of 46.28 percent of the book value, so far cash recoveries amount to about 2.5 percent of all the "resolved" cases. Since every Baht not repaid by borrowers on these loans must be repaid by Thai taxpayers, these cash flows deserve careful monitoring.

3.37 In terms of the legal framework, the two phased amendments to the bankruptcy law, in April 1998 and April 1999, failed to provide a strong legal framework for court-supervised reorganizations or to strengthen foreclosure rules that would provide incentives for borrowers to negotiate out-of-court workouts. For example, the amended law shortened the bankruptcy period so much as to render it ineffectual for creditors pursuing a strategic defaulter suspected of concealing assets.²⁹ FIs have therefore preferred to pursue creditors in the civil court, where creditors may have up to ten years to locate hidden assets. The amended bankruptcy law suffers from other deficiencies.³⁰ Thus the twice amended bankruptcy law failed to make a strong contribution to speeding up the corporate restructuring process.³¹

²⁹ The amendment shortened the bankruptcy period (the period before the debtor could be viewed as having discharged his debts) from ten years after the last allocation by the receivers to three years after the court's bankruptcy ruling. Since it usually takes at least two years from the bankruptcy ruling to the last allocation of assets by the receiver, this shortened the effective bankruptcy period by at least nine years relative to the GOT's initial proposal. See Santiprabhob, p. 74, for additional discussion.

³⁰ For example, the criteria for initiating bankruptcy proceedings are based on balance sheet solvency rather than the debtor's cash flows, which allows debtors to avoid servicing their debts while arguing that they are, nonetheless, solvent. The amended law also fails to provide for a quick conversion of an unsuccessful rehabilitation into a liquidation; if the rehabilitation fails, all insolvency proceedings terminate and the debtor can continue doing business, which provides considerable scope for a nonviable debtor to delay liquidation. See IMF Staff Country Report No. 00/21, p.25.

³¹ In September 2003, the Legal Reform Committee for Development of Thailand (LRC) submitted revisions of the bankruptcy act regarding personal bankruptcy liquidation to the Cabinet, which mainly provide greater protections for bankrupt individuals, except when the Central Bankruptcy Court rules that the individual was dishonest or guilty of fraud. As of the time of this report, it was uncertain when the proposed revisions would be submitted to Parliament

3.38 Progress with the corporate bankruptcy framework is also unsatisfactory. At the time of this report, revisions had been proposed but not yet submitted to the Cabinet, which were essentially debtor-friendly,³² and which do not address the fundamental weaknesses of the existing structure, especially the inadequate leverage provided to creditors for bringing troubled debtors to the bargaining table. Moreover, they do not address the need to identify and rescind transactions with connected parties prior to the bankruptcy that may have contributed to the distress and undermined the repayment priority among debtors. Most of the revisions of the Bankruptcy Act targeted in EFAL II have not been carried out.

Corporate Governance and Disclosure

3.39 New accounting standards have been introduced and implemented. Accounting and auditing professions in Thailand were to become under supervision of the independent, self-regulatory Federation of Accounting Profession (FAP) expected to be established upon enactment of the Accounting Profession Act in 2004. Companies listed on the Stock Exchange of Thailand (SET) have audit committees in place, and the Institute of Directors has provided training to large numbers of corporate directors.

3.40 The promised revisions of the Securities and Exchange Commission Act and the Public Company Act have been in progress, though at a slow pace.³³ The former needs to be revised to strengthen the role and enhance the fiduciary duties of directors, including the imposition of constraints on related party transactions, with sanctions for violations. The latter needs to be amended to provide protection for minority shareholders and legal channels for shareholders seeking redress. And the process of improving accounting and auditing practices needs to be continued.

3.41 The unfinished agenda for corporate governance includes, in addition to the above issues, the introduction of severe sanctions on insiders, misleading disclosure, and disciplinary actions and sanctions for accountants who violate the professional code of accountants or commit fraud.³⁴ More broadly, the expansion of a thriving institutional investor sector – pension plans, mutual funds and life insurance companies – which is critical to capital market development is also likely to increase pressures for improvements in corporate governance.³⁵

³² Some of the proposed revisions included: (1) allowing honest debtors to petition for rehabilitation; (2) regrouping creditors to recognize the revenue and tax authorities as a creditor group on the same level as financial creditors; (3) requiring 75 percent of creditors' vote by credit value to accept a restructuring plan instead of the current 50 percent. Source: *Thailand: Economic Monitor*, April, 2004, p. 38

³³ *Thailand: Economic Monitor*, October 2003, p. 34.

³⁴ *Thailand: Economic Monitor*, May 2003, p.25.

³⁵ The market incentive for adopting good corporate governance practices can be quite significant. An international investor opinion survey, conducted by McKinsey during 1999, showed that institutional investors were prepared to pay at 25.7 percent premium for corporations that adopted good corporate governance practices in Thailand. The mark-up they were willing to pay in the U.S. was 18.3 percent and in the U.K., 17.9 percent (*Thailand Economic Monitor*, July 2001, p.27).

Government Bond Market Development

3.42 Although the development of capital markets has been limited, there has been good progress in developing a strong government bond market, which was the aspect that the Bank supported. Thailand promptly implemented reforms designed to stimulate development of both the primary and secondary markets for government bonds. The BOT made an effort to introduce a quarter-ahead calendar of regular issuance of government bonds in the primary market to enhance transparency. It succeeded in developing a yield curve for government bonds with a maturity range from less than a year to fifteen years.

3.43 In June 1999, the BOT allowed FIs to conduct securities borrowing and lending business to promote risk management and market liquidity. It also instituted a code of conduct for market participants that included the establishment of a market committee to settle any disagreements between participants in the secondary market. Credit ratings were required for those corporate bonds sold to the public and Institutional Investors.

3.44 The BOT developed a primary dealership system to facilitate the conduct of open market operations and required primary dealers to make a market in government securities as well as quote indicative prices. Thailand also planned to further promote inter-dealer broker system to facilitate transactions between dealers, and the repurchase market was expanded. The BOT launched a fully automated delivery-versus-payment real time gross settlement system for government securities. Clearing and settlement of corporate bonds and equities, however, remained with the Thai Securities Depository and was based on a netting system. A unified and integrated clearing and settlement system for all securities holds the promise of increased efficiency and reduced transaction costs. Moreover, it would facilitate cross-collateralization among debt, equity, and derivatives markets that facilitates the development of derivatives markets.

3.45 The GOT also participated in the establishment of a regional bond fund and committed to developing an action plan to harmonize the bond market infrastructure among key capital markets in East Asia including the establishment of regional credit rating agencies, the linking of regional trading platforms and settlement systems and the acceptance of sovereign bonds of the Association of South East Asian Nations (ASEAN) members as collateral at central banks. These initiatives were designed to make better use of the significant pool of savings among the ASEAN countries and decrease reliance on volatile capital flows.

3.46 Also, during May 2003 the Derivatives Act passed to authorize the development of derivatives exchange to facilitate hedging of financial risks. The new derivatives market, which will trade futures on the stock index, interest rates and foreign exchange, was to be established in 2004 with 300 million baht of seed capital from the SET. The MOF committed to review recommendations from an expert panel charged with identifying impediments to asset-backed securitization.

3.47 The Thai Bond Dealing Center is to achieve recognition as a self regulatory organization for the bond market and will be subsidized by the MOF. It will continue to perform its role as an information center for corporate bond trading activities, which are mostly conducted over the counter. Thailand still lacks a significant institutional investor

sector, however – pension funds, mutual funds and life insurance companies – that is the natural source of demand for long term capital instruments and characterizes countries that have flourishing capital markets.

3.48 The reform measures have been more successful in improving the infrastructure of the government bond market and the regulatory framework for the corporate bond market than in stimulating significant activity in the corporate bond market. The secondary market remains rudimentary, and new issues of corporate bonds, although larger than during the pre-crisis period, remain modest. The stock of corporate debt outstanding is 14 percent of bank loans (2003 figure).

3.49 Thai corporations remain mainly dependent on bank lending for external finance. The structure of the Thai financial system has not changed much since the crisis, despite the efforts to restructure the banking system and promote the development of capital markets. Domestic savings continue to flow mainly through a few banks, which continue to collateralize most domestic lending with property, because it remains the most reliable collateral despite the difficulties in foreclosure.³⁶ The potential gains from capital market development are genuine, but they are yet to be realized.

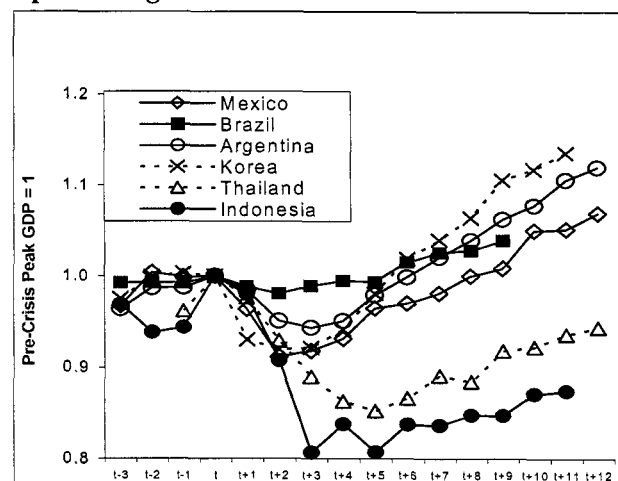
4. Outcomes and Assessment

Macroeconomic and Fiscal Policy: Unsatisfactory

4.1 The fiscal objectives in the FCRL were, in retrospect, too restrictive, based on an initial underestimate of the macroeconomic consequences of the financial system restructuring and on an initially overly optimistic assumption about the ability of the Thai economy to rebound from the crisis. Fiscal austerity may have had damaging consequences for the Thai economy. The subsequent easing of fiscal targets under EFAL I was appropriately expansionary, but GOT was unable to expand its expenditures enough to meet the target.

4.2 In terms of either short-term stability goals, or the long-term health of the Thai economy, the **outcome** is rated as **unsatisfactory**. Although the GOT managed to meet its stringent fiscal surplus target in 1997, it may have been at a cost to economic performance. In addition, its performance was ironically not as good with respect to the subsequent loosening of the fiscal targets (Table 3.1 in Chapter 3). It is likely that the combination of the restrictive fiscal targets and the very high cost to the economy of the

Figure 4.1: Quarterly Real GDP in countries experiencing crisis



³⁶ See Thailand: Economic Monitor, May 2003, p. 20.

financial sector restructuring resulted in poor macroeconomic performance for an extended period of time. Except for Indonesia, Thailand's GDP growth rates fell by more and for a longer period of time following the crisis than in other countries experiencing crisis (see Figure 4.1).

Financial Company Suspension and Closure: Unsatisfactory

4.3 The suspension and subsequent closure of FCs, although decided by the Thai authorities in consultation with the IFIs prior to the FCRL, which the FCRL supported, had a detrimental effect on Thailand via several interrelated channels. These included the macro-economic impact, the effect on other FIs, the effect on the credit culture and the inadequacy of regulatory resources to manage the problem.

4.4 *Macro-economic impact.* With customers of the suspended FCs unable to access funds or acquire new loans, the real economy was heavily affected. Many small, family-owned and medium-sized companies relied on FCs for their working capital, so many healthy companies were denied access to financial services. In addition, borrowers from suspended FCs often could not seek funding at other FIs because their collateral was frozen at the suspended institution. As a result, ongoing, healthy businesses were suddenly without access to working capital, deposits, or collateral, and began to face solvency issues themselves. This added strain to an already-fragile corporate sector (see discussion on corporate restructuring), loans to unsuspended FIs were not paid back and asset quality throughout the system suffered. Thus the abrupt suspension of such a large number of FCs added downward pressure to an already-contracting economy.

4.5 *Impact on other FIs.* Despite Thai officials' desire to prevent the spread of the FCs' problems to commercial banks (CBs), the transmission of the adverse economic impact of the suspension of the FCs to other FIs, even healthy ones, was inevitable. One direct channel of contagion was the substantial direct equity and credit claims of CBs on FCs. In addition, CBs and FCs had many common customers; borrowers from CBs were unable to service their loans because their assets were suspended at FCs.

4.6 *Impact on credit culture.* An indirect impact of the closure was a long-term, detrimental effect on the credit culture. In many cases, little effort was made by suspended FCs or FIs to collect on loans; the public quickly learned that there was little reason to pay back loans to suspended institutions, especially as there was little prospect of receiving additional credit. As a result, loans that could have remained performing became non-performing. In addition to worsening the problems of the FCs themselves, this had a serious negative effect on the credit culture in Thailand, exacerbated by the subsequent disposition of the FC assets (see paragraphs 3.7 – 3.13). The Thai credit culture has not fully recovered today. An alternative to the suspension and closure of the FCs was the use of a bridge bank (described in footnote 11, page 10), which would most likely have had a less negative macroeconomic impact, and a less negative effect on other FIs and on the credit culture.

