Public asset management companies in East Asia

- Case studies[1]

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1. Chinese asset management corporations

1.1 Background

The Chinese economy has been expanding fast over the past ten years, with its real GDP growth exceeding 8% and trade flows rising at 12% per annum. Nevertheless, China's financial system is featured with a large but weak banking sector, with the total loans amounting to 150% of GDP and saddled with high levels of non-performing loans (NPLs) estimated to be around 40% of the total loans outstanding (both carved-out and remaining).[2] China has been moving towards more economic liberalisation since 1978 when it was a still command-based planned economy. As part of the general market-oriented economic reforms, the government has incrementally initiated a series of important banking reforms since 1996, in order to restructure and strengthen the country's weak banking system (Lardy (1998) and BIS (1999)). China's recent entry into the WTO further adds to the urgency of accelerated bank restructuring.

The four largest state-owned commercial banks (the big four banks) dominate the Chinese banking sector, accounting for nearly 70% of its total assets (Table 1). Naturally they have been the primary focus of the government's banking reforms. One such ambitious banking reform was the establishment of four state-owned AMCs in 1999 — one for each of the big four banks — to take over and resolve problem assets. The Asian financial crisis might have helped convince the government to proactively deal with NPLs in the system. The principal legal basis for the four AMCs was an executive order issued by the State Council in 2000, after the actual setting up of the four AMCs. Although official speeches repeatedly mention about an expected 10-year life for the four AMCs, the State Council executive order does not explicitly stipulate the terms of the four AMCs.

Table 1.1

China's four AMCs and big four banks: policy-based NPL transfers in 1999-2000

In RMB billion

AMC	Matched bank	Assets transferred	Share of bank loans outstanding (% end 1998)
Orient Asset Management	Bank of China	267.4	20.4%
Great Wall Asset Management	Agricultural Bank of China	345.8	24.6%
Cinda Asset Management	China Construction Bank	373.0	21.7%
Huarong Asset Management	Industrial and Commercial Bank of China	407.7	17.9%
Total		1393.9	20.7%

Note: In calculating the China Construction Bank loan shares, the table takes into account that RMB100 billion of the assets transferred to Cinda are from China Development Bank and not from any of the big four banks. According to Cinda, the actual book value of the transferred NPLs reaches RMB395 billion instead of RMB373 billion. The difference could owe to the non-policy transfers on top of the policy carve-outs.

Source: Ma and Fung (2002).

1.2 NPL acquisition

The four AMCs have been specifically mandated to take over approximately RMB1.4 trillion (USD170 billion) in distressed assets from the big four banks, equivalent to around 20% of the combined loans outstanding of the big four banks or 18% of China's GDP in 1998 (Table 1.1). This mandated NPL transfer, however, represents less than half of the estimated NPLs of the big four

[2] The primary causes of the high NPL levels in the Chinese banking system are prolonged policy lending for more than five decades, rampant property speculation during the 1990s, a lax internal prudential lending policy and risk control system as well as poor financial performance of most state-owned companies.

banks at that time. The one-off transfer of RMB1.4 trillion in NPLs from the big four banks to the four AMCs mostly took place during 1999-2000. Each AMC is responsible for the NPL acquisition vis-à-vis its teamed up big four bank. There has been no more NPL acquisition by the AMCs since the transfer.

Such NPL stripping out has been generally regarded as “policy-based” transfers. Both the size and the scope of the carved-out problem loans were pre-authorised by the central government, with the explicit aim to bring down the levels of NPLs remaining at the big four banks towards some targeted levels. The lion share of the transferred bank assets were loans extended before the yearend of 1995 and identified as non-performing by the yearend of 1998 when the government first started promoting commercially-based bank lending. This is an indication that the government is willing to take responsibility for the potential financial loss related to the earlier state-directed policy lending but not those NPLs incurred afterwards (Ma and Fung (2002)). The sectoral distribution of NPLs acquired by the AMCs is fairly diverse, with 47% for the manufacturing sector, 6% for the farm sector, 16% for the commercial sector and only 7% for the real estate sector.

Reflecting the main policy objectives of the NPL transfer, the acquisition price of the transferred NPLs was set at a flat rate of book value for the entire block. To support this policy carve-out mission, the Chinese government explicitly approved the financing of the NPL acquisition (see 1.3). Given that the transfer of NPLs is priced at book value, the government has been concerned with the potential moral hazard problem and repeatedly vowed to have no more such policy-based transfers of NPLs.

The primary mission of the four AMCs is to manage and dispose of the acquired NPLs, with an aim to maximise asset recovery while participating in the corporate restructuring related to the debt-for-equity swaps that amount to some 30% of the total policy transfer and involve some 500 large and heavily indebted state-owned enterprises. The main purpose of these debt-for-equity swaps appeared to be meeting the government’s goal of lifting these large state-owned enterprises to profitability within three years. Therefore, the four Chinese AMCs can be considered as some hybrids of decentralised and public funded rapid disposition agencies and medium-term restructuring instruments. In sum, the four AMCs were set up by the government as a pre-emptive measure to restructure and strengthen the Chinese banking system.

1.3 Financing

Pricing the selected NPLs at book value highlights the important role of financing for such policy transfers, since the four AMCs would most likely bear most or all of the potential losses associated with the resolution of the acquired problem assets. Owing to paucity of information on AMC financing in China (Ma and Fun (2002)), we must estimate the structure of the AMC financing. According to government regulations, there are four principal methods of fund raising for the AMCs: equity injection by the Ministry of Finance (MoF), special loans from the People’s Bank of China (PBoC), commercial borrowing from other financial institutions and AMC bonds.

The four AMCs, in theory, are wholly owned by the MoF, which provided RMB 10 billion in equity to each of the four AMCs. In total, the MoF equity injection into the four AMCs amounts to RMB40 billion, only around 3% of the entire policy transfer. However, no official published government budget document so far has explicitly confirmed such budget outlay items as MoF equity injection into the AMCs. Moreover, our research suggests that only one quarter to one third of the AMC equity might be in cash. The rest of the AMC equity could take the form of office properties, office equipments, and money-losing businesses previously owned by the matched big four bank the AMC serves. Such contributions in kind from the big four banks, directly or indirectly, may potentially complicate the AMC-bank relationship.

Given the tiny cash component of the small equity injection, the AMCs would have to fund the large-scale NPL purchase almost entirely via the remaining three fund-raising methods. Our research confirms the absence of commercial borrowing by any of the four AMCs. In the end, the payments from the four AMCs to the big four banks for purchasing the RMB1.4 trillion NPLs were financed by PBoC loans (estimated to be RMB560 billion) and AMC bonds (RMB840 billion) issued by the AMCs to their paired or matched big four banks. The AMC bonds are non-marketable and not explicitly guaranteed by the MoF, and carry a coupon rate equal to the prevailing official one-year deposit rate (Ma and Fung (2002)). In addition, the PBoC loans to the AMCs seemed to take the form of equal reductions in the PBoC claims on the big four banks. In short, the entire policy-based NPL carve-out was funded by some 40% central bank credit and 60% by AMC bonds issued by the AMCs to their matched big four bank.

This AMC funding structure gives rise to several implications. First, the PBoC has been heavily involved in financing the NPL transfer operations. PBoC lending to the four AMCs amounts to more than 10 times of its own capital base. In doing so, it has directly exposed itself to AMC bonds, which are not government guaranteed. Nevertheless, in China, the prevailing view is that these AMC bonds receive implicit government support. This is the so-called constructive ambiguity. Second, the allocation of the eventual AMC loss arising from resolving the problem assets remains uncertain between the PBoC and the MoF. The Chinese central bank could be again asked