4.7 *Impact on regulatory resources.* The regulatory challenge related to the suspension/closure was also a concern. The size and scope of the suspension and subsequent closure overwhelmed regulatory resources and magnified the negative macro-

economic impact. The IFIs should not have supported the suspension or closure of so many FCs at one time, without a coherent plan and clear capacity for security of the assets, and for managing the next steps in their resolution. Most important, the closure, and its perceived effects, undermined public confidence in the Thai authorities, damaged the reputation of the IFIs, and undermined progress on needed structural reforms.

4.8 Given the negative impact on many aspects of the economy and needed reforms in the financial sector, the outcome of FC suspension and closure is rated **unsatisfactory**.

Disposition of Finance Company Assets: moderately satisfactory

4.9 Had the original policy decision of closing so many institutions precipitously not been taken, so large an asset disposition would not have been necessary in such a short time span. If closure and disposition are taken as a given, the overall objective of disposing of the FC assets was accomplished, and the process was very well executed by the FRA. Outcomes might have been better if alternative methods, such as restructuring, and the time needed to restructure or renegotiate loans, had been granted to the FRA. One significant unanticipated outcome of the disposition was the disastrous public perception of it which was, and remains today, devastating to the reform-minded leaders associated with the FRA, the IFIs, and the long-term reform agenda. Taking into account both the satisfactory achievement of the basic objective but the unanticipated outcome of the negative public perception of the process, the overall outcome of the disposition of FC assets is rated as moderately satisfactory.

Treatment of Depositors and Creditors: highly unsatisfactory

4.10 While the deposit guarantee seemed to calm public concerns about the safety of deposits, the distortions caused by the guarantee are costly to Thailand as long as it remains in place. In contrast to IMF advice, and to the Bank's subsequent efforts to support a limited deposit insurance system, the guarantee was not temporary, and was still in place seven years later. The guarantee originally given to creditors was phased out only in November 2003, some six years later. The development of a limited deposit insurance plan to replace the deposit guarantee is still under consideration by Parliament.³⁷

4.11 Deposit guarantees, by definition, subsidize weak institutions and encourage risk-taking. This serious moral hazard problem was magnified in Thailand because the guarantee covered creditors as well as depositors. A creditor-guarantee made all sources of FIs' funding risk free, so creditors had no incentive to ration credit based on risk. In

³⁷ If a limited deposit insurance program were put in place, large depositors, if concerned, would seek out lower-risk institutions or instruments. This would bring market discipline to the deposit market, rather than maintaining risky institutions under a blanket of protection implicitly funded by the taxpayer. Guarantees and deposit insurance should be used only to protect (relatively) small depositors who have few alternatives, not large depositors who can seek alternatives consistent with their risk appetite and liquidity needs. In addition, depositor and creditor guarantees encourage a bank-centric economy. With risk-free bank deposits, the development of other short term, liquid saving instruments is discouraged. If creditors can provide funding for FIs without risk, the development of short-term money markets as alternative sources of liquidity is also discouraged. Thailand, like most emerging economies, has a high need to develop capital and money markets as alternatives to FIs for both saving and borrowing.

such a situation, poorly managed FIs can survive when they should not and prudently managed FIs are put at a competitive disadvantage.

4.12 The guarantee given to FI creditors may have been needed in the very early part of the crisis to calm the market, but its persistence for six subsequent years was not appropriate policy. The deposit guarantee may also have been needed early in the crisis to stabilize the system, and may have been politically expedient, but it was, and remains, detrimental to long-term structural reform.³⁸ The continuation of an unlimited deposit guarantee postpones a healthy recovery of the Thai financial system. The costs and risks shifted to the taxpayer by the guarantee are serious, negative effects. The **outcome** of treatment of depositors and creditors is rated **highly unsatisfactory**.

Restructuring and Recapitalizing Core FIs: Unsatisfactory

4.13 Compared to the earlier closure of the FCs, GOT/BOT approach in intervening core FIs (commercial banks, CBs) had the benefit, in principle, of protecting the performing assets of the intervened FIs. In reality, however, resources were strained and good assets were not given the attention needed. The asset quality of both KTB and BT deteriorated in the aftermath of the mergers. Aside from consolidating problems into fewer institutions, it is unclear whether the forced mergers have remedied anything.

4.14 The debt/equity swap was viewed as a cheap way to recapitalize the state-owned FIs, but the cost was only cheap in the out-of-pocket sense. When the BOT intervened, the losses embedded in those FIs became publicly owned and mergers, debt/equity swaps, and accounting maneuvers only reshuffled the publicly-owned losses. Rather than intervening and converting these institutions to state ownership, a preferable approach might have been for the BOT to combine these institutions into a good bank-bad bank structure and then privatize the good bank and transfer the bad assets to an AMC.

4.15 In addition, the state-owned banks appear to have grown rapidly in recent years. For example, by end 2003, the loans of the two largest state-owned banks had grown at rates of 13 percent and 19 percent, compared to 2-3 percent in the private sector, and the two largest state-owned banks owned 30 percent of the loans outstanding and a 54 percent share of new lending by the eight largest CBs.³⁹ A number of private Thai bankers

³⁸ The IMF supports a blanket guarantee for deposits to bolster confidence and stem deposit outflows, if it is temporary, part of a credible plan to restructure the FI system, and has the strong commitment of the government. It contemplates that the guarantee would last 6 months to a year (IMF, "Managing Systemic Banking Crises" 2003). The IMF's conditional endorsement of their use is in sharp contrast to research results that indicate the far-reaching detrimental effects of deposit guarantees. In analyzing outcomes across countries in crisis, research shows that blanket guarantees raise the ultimate fiscal costs of resolving the crisis, and do not help reduce the output loss associated with the crisis or hasten an economic recovery. In contrast, if deposits are not guaranteed and depositors share some of the costs of resolving FI difficulties, financial intermediation is restored sooner and the economy tends to recover sooner. (See Honohan and Klingebiel (2000) and (2003); Claessens et al (2001); Kane and Klingebiel (2002)).

³⁹ With the many transfers of assets to AMCs and other accounting restructurings, the data on lending are not always consistent. Both the state-owned and private FIs gained share of the loan market since the beginning of the crisis, but it appears that gains for both sectors were at the expense of foreign FIs. Inferences drawn from the Thai loan data seem to be highly dependent on timing. *Thailand Economic Monitor*, May, 2004, p. 25.

reported to the IEG mission that state-owned FIs persistently under price loans. This suggests that the high growth of state-owned FIs is in part at the expense of the growth and profitability of the private banking sector.

4.16 The treatment of the core FIs (isolating NPLs, recapitalization, merger, and other restructuring tactics) was preferable to the treatment of FCs, which has led to greater stability and an improving situation of the NPLs. In addition, there are fewer institutions in a system that needed consolidation, although the consolidation has been largely dictated by the GOT/BOT. At the same time, the banking system is not particularly profitable⁴⁰ and is being taxpayer-subsidized to a larger extent than before the crisis. After nearly seven years of IFI-led restructuring, more FIs are state-owned than before the crisis and, while the data are mixed, it appears that the state-owned sector is controlling a growing share of credit extension. Based on 2004 data, about 28 percent of the total FI sector is state-owned; this state-owned sector was supposed to have been largely privatized by mid-2001. Thus, the outcome of restructuring and recapitalization of core FIs is rated as unsatisfactory.

Improving Supervision and Regulation: Satisfactory

4.17 The outcomes on improving supervision and prudential regulation have been good, though the modernization has not been complete and delays have been long. Nevertheless, stronger regulations are in place, the BOT has greater authority to intervene, licensing standards have been improved, and the BOT has upgraded its skills; on-site exams occur regularly, and its building capacity to move to a risk-based system of supervision. Accordingly, outcome is rated as satisfactory. An unfinished agenda remains, but seems likely to be achieved over time.

Corporate Restructuring: Moderately unsatisfactory

4.18 Progress in corporate restructuring has been slow and incomplete. Although progress has been made with debt restructuring, remarkably little corporate or operational restructuring has been accomplished. Corporate control remains highly concentrated in the hands of 15 families and few mergers and acquisitions have occurred. The failure to efficiently deal with the distressed assets effectively locked up a substantial amount of financial resources that could have been used more productively elsewhere in the economy. Consequently, the recovery of investment was slow – relative to experience in Thailand in earlier recoveries and to the contemporary experience of its East Asian neighbors.⁴¹ Recovery was led primarily by exporting firms that benefited from the substantial depreciation of the exchange rate and tended to have access to foreign funds.

4.19 Second, many legal and institutional reforms supported by the three loans have still not been accomplished. The amended bankruptcy law, for example, contains important

⁴⁰ While profitability has improved, it still lags that for other Southeast Asia economies, including those who went through similar crises in the late 1990's. See, for example, IMF, *Thailand: Selected Issues*, January, 2004, p. 30.

⁴¹ See *Thailand: Economic Monitor*, April 2004, p. 18.

weaknesses, and the bankruptcy framework has not yet been revised; proposed revisions do not address fundamental weaknesses. Most of the reforms in EFAL II to strengthen security rights and foreclosure procedures have not been implemented.⁴²

4.20 Survey data from a sample of local law firms and bankruptcy judges in six middle income countries, reported in *Doing Business in 2004*, show that Thailand appears to lag others in two important respects. Based on the specified bankruptcy scenario, the time to go through insolvency in Thailand (2.6 years) is exceeded only by Indonesia (6 years) and Argentina (2.8 years). Moreover, the costs of going through insolvency in Thailand (38 percent of the bankruptcy estate) are markedly higher than in the six other countries.⁴³

4.21 Progress was slow and much remains to be done before Thailand's bankruptcy and foreclosure laws and institutions can produce the desired outcomes of efficiency, maintenance of the priority of claims and reducing uncertainty. While to some extent Thailand's relatively slow recovery was attributable to the depth of the crisis and the extent of overinvestment that preceded the crisis, it was exacerbated by the weakness of measures taken to improve the legal and institutional infrastructure for restructuring corporate debt. For these reasons, **outcome** for corporate restructuring is rated **moderately unsatisfactory**.

Corporate Governance and Disclosure: satisfactory

4.22 The improvements in corporate governance and disclosure are demonstrable and recognized by international surveys. A 2003 survey on corporate governance practices (released by the Institute of Directors) of the 337 corporations listed on the stock exchange

⁴² Thailand still lacks an automated central credit registry and the legal infrastructure to expand secured lending beyond real estate. Similarly, although two credit bureaus were established to facilitate the sharing of credit information the implementation of the Credit Information Business Act (enacted in 2002 and effective in March 2003) caused both bureaus to temporarily cease operations because of the severe criminal sanctions for any violation of the Act, not just for willful violations and fraud. *Thailand: Economic Monitor*, May 2003, p. 39. The April 2004 edition of the *Monitor* (p. V.) reports that a draft amendment of the Credit Information Business Act was submitted to the Parliament which would reduce the legal risk for Credit Bureaus and their members. *Doing Business 2004*, presents a more optimistic view of the success of the reforms. This survey showed that private credit bureaus are now operating, but have markedly lower coverage than credit bureaus in the five other countries that have credit bureaus. Thailand ties with Korea for the top position with regard to creditor rights. In addition, the number of procedures in Thai civil courts (19) is relatively low. Although Thai civil procedures are much speedier (210 days) than in Malaysia (270 days), Indonesia (225 days), Mexico (325 days) and Argentina (300 days), they lag procedures in Korea (75 days) and Turkey (105 days).

⁴³ For example, although the amendments to the Code of Civil Procedures speeded up foreclosures and asset-disposal by expediting the process of claim, judgment, execution and collection, and limiting the power of judges to rescind auction sales, results have been disappointing. As of December 2003, the backlog of cases in the Civil Courts, where mortgages are enforced, included more than 73,000 cases, about the same number of unresolved cases as the year before. Attempts to reduce the backlog by providing out-of-court mediation had not had much impact by April 2004 (See *Thailand: Economic Monitor*, April 2004, p. 37). Similarly, attempts to speed-up the auction of foreclosed property by reducing the reserve price have been applied only to foreclosed properties that had been on the auction block for over 10 years by April 2004 and thus had limited impact. In May 2003, the *Thailand Economic Monitor* reported that at current rates of sale, it will take the Legal Execution Department "ten years to liquidate the Bt 152 billion (in) foreclosed assets on banks' balance sheets as of end 2002."

of Thailand showed that, relative to 2002, there had been improvement in five standards and deterioration in one (Controlling System and Internal Audit).⁴⁴ A cross-border survey of corporate governance practices shows that Thai practices compare favorably with those in China, the Philippines and Indonesia, but fall short of those in Malaysia, Korea and India.⁴⁵ Thailand received a score of 4.6 out of 10.⁴⁶ A corporate governance ROSC scheduled for 2004 should provide a better measure of how Thailand's corporate governance practices and accounting and auditing practices measure up to OECD principles and international standards. While some improvement in standards needs to be accomplished and enforcement needs to be greatly strengthened, the achievement of this objective has been **substantial**, and the **outcome** is rated as **satisfactory**.

Government Bond Market Development: highly satisfactory

4.23 The improved infrastructure and organization of the government bond market are impressive. Over time this may contribute to the development of a robust corporate bond market, although to date the contribution to the raising of capital by the private sector is not evident. Thus, although the overall development of the capital market is unsatisfactory, the improvements in the government bond market are highly satisfactory. Overall, **outcome** in government bond market development is rated as **highly satisfactory**.

Table 4.1: Summary of Ratings for Themes of World Bank Program

Objective	Relevance	Efficacy	Outcome
Macro-economic Stability and Fiscal Balance	Negligible	Negligible	Unsatisfactory
FC Suspension and Closure	Negligible	Negligible	Unsatisfactory
Disposition of FC Assets	Modest	Modest	Moderately Satisfactory
Treatment of Depositors and Creditors	Negligible	Negligible	Highly Unsatisfactory
Restructuring and Recapitalizing Core FIs	High	Negligible	Unsatisfactory
Improving Supervision and Prudential Regulation	High	Substantial	Satisfactory
Corporate Restructuring	High	Modest	Moderately Unsatisfactory
Corporate Governance and Disclosure	High	Substantial	Satisfactory
Government Bond Market Development	High	Substantial	Highly Satisfactory

Bank performance in Thailand

4.24 *Response to crisis.* Predicting the timing or severity of financial crises is impossible to do, but the classic signs of trouble were evident in Thailand prior to the crisis. But because the Bank was not involved in an active macro or financial sector dialogue in Thailand for some years leading up to 1997, it was unprepared to respond to

⁴⁴ Based on the SET's "Principles of Good Corporate Governance" Source: *Thailand: Economic Monitor*, October 2003, p. 33, Table 8.

⁴⁵ Conducted by CLSA Asia-Pacific Markets, a provider of brokerage and investment banking services, headquartered in Hong Kong.

⁴⁶ *Thailand: Economic Monitor*, October 2003, p. 34. Thailand earned particularly low ratings with regard to "committed and effective enforcement of rules and regulations," "the political and regulatory environment affecting corporate governance and the ability of companies to maximize value without arbitrary restrictions," and "the adoption of International Generally Accepted Accounting Principles," although in each case the rankings showed improvement from 2002 to 2003.

the crisis. Compounded by an internal reorganization (the Bank's Country Director for Thailand had arrived to assume his new duties the day before the collapse of the exchange rate), the Bank was slow to respond, and underestimated the serious impact the crisis would have on the Thai economy. Even once into the crisis, there was a persistent tendency on the part of all the IFIs to underestimate its severity or likely longevity.

4.25 *World Bank-International Monetary Fund Relationship.* During the critical first six months of the crisis, the IMF dominated the policy agenda; in the view of most of the Thai officials interviewed by IEG, IMF advice and conditions were all that mattered. One might argue that this is not a serious problem. The IMF, after all, has primary responsibility for crisis management and the Bank has responsibility for longer term, structural reforms. This position is unpersuasive for at least two reasons.

4.26 First, the way in which crises are managed can compromise essential structural reforms. To be more than a bridge to the next financial crisis, crisis management must be informed by a clear and consistent vision of how the financial system should be changed.

4.27 Second, a country's appetite or tolerance for reform is limited and is typically most intense at the depth of a crisis. As the Thai case illustrates, once the crisis has passed, the urgency of undertaking meaningful reform dissipates. If the crisis management stage has been traumatic for the country, the IFIs may no longer be able to act as effective advocates for reform. Partially due to the policy mis-steps proposed by the IFIs and followed by the Thai government in the early stages of the crisis, the resolution process has been very difficult and controversial in Thailand.

4.28 The IMF and Bank need to forge an agreement about the appropriate policy recipe for addressing financial crises. The actions taken in Thailand indicate clearly that the IMF and Bank did not agree up front on some of the most basic principles and advice. Beyond this, both IFIs need to commit to a more collaborative process in the design of a program for a particular country when a problem emerges. This would allow all IFIs to speak with one voice, and with a voice that speaks to long-term structural needs, as well as short-term crisis management. Failure to do so makes the long-term role of the Bank more difficult. If the IFIs are not able to converge around an appropriate prescription for such crises and work together to agree on appropriate policies, the Bank needs to decide what it will do in the event of disagreement with IMF policy decisions.

4.29 The policymaking process resulted in Thailand in conflicting views, confusion of the long-term effects of short-term actions, and a failure to recognize the interaction between micro-policies and macro-conditions. One former senior Thai official noted that the problem with the policy advice was that he had "received a cacophony of advice" from the IFIs.

4.30 Early in the crisis a division of labor was agreed to among the IFIs. Under this agreement, the IMF had responsibility for commercial banks, the Bank had responsibility for finance companies and structural reform of the system, and the Asian Development Bank had primary responsibility for capital markets development. This division may have made sense, but it needed close cooperation among the IFIs to ensure coherent and

comprehensive reform. In addition, the division of labor was not followed in fact under the loans, and this may have added to a lack of coherence in approach.

4.31 *Resources.* The Bank's slow response was compounded by the lack of personnel with hands-on experience in dealing with a financial crisis. The first teams sent to Thailand were described by Thai officials interviewed by the IEG mission as young and inexperienced. When more experienced practitioners arrived, they lacked experience with the weak institutional and legal environment of emerging markets. Moreover, there were tensions within the Bank teams between the economic policy researchers and the practitioners.

4.32 With EFAL I and EFAL II the Bank sent new and increasingly larger teams. Some Thai officials expressed frustration at the lack of continuity, confusion about roles and responsibilities, and lack of expertise on Bank teams, although the more experienced Bank teams assembled subsequently along with a strengthened local Bank team are given high marks by Thai officials for their responsiveness, the quality of their advice, and their commitment to the task.

4.33 With the importance and frequency of financial and banking crises, the Bank should maintain the expertise to be able to respond quickly in such crises. This expertise needs to include both experienced practitioners, who have relevant real world experience, and knowledgeable researchers to provide historical perspective and state-of-the-art advice. Allowing the experience gained in East Asia to dissipate would be a mistake, although this assessment does not have the basis for recommending whether this requires a defined group, such as was established in the Bank to deal initially with the Asian crisis, or a "virtual team" of experts within the Regional organization that can be called upon with little notice.

4.34 Thai policymakers praised publications and research made available to them from the Bank, such as comparative studies conducted by Bank economists, which highlighted the policy choices confronting countries in crisis and indicated the outcomes most often associated with these alternatives.

4.35 *Conflicts of Interest.* In Thailand, the Bank operated in at least three capacities: advisor, investor (through the International Finance Corporation [IFC]) and fiduciary agent (on behalf of investors in IFC projects). The potential conflict of interest among these roles caused two notable problems. First, senior Thai officials told IEG that they agreed to the blanket guarantees for creditors because of pressure from the IFC. Second, the IFC devised a good bank/bad bank restructuring for Finance One, the largest of the failed FCs, a plan that was rejected. Although IEG found no evidence the rejection was due to fear that it would appear that the Bank, acting as advisor, was showing favoritism to the IFC, the potential conflict of interest was genuine and the perception of it affected the reputation of the Bank.

4.36 *Conditionality of Loans.* A fundamental function of the FCRL was balance of payments support; the loan was approved within six months after the crisis erupted and, like the other loans that followed, was paid out immediately. The conditionality in this kind of loan needs to be carefully phased, so that a set of realistic and highly targeted

reform areas are selected. The scope of conditionality became broader with each successive loan, so that by the time that EFAL II was approved, the policy matrix contained a very broad range of policy areas, with no clear set of priorities or sequencing. When every policy change is a priority, there is no clear priority. Such broadening can detract the attention of the authorities from the more critical areas for reform.

Ratings for Individual Loans

4.37 To arrive at ratings for the individual loans, IEG considered the importance of the nine objectives listed above in each loan, reflected in Table 4.2, and the ratings of each loan, reflecting these weights, are summarized in Table 4.3 below (page 33).

Table 4.2: Importance of each theme in Bank loans

Objective	FCRL	EFAL I	EFAL II
Importance of objective			
Macro-economic Stability and Fiscal Balance	Moderate	Moderate	Moderate
FC Suspension and Closure	High	None	None
Disposition of FC Assets	High	High	High
Treatment of Depositors and Creditors	High	High	High
Restructuring and Recapitalizing Core FIs	Low	Moderate	High
Improving Supervision and Prudential Regulation	Moderate	High	Moderate
Corporate Restructuring	Low	Moderate	High
Corporate Governance and Disclosure	Low	High	High
Government Bond Market Development	None	None	Moderate

FCRL Ratings

4.38 The FCRL focused mainly on the suspension and closure of the FCs (which had a detrimental impact on the economy), the disposition of FC assets (which had a moderately satisfactory outcome), and the treatment of depositors and creditors (because the blanket guarantee persisted far longer than anticipated is considered highly unsatisfactory); and to a somewhat lesser extent on improving supervision and prudential regulation (under this loan, it is considered moderately satisfactory, mainly because of forbearance by BOT in the early years, although for all three loans together, its outcome is considered satisfactory). In addition, the outcome of the macroeconomic objectives is considered unsatisfactory because it supported a fiscal surplus which IEG considers to have been the wrong policy for that point in time. Overall, the outcome of the FCRL is considered moderately unsatisfactory.

4.39 The sustainability of FCRL's benefits is difficult to assess, as the macroeconomic targets are not considered a benefit and in any case were reversed in later loans (thus the surplus was not sustained), and the closure and disposition of assets of the FCs were one-time actions for which the notion of sustainability isn't easily applied. At the same time, the blanket deposit guarantee, which was not specifically addressed through conditionality under the FCRL, is detrimental to the development of prudent financial intermediation, and thus works against sustainability. The improvements to supervision and prudential regulations are, however, likely to be sustained. Given all these considerations, IEG has not rated the sustainability of the FCRL.

4.40 On institutional development impact (IDI), the closing and disposing of assets of FC involved the acquisition of expertise by Thai professionals associated with the process, and thus may have put the country in a better position to deal with another crisis should one occur in the near future. On the other hand, an unintended impact was the public perception of the process, which was so negative that it detracted from public support of the longer-term reform agenda. While the strengthening of banking supervision and prudential regulatory policies has been substantial, the failure to address the blanket guarantee of creditors and depositors was detrimental to longer term institutional development. Given these quite different impacts on institutions under the FCRL, *IDI is considered modest.*

4.41 *Bank performance is mixed under FCRL.* The Bank supported two policies – fiscal tightening, and suspension and closure of the FCs, which may have contributed to the contraction of the economy and exacerbated the crisis. Although the Bank played a supporting, rather than a leading, role in these policy decisions, the FCRL provided reinforcement for them. On the suspension and closure of the FCs, these decisions were technically made by the Thai authorities before this loan was approved, but they were part of a larger program for restructuring the financial sector which the Bank supported prior to going forward with the first adjustment loan. During the formulation of this restructuring program, in the immediate aftermath of the onset of the crisis, the Bank provided technical assistance to the authorities and participated in IMF missions that also provided assistance to the authorities to articulate the restructuring program, which included dealing with the FCs. Even if the Bank did not take the lead in the discussions, and even if there were Bank staff who disagreed with the approach, much of the focus of the FCRL was on implementing the fundamental decision to close the FCs, so the loan was implicitly fully supportive of the decision. In this aspect, Bank performance is considered unsatisfactory. By contrast, Bank performance is considered satisfactory in its support for the disposal of FC assets. On balance, *Bank performance under FCRL is considered unsatisfactory.*

4.42 Thai authorities and agencies did a good job of implementing the policies agreed with the Bank, closing the FCs and, in particular, disposing of FC assets under difficult circumstances; the agency involved hired appropriate consultants, and carried out its difficult mandate as efficiently as possible; their performance on this aspect is considered highly satisfactory. Against this should be set Borrower performance on creditor and depositor guarantees, considered highly unsatisfactory. While the authorities made progress on strengthening prudential regulations, considerable BOT forbearance meant that there was little enforcement of the new standards. *On balance, however, Borrower performance under FCRL is considered satisfactory.*

EFAL I Ratings

4.43 The *policy objectives of EFAL I* was better designed than under FCRL, but achievement of the objectives was mixed, with significant weaknesses. EFAL I incorporated a change in the direction of fiscal policy, from a surplus target under FCRL to a fiscal deficit target, but the Government was unable to increase expenditures enough to reach the deficit (the actual fiscal deficit for FY98 was lower than the target). To deal with the FCs, it included the establishment of the bridge bank to manage the assets of the FCs, although it was too late in the process of FC closure to be useful, as the good assets

had turned bad and there was little for the bridge bank to manage. It placed greater emphasis on starting the process of restructuring core FIs (not just the FCs), which was begun but not carried out satisfactorily, and of defining the longer term strategy for the FIs, which was done. But EFAL I did not successfully address the blanket guarantee on depositors and creditors, which remained in effect. EFAL I continued the process of strengthening FI supervision and regulation, although BOT forbearance continued; focused on establishing the framework for bankruptcy and strengthening other commercial legislation, whose progress has been limited; and focused improving corporate governance and disclosure practices, whose outcome is considered satisfactory. On balance, *the outcome of EFAL I is considered moderately unsatisfactory.*

4.44 *The sustainability of the benefits achieved under EFAL I is considered likely.* Although some of the benefits under EFAL I, such as the start of FI restructuring, may not be resilient to risks, most other benefits achieved under the loan are considered sustainable. These include continued progress on strengthening prudential regulation and supervision, and improvements in corporate governance and disclosure, where external pressures involving international reviews of standards and codes and private sector surveys of the business climate and accounting standards are likely to sustain the momentum to work toward international standards.

4.45 Institutional development impact in some areas supported by EFAL I was substantial – strengthened FI prudential regulation, for example, as well as improvements to corporate governance and disclosure. In corporate restructuring, although progress achieved was not as rapid or as substantial as hoped, the emphasis on civil court procedures and the development of a specialized bankruptcy court should lead to an improved process and better performance over time. In other key areas, however, such as restructuring FIs, and continued BOT forbearance in enforcing the strengthened prudential regulations, *IDI is considered modest*, and this is the overall rating under EFAL I.

4.46 *Bank performance is considered satisfactory under EFAL I.* EFAL I placed greater emphasis on restructuring the whole financial sector, in spite of the earlier agreement on the division of responsibilities among the international financial institutions (IFI), and focused on longer term issues for the sector, all of which were appropriate. It also focused on the critical area of corporate restructuring and reforms, and provided substantial technical assistance in this area to help the Government deal with corporate restructuring. The Bank thus addressed important weaknesses in the overall environment for effective financial intermediation and took a pro-active approach to implementing the broader set of reforms.

4.47 In contrast, *Borrower performance is rated unsatisfactory* under EFAL I. Although the Borrower continued satisfactory disposal of FC assets and it strengthened its regulation and supervision of FIs, it did not enforce the stricter prudential regulations, and it allowed the blanket guarantee to persist. It carried out reforms in the framework for corporate governance, but its performance on restructuring and recapitalization of FIs and on restructuring corporations is considered weak, and progress with the corporate bankruptcy law was unsatisfactory, due in part to stiff resistance from Parliament.

EFAL II Rating

4.48 The objectives of EFAL II appropriately shifted the emphasis for the treatment of depositors to developing a deposit insurance scheme with limited protection; it also appropriately included for the first time the development of the government bond market. Although there was some progress toward putting in place the limited deposit insurance scheme, which was to have occurred by end-1998, it was not completed at the time of this writing. The outcome of the development of the government bond market is considered to have been highly satisfactory. As noted in paragraph 8, banking supervision continued to be strengthened and the outcome of this component is considered satisfactory. The other objectives which received particular emphasis under EFAL II were achieved to a much more limited extent, in some cases with significant shortcomings; these include core FI restructuring, strengthening the legal framework for corporate restructuring, and improving progress on corporate restructuring, as discussed in paragraphs 7 and 9. As a result, *the outcome of EFAL II is considered moderately unsatisfactory.*

4.49 *EFAL II receives a sustainability rating of likely*, because the benefits such as strengthened supervision and regulation and improved corporate governance and disclosure are likely to be resilient to risks for reasons noted in paragraph 18. Although one aspect, FI restructuring, is not considered sustainable, the sustainability of the development of the bond market is considered highly likely, as the probability is high that the benefits will continue to grow under most economic scenarios.

4.50 *IDI for EFAL II is rated as substantial*, because in addition to the factors mentioned in paragraph 19 under EFAL I, the development of the government bond market represents a significant contribution to the institutional development of the financial sector. It permits the establishment of a benchmark yield curve, a crucial element for further capital market development. These achievements will facilitate the development of the corporate bond market, trading in derivative instruments and more efficient pricing of equities. Thus the institutional contribution of EFAL II to capital market development is considered high.

4.51 *Bank performance is rated satisfactory*. As in the case of EFAL I, the design of EFAL II was appropriately focused on broader and longer-term issues than was the case under FCRL. EFAL II design also added an objective of capital market development, which was highly relevant to longer term financial market development and stability. The Bank worked effectively with government and relevant private sector entities to develop a sound plan for corporate governance and disclosure. And although the division of responsibilities following the crisis allocated capital market development to the Asian Development Bank, the Bank took the lead under EFAL II in a first step in this process of supporting improvements to the government bond market.

4.52 *Borrower performance under EFAL II is also rated unsatisfactory*. Although performance was highly satisfactory with respect to improvements in corporate governance and disclosure and development of the government bond market, it was considerably weaker on other key objectives of EFAL II. While it may be argued that the blanket creditor and depositor guarantee initially put in place was the joint responsibility of the IFI and Thai authorities, the failure over a sustained period of time to phase out the deposit guarantee and

replace it with a limited deposit insurance program, supported under EFAL II, was the responsibility of the government. In addition, there was considerable political opposition to legislative proposals that would have served to strengthen the legal and institutional infrastructure for corporate restructuring, and as noted in paragraph 4.19, some of the legislative proposals have served to weaken the framework for bankruptcy and other aspects of corporate restructuring, and there has been insufficient progress on both corporate restructuring and FI restructuring and strengthening. Offsetting these weaknesses in performance is the satisfactory progress achieved by the Borrower on corporate governance and disclosure and the reforms made on developing the government bond market (paras. 4.22 and 4.23).

Table 4.3: Summary of Ratings for Loans

Bank Loan	Outcome	Sustainability	IDI	Bank Performance	Borrower Performance
FCRL	Moderately Unsatisfactory	Not evaluable	Modest	Unsatisfactory	Satisfactory
EFAL I	Moderately Unsatisfactory	Likely	Modest	Satisfactory	Unsatisfactory
EFAL II	Moderately Unsatisfactory	Likely	Substantial	Satisfactory	Unsatisfactory

5. Findings and Recommendations

Lessons Learned

5.1 The significant cost of cleaning up financial crises can offset the progress made over many years in poverty alleviation and other social improvements, both of which are central to the Bank's mandate. Given this, the Bank should continue to play a role in client countries in both improving financial sector governance and soundness to reduce the probability of crisis and in post-crisis management and well-structured recovery.

5.2 The severity of the crisis was, in retrospect, initially underestimated by the Bank and others, as was the negative impact on the economy of the large scale closure of the FCs in the early phase of the reforms. Thai officials interviewed by the IEG mission noted that these early mis-readings of the severity of the crisis and the impact of the closure of the FCs on the economy raised concerns about the credibility of the IFIs' approach and, most important to Thailand's future, about the financial reform itself. This suggests that crises in other countries should be approached more comprehensively, taking into account potential negative impacts of large scale closures.

5.3 Short-term crisis management policies can compromise essential structural reforms. The failure to factor into the design of the reforms the inadequacies of the Thai legal and regulatory infrastructure led to approaches that may have increased the cost of

cleanup. For example, traditional procedures in Thailand for corporate restructuring were notoriously slow and generally benefited the debtor; thus, the corporate reorganization procedures modeled after the United States (Chapter 11 style) were ill-suited to the situation and may have served to worsen it (longer-delays, reduced restructuring). A better approach would have been to simplify liquidation procedures, involving the stakeholders and a bankruptcy administrator, rather than the court system.

5.4 The sequencing and timing of reforms is critical. Too little early emphasis was placed on reforming bankruptcy and foreclosure laws, developing a deposit insurance scheme, and fostering development of capital and money markets. The government that came to power just after the crisis emerged was reform-minded, but the adverse macro-economic impact of the early policy changes gave “reform” a bad name in Thailand.

5.5 The allocation of pieces of the reform package among the three International Financial Institutions (IFIs) may have made sense, but only if it had been followed by better coordination. As it turned out, the division of responsibilities resulted in an absence of a clear guiding vision for the reform of the financial system. Thus, for example, commercial bank restructuring was carried out very differently from finance company restructuring, even when they suffered from the same problems. In addition, the division of labor broke down, as the Bank fairly quickly became involved in FI restructuring and capital market development.

5.6 Succeeding loans with increasingly broader goals and a growing list of conditions diffused the focus of reform and undermined meaningful monitoring; a better approach would have been the programmatic one now used widely (but not available at that time), which seeks to develop a coherent set of priority reforms and sequences the steps for carrying out those reforms in each successive loan.

Annex A: Basic Data Sheet

FINANCE COMPANIES RESTRUCTURING LOAN (LN. 4268-TH)

Key Project Data (amounts in US\$ million)

	Appraisal estimate	Actual or current estimate	Actual as % of appraisal estimate
Original commitment	350	350	100
Total cancellation	-	-	-
Total project cost	-	-	-
Cancellation	-	-	-

Project Dates

	Actual
Departure of Appraisal Mission	November 30, 1997
Board approval	December 23, 1997
Signing	December 24, 1997
Effectiveness	December 29, 1997
Closing date	June 30, 1998

Staff Inputs (staff weeks)

	Actual/Latest Estimate	
	No. of Staff weeks	US\$US\$('000)
Preparation to Appraisal	51.9	227.5
Negotiations through Board Approval	8.5	28.4
Supervision	15.6	25.7
Completion (ICR)	3.0	7.0
Total	79.0	288.6

Mission Data

	Date (month/year)	No. of persons	Staff days in field	Specializations represented	Performance rating (Development Objectives)
Preparation through Appraisal	Oct – Nov. 1997	12	85	E, F, A	N/A
Appraisal through Board	Dec. 1997	5	15	E, F, A	N/A
Supervision	Jan-March 1998	10	30	E, F, A	S
Completion	N/A	-	-	-	S

E – Economist
 F – Financial Analyst
 A – Accounting

ECONOMIC AND FINANCIAL ADJUSTMENT LOAN (LN. 4372-TH)

Key Project Data (amounts in US\$ million)

	<i>Appraisal estimate</i>	<i>Actual or current estimate</i>	<i>Actual as % of appraisal estimate</i>
Original commitment	400	400	100
Total cancellation	-	-	-
Total project cost	-	-	-
Cancellation	-	-	-

Project Dates

	<i>Actual</i>
Departure of Appraisal Mission	May 27, 1998
Board approval	July 9, 1998
Signing	July 13, 1998
Effectiveness	July 22, 1998
Closing date	December 31, 1998

Staff Inputs (staff weeks)

	<i>Actual/Latest Estimate</i>	
	<i>No. of Staff weeks</i>	<i>US\$US\$('000)</i>
Preparation	41.0	142.6
Appraisal	20.7	41.6
Negotiations	6.3	17.7
Supervision	28.0	86.7
Completion (ICR)	3.0	7.5
Total	99.0	296.1

Mission Data

	<i>Date (month/year)</i>	<i>No. of persons</i>	<i>Staff days in field</i>	<i>Specializations represented</i>	<i>Performance rating (Development Objectives)</i>
Appraisal through Supervision Completion	-	15	120	E, F, LEG	S

E: Economists
F: Financial
LEG: Legal

SECOND ECONOMIC AND FINANCIAL ADJUSTMENT LOAN (LN. 4447-TH)

Key Project Data (amounts in US\$ million)

	Appraisal estimate	Actual or current estimate	Actual as % of appraisal estimate
Original commitment	600	600	100
Total cancellation	-	-	-
Total project cost	-	-	-
Cancellation	-	-	-

Project Dates

	Actual
Departure of Appraisal Mission	November 1998
Board approval	March 25, 1999
Signing	March 26, 1999
Effectiveness	March 30, 1999
Closing date	October 31, 1999

Staff Inputs (staff weeks)

	Actual/Latest Estimate	
	No. of Staff weeks	US\$US\$('000)
Identification/Preparation	80.0	270.7
Appraisal/Negotiations	38.6	103.5
Supervision	28.0	94.5
Completion (ICR)	3.5	6.4
Total	150.1	475.1

Mission Data

	Date (month/year)	No. of persons	Specializations represented	Performance rating (Development Objectives)
Identification/Preparation	August-November 1998	16	E-3, F-2, Corp. - 2, L-2, S-4, CG-1, Comp.-2	S
Appraisal/Negotiation	December 1998-March 1999	11	E-2, F-2, Corp.-2, L-1, S-2, CG-1, Comp.-1	S
Supervision	October 1998-June 1999	11	E-2, F-2, Corp.-2, L-1, S-2, CG-1, Comp.-1	S
Completion (ICR)		14	E-4, F-3, Corp.-2, L-1, S-2, CG-1, Comp.-1	S

E - Economist (macro)

F - Financial

Corp - Corporate restructuring

L - Legal

S - Labor market and social safety net

CG - Corporate governance

Comp - Competition

Annex B: Borrower Comments



No. 0902/

Public Debt Management Office
Ministry of Finance
Rama VI Road
Bangkok 10400

January B.E. 2549 (2006)

Dear Mr. Porter,

Re: Comments and suggestions on Thailand-Finance Companies and Restructuring Loan (Ln. 4268-TH); Economic and Financial Adjustment Loan (Ln. 4372-TH); and Second Economic and Financial Adjustment Loan (Ln. 4447-TH) Draft Project Performance Assessment Report

Please refer to your letter dated November 10, 2005 requesting our comments on the above reports. Please be informed that we agree on the above-mentioned draft report in principal. However, we have some comments as follows:

I. Preface

- This section should be added more details about the Implementing Agency of those projects.

II. Context

- We feel that in each section in both the summary and the context should have more linkage between subjects.

III. Implementation Experience

- **Page 16**
 - Footnote No. 20: There is a quotation of Thai senator which is "I will not run. I will not hide. I will not pay!" We think that it is not necessary to refer to that quotation.

IV. Outcomes and Assessment

- **Page 21**
 - In line 5th, it should be "EFAL" not "ECAL".

V. Findings and Recommendations

- We feel that some issues in the 5th paragraph of this section may be too sensitive such as *the division led to incoherent advice to the Thai authorities and no clear guiding vision for the reforms.*

/We would like to...

Mr. Ian C. Porter
Country Director, Thailand
East Asia and Pacific Region
The World Bank Office Bangkok
30th Floor, Siam Tower
989 Rama I Road, Pathumwan
Bangkok 10330

- We would like to suggest that this report should provide outcomes of those projects through Thailand's economic growth, living standard or the development of national infrastructure or capital market, etc.

Thank you very much for your continuing support and we looking forward to receiving the final report.

Sincerely yours,

Sun Vithespongse
Deputy Director-General
for Director-General

Annex C

Thailand—Finance Company Restructuring (Ln. 4268)—Board Conditions (From MOP)

BOARD CONDITIONS	
I. MACROECONOMIC AND FISCAL STRATEGY	
1. Maintain macroeconomic stability and fiscal balance	Satisfactory progress made in implementing the macroeconomic stabilization program announced on August 20 and revised on November 24, 1997.
2. Facilitate stable capital flows	
II. FINANCE COMPANY RESTRUCTURING PROGRAM	
1. Resolution of Suspended Finance Companies	
1. Establish institutional structure for the resolution of suspended finance companies	<ol style="list-style-type: none"> 1. FRA established by decree promulgated on October 25, 1997. 2. FRA Decree allows prompt closure and takeover by FRA of suspended finance companies. 3. FRA fully staffed. 4. FRA fully operational. It has: <ul style="list-style-type: none"> • established processes for evaluating rehabilitation plans, including, (i) development of models to evaluate viability of proposed business plans and (ii) validation, in accordance with BOT rules, of the asset values utilized in submitted rehabilitation plans; • established step by step procedures for takeovers of suspended companies; and • developed guidelines to be used by the committees and managers appointed to resolve closed companies. 5. AMC established by decree promulgated October 25, 1997. It will be able to purchase impaired assets from either suspended finance companies or commercial banks and operating finance companies that are intervened. 6. AMC Board members appointed on December 2, 1997. Search for a Manager underway. 7. Responsibilities of BOT, MOF, FIDF, FRA and AMC in the resolution of suspended finance companies rationalized via decree package of October 25, 1997. 8. Financial Restructuring Authority Coordinating Unit (FRACU) established (December 15) for the monitoring and appropriate surveillance of the activities of the special managers and the Board of Directors of each closed finance company (section 13 committees).
2. Progress in the rehabilitation/resolution process	<ol style="list-style-type: none"> 1. Final Rehabilitation criteria announced on October 13, 1997, in agreement with the IMF and World Bank. 2. Rehabilitation Plans submitted by the suspended FCs to FRA on October 30, 1997. 3. Rehabilitation plans for all 58 suspended finance companies, consistent with the above criteria, reviewed by FRA. 4. An independent third party review of the FRA decisions completed (December 8, 1997). 5. Decision taken and announced on December 8, 1997 to close—suspended finance companies and approve—rehabilitation plans.

BOARD CONDITIONS	
3. Fiscal impact of the resolution process	<p>1. Emergency Decrees of October 25, passed enabling the Government to provide appropriate financial assistance if losses are incurred by FRA or AMC.</p> <p>2. The Decree amending the BOT Act, promulgated enabling Government to provide FIDF with financial assistance to finance the note exchange program for the 58 suspended finance companies and for losses incurred.</p> <p>3. Separate accounts established by FIDF to reflect costs it incurs in financial sector restructuring.</p> <p>4. Government has (on December 9, 1997) authorized all funding, B 500 million for the FRA. In the case of AMC initial capital of B 1 billion authorized. The first payment has been approved.</p>
4. Treatment of depositors and creditors	<p>1. Note Exchange Programs in place and operating.</p> <p>2. Decree passed to empower FIDF to relinquish preferential claim on collateral. Companies to be suspended (6/97) were not given this option.</p> <p>3. Announcement made that creditors can request stretch-out of FIDF repayment terms if they similarly restructure their own claims. Other creditors can convert claims to equity <i>pari passu</i> with the FIDF.</p> <p>4. Creditors (domestic and international) will be treated equally and in <i>pari passu</i> with the FIDF and that the asset disposal process will be orderly.</p>
1. Conditions of liquidity provision by FIDF	<p style="text-align: center;">2. Liquidity Support</p> <p>1. Interest rates payable on FIDF advances raised beyond the highest deposit rates in the financial system.</p> <p>2. Decision taken that FIDF advances are to be made at a minimum (in case of collateralized advances) of the repurchase agreement rate (RP) plus 1% (i.e. over 20% per year nominal); rates can rise to RP+2.5% in the case of noncollateralized advances.</p> <p>3. Conditions for granting advances to financial institutions beyond certain thresholds implemented by FIDF. If the ratio of a financial institutions borrowing from FIDF to its Tier 1 capital is 75% or greater, further advances will be granted under the following conditions:</p> <ul style="list-style-type: none"> • an immediate cessation of dividends will be required and all bonuses or benefits to directors and executives will be eliminated. • FIDF representative(s) may be appointed as member(s) of the Board of the borrowing finance company (FC) and will restrict future asset growth as well as not permit payment of dividends.

BOARD CONDITIONS

3. Strengthening the Supervision and Regulatory Environment for Financial Institutions

1. Handle weak open finance companies

1. Intervention of unsafe or unsound Finance Companies (FCs) advanced:
 - Principle established that distressed FCs will be intervened in by the BOT/FIDF.
 - Finance Company Act amended by Emergency Decree of October 1997 to permit timely intervention of FCs by BOT/FIDF.
 - BOT actually intervened in two FCs (in one FC experiencing serious liquidity problems, the Board has been replaced; in another FC, the management has been taken over by BOT after discovery of fraud).
2. A short term plan for strengthening supervision of the 33 nonsuspended FCs*7 prepared by BOT, including:
 - stratification of all the 33 FCs in categories through careful off-site analysis
 - undertaking of diagnostic reviews in specific FCs
 - agreement on MOUs with undercapitalized FCs
 - intervention of distressed FCs that are unable to propose an acceptable recapitalization plan
 - Stratification outcome will be updated by the end of the first
3. A Preliminary screening of all non suspended FCs undertaken by BOT (applying the new stricter loan classification and provisioning criteria to be applied year end 1997) to stratify them into categories:
 - standard FCs (in compliance with statutory risk adjusted capital adequacy ratios);
 - undercapitalized FCs (risk adjusted capital adequacy ratios under 8%) that are expected to be recapitalized by their shareholders;
 - undercapitalized FCs (risk adjusted capital adequacy ratio under 8%) whose parent companies are weak;
 - unsafe and unsound FCs that require sound supervisory measures.
4. Steps taken by BOT to promote capital strengthening of undercapitalized FCs:
 - each FC has been communicated the amount of capital estimated to fully meet the forthcoming imposition of tougher loan classification and provisioning requirements to be issued at the latest on March 31, 1998 with progressive implementation (see Section 11.3.2.), and has been asked to voluntarily increase capital in anticipation of these needs.
 - agreement has been reached with the management of each FC to recommend to their shareholders that no dividend be paid for the remaining of 1997 and the first half of 1998.
 - foreign investment framework has been liberalized for FCs as well as commercial banks.
 - The two suspended finance companies whose rehabilitation plans were accepted will be transferred to BOT for supervision, after they have satisfied the conditions of the rehabilitation plan.

BOARD CONDITIONS	
<p>2. Ensure stricter loan classification, income recognition and provisioning requirements, to be consistent with international standards.</p>	<ol style="list-style-type: none"> 1. Law passed to permit Financial Institutions to treat all loan loss provisioning required by BOT as a tax deductible expense. 2. Provisioning requirement for substandard loans set to 15% for commercial banks and 20% for finance companies as of June 1997, to be fully phased by December 31, 1998; immediately applicable for all loans classified after June 1997. 3. FCs and commercial banks required by BOT to set aside provisions for all loans that are more than 6 months overdue, effective December 31, 1997. 4. Accrual of interest on nonperforming loans for more than 6 months prohibited by BOT for FCs and commercial banks (versus current regulations that permit 12 months), effective January 1, 1998.
<p>3. Establish procedures for prompt corrective action.</p>	<ol style="list-style-type: none"> 1. Guidelines issued by BOT on the "fit and proper" conditions, to be met by: <ul style="list-style-type: none"> • shareholders of any merged FC • shareholders and managers of new banks resulting from the resolution process of the 58 FCs. 2. Announcement made by Government that financial institutions will be allowed to purchase up to 100% of an existing finance company so long as they maintain a sound financial condition. 3. New licensing policy adopted and announced whereby the capital base, liquidity position, loan portfolio quality, and management quality of an institutions will be primary criteria for getting a bank license, in addition to it is asset size.
<p>5. Strengthen prudential regulation.</p> <p>6. Strengthen supervisory regime</p>	<ol style="list-style-type: none"> 1. Amendments to the Bankruptcy Act passed first reading of the Parliament in November 1997, and now in second reading.
<p>1. Legal and regulatory framework for corporate workouts</p> <p>2. Strengthen and enforce accounting, auditing and disclosure standards</p> <p>3. Strengthen capability of the Emergency Comprehensive Guarantee and develop strategy for Phasing it out</p>	<p style="text-align: center;">4. Strengthening Market Discipline</p> <ol style="list-style-type: none"> 1. Emergency comprehensive guarantee program implemented by amending the BOT Act in the October decree package. 2. A guarantee fee of 0.15% introduced for the remainder of 1997. In 1998 it will be 0.4% and will be applied to all covered liabilities. This includes the previously existing fee of 0.1%. 3. Deposit rates capped at 3% above the average deposit rate of the five largest banks (implemented September 26, 1997 and in force).

**THAILAND – ECONOMIC AND FINANCIAL ADJUSTMENT LOAN I (LN. 4372)
BOARD CONDITIONS (FROM MOP)**

BOARD CONDITIONS	
I. MACROECONOMIC AND FISCAL	
	Satisfactory progress made in implementing the revised macroeconomic program announced on May 19, 1998.
1. Maintain macroeconomic stability and fiscal balance	
2. The Fiscal Program	Make available credit to exporting firms through bilateral and multilateral sourcing of funds under transparent eligibility criteria.
3. Easing the liquidity crunch of the Thai corporations and increasing competitiveness	The Ministry of Finance has established a working group to provide advice on corporate debt and equity restructuring.
4. Corporate Restructuring	
5. Additional Tax Measures	
II. FINANCIAL SECTOR RESTRUCTURING	
1. FINANCE COMPANIES RESOLUTION	
1. Progress in the FRA sales process	FRA has adopted and begun implementation of a program to sell the portfolio of core financial assets pertaining to finance companies taken over by FRA.
2. Establishment of the AMC	The Government has taken steps to enable AMC to be fully operational, including through: (a) approving an increase to the authorized capital of AMC; (b) approving internal policies and procedures; (c) setting-up of a Management Information System (MIS) for asset management and disposition; and (d) approving bidding methodology and asset valuation procedures for the resolution of assets pertaining to finance companies taken over by FRA.
3. Establishment of the Radhanasin Bank	
2. SAFETY AND SOUNDNESS OF THE FINANCIAL SECTOR	
1. Restructure and strengthen the core financial institutions	The Bank of Thailand has launched a due diligence program in order to assess the financial condition of four intervened banks.
2. Redefine the role of financial players in a modernized Thai financial sector	
3. Develop a comprehensive framework for supervision of financial institution	
4. Improve legal provisions and regulations for supervision	The Bank of Thailand has adopted a time-bound program to develop its institutional capacity to supervise banks and finance companies.
5. Strengthen the supervision capacity of the supervisory agencies	
6. Strengthen market discipline	
III. LEGAL REFORM	
1. Provide appropriate legislative and institutional frameworks for corporate bankruptcies and reorganizations	Cabinet has approved further revisions to the amended Bankruptcy Act B.E.2483 (1940) in order to facilitate corporate bankruptcies and liquidations.
2. Provide appropriate legislative and institutional frameworks for secured lending	Government has adopted a time-bound action plan for legislative changes necessary to accelerate the process of foreclosing on collateral.
3. Ensure improvements in the process of enforcing commercial contracts and of corporate and commercial legislation, broadly defined	

BOARD CONDITIONS

IV. FINANCIAL ACCOUNTABILITY AND CORPORATE GOVERNANCE

<p>Government has adopted a time-bound program to establish an independent organization responsible for setting accounting standards consistent with international best practices, by December 31, 1998.</p> <p>Government has adopted a time-bound program to review role and functions of the Institute of Certified Accountants and Auditors of Thailand (ICAAAT) to become an independent self-regulatory professional body consistent with international best practices, by December 31, 1998.</p> <p>Government has announced that financial statements of listed and non-listed public companies, banks and financial institutions with assets in excess of one billion Baht will be required to be prepared and audited in accordance with international best practices beginning with the year 1999.</p>	<p>1. Rationalize the institutional framework for setting standards and regulating accounting and auditing practices</p> <p>2. Strengthen the ICAAT to play a leadership role in development of the profession consistent with international best practices</p> <p>3. Improve the quality and reliability of key financial information provided by public corporations to regulators, shareholders, and the general public</p> <p>4. Strengthen the financial oversight role of the board of directors of corporations by requiring the establishment of audit committees</p> <p>5. Improve accountability of boards of directors and management of public companies</p> <p>6. Rationalize the regulatory framework for enforcement of laws and regulations for public companies</p>
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V. PUBLIC ENTERPRISE REFORM/PRIVATIZATION

<p>1. Organizational Arrangement for State-Enterprise Reform</p>	<p>The Cabinet has approved the draft Corporatization Law to enable State-Owned-Enterprises to convert into corporatized companies.</p>
<p>2. Corporatization Law</p>	
<p>3. Master Plan for State-Enterprise Reform</p>	

**THAILAND – ECONOMIC AND FINANCIAL ADJUSTMENT LOAN II (LN. 4447)
BOARD CONDITIONS (FROM MOP)**

BOARD CONDITIONS

I. MACROECONOMIC AND FISCAL

<p>1. Fiscal Stimulus</p>	<p>The Borrower has prepared specific spending projects totaling about one percent (1%) of gross domestic product, and has allocated an amount of about forty percent (40%) of said amount to expenditures to protect the poor, including expenditures on: (a) public workfare, and (b) means-tested cash transfer and in-kind transfer.</p> <p>The Borrower has adopted a program to make more credit available to corporate entities carrying out government contracts.</p>
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II. FINANCIAL SECTOR RESTRUCTURING

BOARD CONDITIONS

1. MANAGING PROBLEM INSTITUTIONS

Independent experts of international standing selected by MOF have completed a satisfactory review of the FRA and of the AMC.

1. Orderly Resolution of the 56 Closed Finance Companies

The FRA has completed the third round of auction of core financial assets and has formulated an action plan to deal with residual assets.

The FRA has finalized and communicated to creditors the procedures for submitting and adjudicating claims.

2. Restructuring and recapitalization of the Core Financial Institutions

The BOT has approved:

- a time-bound plan for the consolidation of the twelve finance companies into KTT, and for the subsequent consolidations of KTT with UBB;
- a plan for the recapitalization of the consolidated KTB

The Bank of Thailand has signed Memoranda of Understanding with all banks and finance companies needing to raise additional capital through June 1999.

BOT will have developed an operational restructuring plan for the combined KTB, which should include steps toward its privatization within two years.

2. STRENGTHENING THE FINANCIAL SECTOR STRUCTURE

The Financial Services Task Force (FSTF) has been established.

1. Strategy for the future of financial services (see also 2.3 and 3.1)

The Working Group for Domestic Bond Market Development has identified areas that need to be addressed to deepen the government bond market and has established Task Forces to develop recommendations on each identified issue.

2. Capital market development

3. Specialized Financial Institutions (SFIs)

On-site examinations have been initiated in all SFIs under BOT supervision.

BOT has adopted a preliminary action plan to enable it to carry out effectively its new supervisory responsibility over SFIs.

3. ENHANCING THE REGULATORY AND SUPERVISORY REGIME

1. A comprehensive supervision framework

The BOT has completed a review of the draft commercial bank and finance companies laws.

2. Strengthening supervision and regulation of financial institutions

3. Deposit insurance scheme

III. CORPORATE RESTRUCTURING

1. STRENGTHENING THE LEGAL FRAMEWORK

The Borrower has taken the following measures to strengthen the legislative and institutional frameworks for corporate restructuring: (a) further revisions to the Bankruptcy Act. B.E. 2483 (1940), as amended, have been approved by the Lower House of Parliament to facilitate the process of corporate bankruptcy and reorganization; (b) and Act to establish the bankruptcy court and its proceedings has been passed by the Lower House of Parliament; and (c) the Borrower has adopted an action plan to enhance the capacity of the Ministry of Justice to expedite the processing of bankruptcy cases.

1. Provide appropriate legislative and institutional frameworks for corporate bankruptcies and reorganizations

BOARD CONDITIONS

	<p>The Borrower has taken the following measures to strengthen the legislative and institutional frameworks for secured lending: (a) amendments to the Code of Civil Procedure to expedite the enforcement of security interests have been approved by the Lower House Parliament; and (b) to facilitate the use and enforcement of security interests and to create new security interests, the Cabinet of Ministers of the Borrower has adopted an action plan to prepare additional draft legislation, including legislation regarding the establishment of an automated modernized registry system.</p>
	<p style="text-align: center;">2. STRENGTHENING THE ENABLING ENVIRONMENT</p> <p>The Cabinet has approved the establishment of a Credit Bureau open to all financial institutions and trade creditors.</p> <p>BOT has put into effect a regulation to enable the establishment and operation of private asset management companies.</p> <p>The Working Group on tax impediments to restructuring has been reconvened to consider the need for improvements to the tax treatment of mergers, acquisitions and other restructuring transactions. This Working Group has solicited suggestions from private sector experts.</p>
	<p style="text-align: center;">3. SPEEDING THE RESTRUCTURING PROCESS</p> <p>The Borrower has put into effect an improved system to monitor progress in corporate restructuring to enable it to revise the estimate of progress in corporate restructuring and provided monthly updates thereof.</p> <p>CDRAC is supporting improved sequencing of voluntary workouts (e.g. encourage a creditor meeting within 30 days after a loan becomes non-performing) and continues to identify impediments to successful resolution.</p> <p>CDRAC is supporting the enhancement of professional restructuring capacity and public awareness of corporate restructuring through the Thai Bankers Association, Association of Finance Companies, and Federation of Thai Industries.</p> <p>BOT requires creditors to choose to either continue a voluntary restructuring process, court-supervised reorganization, or bankruptcy within 90 days of the initial meeting between lead creditor and debtor.</p> <p>BOT has provided to financial institution creditors a sample arbitration contract to encourage the development of inter-creditor dispute resolution mechanisms and 75% voting thresholds for approval of restructuring plans.</p> <p>The Borrower will encourage state-owned financial institutions to exercise their role as creditor to speed up corporate debt restructuring.</p>
	<p style="text-align: center;">IV. COMPETITIVENESS</p>
	<p style="text-align: center;">1. FINANCIAL ACCOUNTABILITY AND CORPORATE GOVERNANCE</p> <p>The Cabinet of Ministers of the Borrower has approved a framework to: (a) streamline the institutional framework for setting accounting and auditing standards and regulating the profession; (b) establish the Thailand Financial Accounting Standard Board as an independent entity with authority to set accounting standards, with members from the accounting profession, business, government and academia; and (c) make the Institute of Certified Accountants and Auditors of Thailand an independent self-regulatory professional body consistent with international best practices.</p> <p>The Ministry of Commerce has submitted draft legislation to Cabinet for its approval.</p>
<p>2. Provide appropriate legislative and institutional framework for secured lending</p>	
<p>1. Facilitate information sharing among creditors on debt service performance by individual companies</p> <p>2. Facilitate debt/equity conversions and the efficient sale of distressed financial assets</p> <p>3. Eliminate remaining tax disincentives to corporate restructuring</p>	
<p>1. Provide improved monitoring of progress on corporate restructuring</p>	
<p>2. Develop an efficient mechanism to resolve disputes among financial institution creditors.</p>	
<p>3. Develop a clear strategy concerning the position of the Government as a creditor or shareholder of distressed corporates.</p>	
<p>1. Rationalize the institutional framework for setting standards and regulating accounting and auditing practices</p>	

BOARD CONDITIONS	
<p>2. Improve the quality and reliability of key financial information provided by public corporations to regulators, shareholders, and the general public</p>	<p>Improved accounting and auditing standards for listed companies have been adopted, as well as large non-listed public companies, and banks and financial institutions with assets in excess of Baht 1 billion. This includes revision of standards for financial statement disclosures, asset classification, and marketable securities, as well as issuance of new standards for troubled debt restructuring.</p> <p>The plan to improve the quality of audit reports has been implemented for listed companies, non-listed public companies, as well as banks and financial institutions. The implementation included a revised format (proposed by ICAAT) for audit reports, consistent with international best practices.</p> <p>MOC has deleted inactive companies from the registration files.</p>
<p>3. Strengthen the financial oversight role of the board of directors of corporations by requiring the establishment of audit committees</p>	<p>The Working Group has submitted to MOC its recommendations on appropriate changes to legislation and regulations to improve the appointment process of directors, ensure protection of minority shareholder rights, increase accountability and liability of officers and directors, and impose sanctions in the case of breach of duty.</p>
<p>4. Improve accountability of boards of directors, management, and shareholder rights of public companies</p>	<p>SEC has completed the review of the roles and responsibilities of SET, SEC, MOC and MOF in enforcing laws and regulations related to public companies by SEC and submitted its recommendations on such roles and responsibilities to the respective agencies for adoption.</p>
<p>5. Rationalize the regulatory framework for enforcement of laws and regulations for public companies</p>	<p style="text-align: center;">2. PRIVATIZATION</p>
<p>1. Regulatory Framework Legislation for Privatization</p>	
<p>2. Organizational Structure for Privatization; Institutional Capacity Building</p>	<p>The Corporatization Law has been approved by the Lower House and is being considered by the Senate.</p>
<p>3. Corporatization Law</p>	<p style="text-align: center;">3. COMPETITION POLICY AND INVESTMENT INCENTIVES</p>
<p>1. Competition policy</p>	
<p>2. Investment Incentives</p>	<p style="text-align: center;">V. POVERTY AND SOCIAL PROTECTION</p>
<p>1. Improve the coordination of social policy</p>	<p style="text-align: center;">1. IMPROVE STRATEGIC DESIGN AND CO-ORDINATION OF SOCIAL POLICY</p> <p>The Borrower has appointed the Council of Social Ministers (National Social Policy Committee), under the direct leadership of the Prime Minister, to develop and implement a coherent social policy, with NESDB serving as the secretariat for said Council.</p>
<p>2. Improve the design of the old-age pension and family allowances system</p>	<p>The Borrower has established, through internal administrative decisions, revised contribution rates to the old-age fund and the family allowances fund of the Social Security Office: (a) for the old-age fund, 1% each from the employers and from the employees for a period of 2 years; and (b) for the family allowances fund, 1% from the Government.</p> <p>The Borrower has appointed a high-level task force with membership from MOF, SEC, MOL, SSO and DPW to evaluate the existing social security system, and develop options for implementing an improved and integrated pension system.</p>
<p>1. Increase public expenditures for protecting the poor</p>	<p style="text-align: center;">2. PROTECTING THE POOR</p>

BOARD CONDITIONS	
2. Expand provision of public workfare programs	The Borrower has: (a) adopted and made public revised criteria for its public workfare programs under the enhanced public expenditures program including: (i) unskilled labor intensity of at least 30% on average; (ii) remuneration for unskilled labor set close to applicable rates in rural areas; and (iii) poverty incidence will be a key criterion for the geographic distribution of workfare budget; and (b) prepared plans for monitoring and evaluation of said workfare programs.
3. Expand means-tested cash and in-kind transfer programs	Under the enhanced public expenditures program, the Borrower has adopted a policy of increased coverage for (i) cash transfer programs for needy families and poor elderly, and (ii) the in-kind transfer programs.
3. SOCIAL PROTECTION FOR WORKERS	
1. Strengthen compliance with severance pay provisions	
2. Develop cost-effective training and employment services for unemployed	The Borrower has established a task force with representation from workers, employers and government to design, target, and evaluate cost-effective training and employment services for unemployed workers.
4. PROTECTING THE ELDERLY	
1. Strengthen voluntary provident funds for private employees	
2. Strengthen existing administrative structure in SSO	The SSO database has been cleaned to ensure data integrity by (a) removing excess records; (b) correcting misrecording of contribution collections; and (c) attaching the 13 digit identifier to each record.
5. IMPROVE THE INFORMATION BASE FOR MONITORING	
	The Borrower has provided adequate resources to: (a) enable the carrying out in 1999 of a survey to monitor poverty based on a component of the SES, and accelerate turnaround time to 3 months for updating the annual poverty map; and (b) increase frequency of LFS to 4 rounds/year, implement appropriate questionnaire improvements and seasonal adjustments, and accelerate analysis turnaround to 3 months.

Annex D

Why Foreign Investors View Thai Bankruptcy and Foreclosure Reforms as Incomplete: The Case of Thai Petrochemical Industry (TPI)

TPI was the largest corporate debtor in Thailand with total debts of \$4.5 billion⁴⁷. What follows is a brief synopsis of attempts to restructure the company.

A conglomerate that borrowed heavily to expand from rice to burlap rice sacks, to plastic rice sacks to plastic to petrochemical refining, gasoline and cement.

IFC lent \$500 million in 1996, just months before the collapse.

After 1997 devaluation, TPI was unable to pay its debts with debt-to-equity ratio greater than 6 and a doubling of debt-service costs.

CEO, a senator, had particular political clout and a propensity to portray the debt crisis in nationalist terms. Helped block passage of foreclosure law.

In mid-1998, creditors discover that CEO has diverted \$25 million from TPI to family controlled companies that held 60 percent of TPI shares, while maintaining moratorium on paying creditors.

Bankruptcy law, passed in 1998, becomes effective January 1, 1999. March 2000, TPI judged to be insolvent.

April 2000 vote of creditors favored an Australian firm to act as Planner and control the restructuring.

June to September, 2000 creditors developed plan for debt-equity swap that would transfer management control to debtors.

November 17, 2000, 6,000 TPI workers disrupt creditors' meeting to vote on proposal.

November 27, 2000, plan approved in rescheduled meeting.

December 1, 2000, CEO claims meeting lacked ten day notice and was unlawful. Filed suit against Planner on grounds of embezzlement.

December 12, 2000, CEO asks for replacement of judges on panel to hear complaint on ground of conflict of interest.

December 28, 2000, CEO dismissed by Planner. Protested dismissal because CEO also served as head of union and unlawful to fire a union representative.

April 16, 2001, Planner jailed for conducting business at TPI, outside of their offices in violation of visa.

May 18, 2001, lawsuit on embezzlement dismissed.

May 25, 2001, new lawsuit against Planner, claiming paid illegal bonus.

October 3, 2001, TPI misses interest payment.

October 26, 2001, TPI received long-awaited infusion of working capital from creditors.

December 2001, delay in sale of non-core assets announced due to global recession and over 30 legal actions by ex-CEO against Planner.

December 31, 2001, TPI missed payment, triggering a technical default.

January 16, 2002, Planner hires President of Government Housing Bank as CFO.

January 23, 2002, Thai criminal court dismisses embezzlement charges.

February 6, 2002, 87.82 percent of creditors vote to take no action on default, but 1.59 percent fail to approve the restructuring plan, thus blocking its implementation.

April 6, 2002, ex-CEO files claim that Planner's certification to do business in Thailand lacks appropriate corporate seal.

May 7, 2002, the restructuring plan was approved under amended voting rules.

May 8, 2002, ex-CEO files amended voting rules illegal.

June 10, 2002, the Supreme Court throws out appeals challenging the Planner's authority and restructuring plan.

June 13, 2002, ex-CEO files new complaint alleging lack of transparency to TPI shareholders in violation of bankruptcy law.

June 19, 2002, ex-CEO petitions Prime Minister to create a panel to monitor the debt restructuring and ensure that the interests of workers are respected.

July 3, 2002, arrest warrants issued for Planner and staff for violating work permits.

July 3, 2002, protest by workers disrupts attempt sale of TPI power plant.

July 20, 2002, court refuses to approve delay of asset sales originally planned for December 1, 2001.

⁴⁷ Darren McDermott, "Cultural Differences David Creditors and Asian Debtors, TPI Show Problems of Foreclosure After Default," *The Asian Wall Street Journal*, December 3, 1998.

July, 27, 2002, court throws out ex-CEO's claim that Planner lacks proper qualifications.

August, 29, 2002, court agrees to hear case filed by ex-CEO that Planner is illegitimate and incompetent because it failed to liquidate non-core assets on December 1, 2001.

September 9, 2002, potential buyer for power plant pulls out.

October 9, 2002, court throws out claim of illegitimacy and incompetence.

January 8, 2003, court approves rescheduling of liquidation of non-core assets and subsequent creditor decisions by 75 percent majority.

February 10, 2003, 82 percent of creditors approve restructuring plan.

April 21, 2003, court ruled that Planner should be ousted because failed to sell non-core asset on schedule. Ex-CEO appointed as new, interim administrator.

Creditors suspended working capital and froze bank accounts.

Ex-CEO fires employees hired by Planner and files money laundering suit against Planner for accounting irregularities.

May 2003, creditors, including Citibank, IFC and three local banks, propose new administration board that would include a prominent Thai attorney and several former government officials.

Ex-CEO proposes administration board made up of members of his family.

May 2003, Prime Minister Thaksin intervenes, contravening the bankruptcy law and proposing mediation of dispute.

IFC requests immediate repayment of debt, but is denied.

Creditor's slate is approved with a 99.68 percent majority

June – July 2003, bankruptcy court overrules creditors and appoints current MOF as debt administrator and creditors accept.

Ex-CEO continued to serve as "unofficial manager" for TPI's day-to-day operations.⁴⁸

August 2003, MOF orders state-owned bank to provide \$750 million to TPI Polene, cement subsidiary.

Ex-CEO is appealing bankruptcy decision in 2000, claiming that creditors applied an interest rate higher than the prevailing market rate to discount TPI's future cash flows, which understated its valuation.

June 2004, MOF proposed that a state-controlled oil and gas group PTT become a strategic partner for TPI.

August 2004, MOF approved a restructuring plan that permit TPI to raise Bt 12 billion in new equity capital to help pay creditors. The capital increase would dilute the Bt 10 par value of TPI shares to Bt 1 per share and would open the way for a new Thai investor to take a 30 percent strategic stake in TPI. The plan also includes a debt-for-equity swap and a rescheduling of \$1.8 billion in debt, with repayment over 12 years.

⁴⁸ Sawn W. Crispin, "Thai Petrochemical May See Revival as a Debt Deal Nears," *Wall Street Journal*, August 6, 2004.

Annex E

List of People Met by IEG Mission

Mr. Amaret Sila-On, S&P Syndicate Public Company, Ltd. Formerly, Chairman of SET; and, during the crisis, head of FRA.

Mr. Magdi M. Amin, Senior Private Sector Development Specialist, The World Bank.

Dr. Ammar Siamwalla, Thailand Development Research Institute (TDRI).

Mr. Richard J. Carroll, Economic and Financial Consultant, Carroll Consulting.

Mr. Chaiyapat Paitoon, Associate Director, Financial Institutions, Fitch Ratings (Thailand) Limited.

Ms. Chantavarn Sucharitakul, Director, International Economics Department, Monetary Policy Group, Bank of Thailand.

Mr. Chatu Mongol Sonakul, The Thai Farmers Bank. Formerly, Governor, Bank of Thailand.

Mr. Chulakorn Singhakowin, President and Chief Executive Officer, Bank of Asia.

Mr. Jonathan L. Fiechter, Deputy Director, Monetary and Financial Systems Department, The International Monetary Fund.

Mr. Oliver Fratzscher, Senior Financial Economist, Financial Sector Operations and Policy, The World Bank.

Mr. Thomas C. Glaessner, Unit Head Integrator Group, Lead Financial Economist, Financial Sector Strategy and Policy, The World Bank.

Mr. Sameer Goyal, Senior Financial Economist and Senior Financial Sector Specialist Financial Sector Group, East Asia and Pacific Region, The World Bank.

Mr. Mats Josefsson, Senior Financial Sector Advisor, Systemic Issues Division, Monetary and Financial Systems Department, International Monetary Fund.

Mr. Kiatchai Sophastienphong, Senior Financial Sector Specialist, South Asia Finance and Private Sector South Asia Region, The World Bank.

Mr. Kitipong Urapeepatanpong, Barrister-at-Law, Baker & McKenzie.

Mr. Vincent Milton, Managing Director, Fitch Ratings (Thailand) Limited.

Mr. Khalid Mirza, International Finance Corp. Formerly, IFC representative in Bangkok.

Ms. Marina Moretti, Economist, Systemic Banking Issues Division, Monetary and Exchange Affairs Department, International Monetary Fund. Formerly, World Bank official in Bangkok.

Mr. Ijaz Nabi, Sector Manager, Economic Policy
Poverty Reduction and Economic Management, South Asia Region, The World Bank.

Dr. Olarn Chaipravat, Council Chairman, Fiscal Policy Research Institute, Shinawatra
University. Formerly, President of Siam Commercial Bank.

Dr. Pakorn Vichyanond, Research Director, Macroeconomic Policy Program,
Thailand Development Research Institute.

Dr. Pisit Leeatham. Former Deputy Minister of Finance.

Dr. Prasarn Trairatoworakul, President, Kasikornbank. Formerly, Secretary General of SEC.

Mr. Thomas A. Rose, Program Manager, Financial Sector Group,
East Asia and Pacific Region, The World Bank.

Dr. Sethaput Suthiwart-Narueput, Senior Economist, The World Bank.

Mr. J. Shivakumar, Project Director, The World Bank.

Dr. Tanatat Puttasuwan, Senior Private Sector Development Specialist
East Asia and Pacific Region, The World Bank.

Dr. Tarisa Watanagase, Deputy Governor, Bank of Thailand.

Mr. Tarrin Nimmanahaeminda, Member of Parliament, The House of Representatives,
National Assembly of Thailand. Formerly, Minister of Finance.

Mr. Therapong Vachirapong, Director, Research Group,
Phatra Securities Company Limited.

Dr. Twatchai Yongkittikul, Secretary General, The Thai Bankers' Association.

Mr. Vicharat Vichit-Vadakan, former President of Stock Exchange of Thailand; Senior
Official of FRA during the crisis.

Mr. Wisit Wisitsora-At, Director General, Office of Justice Affairs, Ministry of Justice.

Annex F

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4. Investment Climate

In the late 1990s Yemen's investment climate seemed to be on an upswing. With the end of the civil war, security improved. Infrastructure was being rehabilitated. A stabilization program supported by the IMF had reduced the budget deficit and inflation. Debt relief substantially reduced Yemen's payments to creditors.

Despite the improvements, the investment climate did not become adequately attractive. Investor confidence again deteriorated with the bombing of the USS Cole in October 2000 and in the aftermath of September 11, 2001. The economy and the budget remained heavily dependent on oil. Fuel and water subsidies distorted incentives. A large and inefficient state-owned sector impeded private sector development. Pervasive corruption was a serious obstacle to increased investment. Yemeni business was highly taxed in comparison with neighboring countries. A few large business groups dominated the small and relatively protected domestic market.

Bank Strategy

The OED's 1999 Country Assistance Review was critical of the Bank's earlier strategy for improving the investment climate. It stated:

"A weakness of the assistance strategy is *the relatively low priority given to removing constraints to private sector development*. IDA's efforts in this area have included modest support for privatization of public enterprises; a large credit for financial sector reforms; and support for private investments for Aden port. *But IDA could have done more*. Except for the FIAS report in 1997, IDA has carried out no Private Sector Assessment. In addition, IDA could have supported efforts to limit illegal and destructive fishing practices in the Red Sea."

Since then, improving the investment climate has become a central objective of the Bank's country assistance strategy. CAS99 sought "to attract diversified productive private investments that help the economy grow out of poverty and dependence on oil". CAS02 aimed to create an "attractive investment environment to generate job opportunities". Both documents emphasized the interdependence with other CAS objectives, in particular the contribution that better public administration and governance could make to improve the investment climate.

The underlying challenges were to diversify the production base and to create jobs for a rapidly-growing labor force. Oil production peaked in 2002 and declined steadily thereafter. Barring new oil discoveries, Yemen's oil was projected to be depleted by around 2015. Moreover, the oil sector provided relatively few jobs. Non-oil investment and diversification for employment growth were critical to prospects for poverty reduction. Further complicating the challenge of diversification and job creation was the potential exhaustion of groundwater in the highlands. This implied a need to shift the focus of growth toward coastal regions. The Bank focused on three major needs:

- (i) To improve the private business environment by altering the way government interacted with the private sector;

- (ii) To develop Aden as a magnet for investment, and
- (iii) To address sectoral constraints to growth.

Bank Program

CAS99 proposed an ambitious program of lending and AAA to promote improvements in the investment climate. Proposed lending included a privatization project, financial sector adjustment credit, a series of adjustment credits to promote budgetary management, two legal and judicial reform projects, as well as infrastructure projects in support of transport, power, and water. Substantial ESW and strategy/policy advice was also planned to improve public expenditure management, promote non-oil growth, and improve the investment climate, including sector work on land registration and advice on establishing an independent commission against corruption.

Much of this program was not implemented. It was unrealistically ambitious, given the problems in recruiting experienced field staff and the waning reform momentum as the price of oil rose and obscured the need for action. Furthermore, the Government enthusiasm had not been sustained, while opponents of the reform mobilized against many program elements. CAS02 was less ambitious, proposing, among others, a Port Cities Development Project, a Rural Access Project, and a project for Power Restructuring and Expansion. Proposed AAA remained wide-ranging and included non-lending advisory support for investment climate reforms, financial sector dialogue and technical assistance, trade policy advice in conjunction with the Integrated Framework for Trade and Development, as well as sector work on land registration.

In all, five of eleven proposed new projects¹ under the CAS programs were carried out during FY99-05. The privatization project was approved but never became effective because of Parliamentary opposition. The proposed series of three PSMAC projects was terminated after one project. Only one of the two proposed legal and judicial projects was carried out. Support for development of the Aden Free Port was given, after some delay. In both the power and transport sectors, two projects were proposed. Only one was approved in each sector during the review period.

Implementation of AAA is harder to track but the pattern of slippage and dropped work was similar. A broad-ranging CEM on sources of growth was completed in 2002. It also included a useful Investment Climate Assessment. Only one PER was completed and the dialogue on expenditure rationalization did not last in most sectors – nor did the proposed sector strategy advice. However, the Bank completed a useful study of the Budgetary and Poverty Impact of Petroleum Pricing in December 2004.

Progress in Achieving Bank Objectives

From 1998-2004 Yemen's real GDP growth slowed down considerably compared to the preceding six-year period, averaging 3.7% per year, barely above the population growth rate of 3.5%. This partly reflects the fortunes of the oil sector. In 2004 real output of oil

¹ This excludes seven new water projects. These are discussed in another paper.

and gas was only 11% above that of 1998 (average annual growth rate of 1.8%) and output has been declining since 2002. But slow overall growth also reflects the modest growth of the non-oil economy, an average of 4.0% per year.

The sectoral composition of growth casts doubt on the sustainability of much of the growth that has taken place. Government services accounted for 28.9% of non-oil growth from 1998 through 2003 -- the most recent year for which data is available. Because of the way output of government services is usually measured in national income accounts -- mainly as a function of government employment -- there is reason to be skeptical of the actual contribution of this sector to growth. Rather, the growth of government employment is a reflection of high oil revenues and is unsustainable.

There are also reasons to question the contribution and sustainability of qat, which accounted for 9.4% of incremental growth of non-oil output from 1998-2003. Because of its water intensity, qat production plays a key role in the depletion of Yemen's aquifers. If water were valued at its true economic and social cost, the value added of qat would be much lower than its value added at market prices. See the Box nearby.

Yemen's short-term macro management was adequate during the first half of the review period, but faltered during the second half. The Government cut expenditures in response to a sharp drop in the price of oil in 1998 and then maintained expenditure restraint after oil prices began to rise. The current account moved into surplus in 1999 and has since remained positive. The overall fiscal balance (including grants) also moved into balance in 1999 and surplus in 2000. However, by 2002 an overall fiscal deficit had re-emerged as revenue fell and expenditures continued to rise. More importantly, the Government failed to come to grips with Yemen's longer-term macroeconomic challenges. High oil prices obscured Yemen's long-term dilemma and reduced the Government's incentive to sustain fiscal (and reform) efforts. The IMF has estimated that in order for Yemen to reach a sustainable debt burden in the absence of new oil discoveries, Yemen will need to reduce its fiscal deficit by about 2% of GDP each year for the next 12 years.

Bank Contribution

Growth and diversification The Bank's main contribution to development of labor-intensive non-oil production has been in small-scale fishing development. In a Fishery Sector Strategy Note (Report No. 19288-YEM), the Bank warned that licensing agreements with foreign commercial trawlers brought little benefit to the economy, impeded local small-scale fishing development, and threatened depletion of coastal fish stocks. The Note recommended that further lending in the sector should be contingent on improving policy. The Government responded by strictly enforcing foreign agreements, leading to cancellation of almost all foreign industrial fishing licenses. In the last four years small-scale fishing production, employment, and exports all grew at double-digit rates. Fish exports in 2004 amounted to \$210 million, making fish the second largest export. A new Bank fisheries project will support fisheries resource management and infrastructure for small-scale fishing development.

Box: The Social Cost of Producing Qat

Qat has been widely grown and used in Yemen for centuries. There has long been a tendency for outsiders to view qat as a quaint or charming custom and for Yemenis to take a degree of national pride in a distinctive custom. But in recent years, rapidly-growing production and use have led to an intensified debate over qat and its effects on society.

The social and health effects of qat use have been especially contentious. Chemically, it is a mild narcotic similar to amphetamines. Prolonged chewing is necessary to achieve any effect. It is used mainly primarily by groups of men who sit in rooms in the afternoon chewing qat and conversing. The effects are said to be suppression of appetite and wakefulness. Proponents view it as a harmless social convention, promoting social harmony and providing a forum for collective decision-making. Many business and government policy decisions are said to be made during qat sessions. Opponents say it is harmful to health, leads to absenteeism, excludes women, and impoverishes families. Qat use also lowers spending on education and even food for poor families.

Government policy toward qat is ambivalent. Imports are banned, but production is legal and sales are taxed heavily. This contrasts with policy in Saudi Arabia and some other neighboring countries where production and consumption are illegal. A few politicians have spoken out against qat use, but there has been no coordinated anti-qat campaign.

Though less debated, the effects of qat production may be even more important than that of consumption. Qat production has lifted many rural households out of poverty because it has a higher value at market prices than alternative crops such as coffee. But qat has potentially disastrous environmental effects. It is very water-intensive and probably unsustainable. It reduces not only current production of alternative crops, but also the future of agriculture because it is mining non-rechargeable fossil aquifers. It also imperils the viability of urban areas in the highland. The poverty benefits of qat production are largely illusory, and certainly unsustainable. Whatever the social costs of qat consumption, the real economic and social costs of qat production are much higher than market costs. The contribution of qat to output, properly valued for externalities, is less than measured at market prices.

The Bank's Agricultural Strategy Note of 1999 analyzed the costs and benefits of qat production. The analysis showed that the domestic resource cost (DRC) of qat was above average and the report recommended that the Government should lift the ban on imports of qat, along with that on competing crops, and that diesel subsidies be eliminated to reflect actual economic costs of pumping. (Imports of qat are equivalent to "virtual imports" of water.) The 1999 CAS endorsed these recommendations and also called for Bank support for public education on qat. This was fine as far as it went, but the Bank gave fairly low priority to its efforts, and the 2002 CAS had little discussion of qat and proposed no new programs.

In power and transport, the Bank's contribution was mixed. Project ratings for outcome varied from moderately satisfactory to unsatisfactory, but in most cases institutional development was considered modest. The series of Public Works and Social Fund projects were motivated mainly by social protection objectives, but they have had an impact on the investment climate as well. The micro credit facility of the SFD has reportedly been successful in helping micro enterprises, while the contracting and supervision methods of these projects have given a boost to small-scale contractors and the local contracting industry.

Development of the Aden Free Port has gone slowly. The Port Development Project only started in FY03 and there have been some delays in implementation. Industrial estates in Aden and other coastal areas have so far attracted little investment. The Bank did, however, make a significant contribution to Port development through advice on the process for contracting out port management after dissolution of the original management agreement. This was not a formal part of the Bank project. Bank assistance was given on an informal basis, but was instrumental in helping conduct an arms-length search and bidding process.

Perhaps the greatest shortcoming of the Bank's assistance program was the failure to develop a more coherent and aggressive stance on qat production (see Box). The Bank helped sponsor a workshop on qat in 2002. But it should have built on its analytical work to elaborate on qat's production costs and benefits and to link this information to water policy and institutions. This could have provided a basis for a more active and better-informed public information program and policy dialogue.

Macroeconomic management Although Yemen's short-term macroeconomic management was adequate during the review period, the Government missed an opportunity afforded by high oil prices to restructure taxes and expenditure for sustainable debt and budget management after oil earnings disappear. The IMF took the lead on tax issues while the Bank focused mainly on the expenditure side of fiscal policy. Bank projects have been largely unsuccessful in helping improve Yemen's public expenditure policy. The proposed series of PSMACs was cut short after one operation. OED rated the outcome of that operation marginally unsatisfactory on the grounds that it was too modest for an adjustment operation.

The contribution of the Bank's AAA is more ambiguous. The Bank did less work than anticipated on public expenditure allocation, but a policy note entitled "Budgetary and Poverty Impacts of Petroleum Pricing in Yemen" attracted attention. Building on a longstanding dialogue and other analytical work such as an ESMAF study ("Household Energy Supply and Use in Yemen"), the note stressed the high cost of petroleum product subsidies to the budget (6.5% of GDP in 2004) and to resource allocation (overuse of pumped groundwater and smuggling of cheap diesel fuel out of the country). The Bank's note recommended a gradual, pre-announced series of price increases to be followed by the creation of an automatic price adjustment mechanism thereafter) combined with increased pro-poor spending to offset the impact of price increases.

In the event, the Government raised the price of diesel substantially (from YR 17 to YR 45) in one step on July 19th 2005. Although expenditure on social welfare was also expanded and other tax and salary adjustments were made, the Government rolled back the price of diesel to YR 35 on July 26th in response to mass demonstrations and riots and reported deaths of 36 people. The Bank's approach was in line with best practice in this case – grounded in analysis and sensitive to protecting the poor and to considerations of the political economy of reform. The Government's judgment was that it was better to get

the pain of adjustment over with quickly. Clearly the Bank did not succeed in persuading the Government to follow a gradual approach.

Structural and institutional reform The Bank has tried to promote structural and institutional reform in the areas of privatization, investment promotion, financial sector reform, trade reform and integration, and land policy. Its efforts in these areas have been generally well-designed but have had only a modest impact on outcomes.

The Bank's potential contribution to privatization was reduced by the collapse of the privatization project. Although the Bank has continued to work informally with the Government to provide advice on privatization issues, the resources it can devote and the influence it can bring to bear on resolving difficult problems are limited. Advice from FIAS in 1997 underpinned changes in investment legislation and the establishment of the GIA and Export Council. The institutional changes have had only a modest impact on the investment climate, however. Some officials in the Ministry of Planning were dismissive of Yemen's investment promotion efforts. In their view, Yemen has every agency but does not follow through on substantive reforms.

The Bank has given considerable support for financial sector reform and development, but the impact has been modest. A Financial Sector Adjustment Credit (FSAC) approved in FY98 and completed in FY00 was rated satisfactory by OED. The project had appropriately limited objectives, but implementation of reforms has been slow because of a failure to provide complementary technical assistance. At the end of FY05 the Government issued a decree outlining reforms to restructure public sector banks with World Bank support. OED cross-country reviews of financial sector reform and of FSAPs, however, concluded that Yemen's financial sector remains weak and that Bank interventions had a negligible impact.

Lack of access to land and insecure registration has long been identified as important obstacles to business development. Both CAS99 and CAS02 proposed to do AAA on land issues, but the work was only completed at the end of FY05. The analysis and policy proposals seem sound, but it is too soon to evaluate its impact.

Overall Assessment

Outcome The overall outcome for the investment climate was ***moderately unsatisfactory***. Although short-term macroeconomic performance (growth, inflation, fiscal and balance of payments deficits) was adequate, much of this was due to high oil prices. But these same high oil prices reduced the incentive to address the longer-term macroeconomic challenge of reducing the non-oil fiscal deficit. Growth of the non-oil economy was too low (4% per year on average) to promote diversification and much of the growth that did take place, notably government services and qat production, was of questionable benefit for long-term development. Progress on structural and institutional reforms such as privatization, trade policy, financial sector development, and investment promotion was modest. Progress in combating the critical constraint of corruption was

negligible. Finally, exogenous events reduced security, though strenuous Government efforts have yielded some improvements in recent years.

Institutional development Institutional development has been modest. Although investment legislation was brought into line with that of other countries and investment promotion and export agencies were established, these do not yet function very effectively. There have been some improvements in banking supervision and regulation. The Technical Privatization Office established at the Bank's recommendation has effectively promoted privatization (or liquidation) of small-scale enterprises, but major companies have not yet been privatized. Some improvements in public financial management are under way, but tax and expenditure policy is still largely ad hoc.

Sustainability Because of the precarious security situation, continued corruption, and uncertainty in the long-term economic outlook, sustainability does not seem likely. The risks of deterioration in the investment climate seem to outweigh prospects for improvement. Nonetheless, what needs to be done is well understood by the Government and a crisis may help galvanize action as it did when oil prices fell in 1998.

Bank contribution The Bank's assistance strategy has been largely relevant to Yemen's needs for improving the investment climate, with the exception of a failure to link the issue of qat production and the critical water constraint. The Bank's Investment Climate Assessments have helped focus attention on critical constraints to improving the investment climate, and AAA on oil pricing, public financial management, and (belatedly) land issues has created a good basis for policy dialogue and future action in important areas. The impact or efficacy of the Bank's assistance in bringing about improvements in the investment climate has been limited, however. The Bank's program was for the most part too ambitious to be implemented, especially in the post 9/11 environment, but the main limiting factor was the Government lack of receptivity.
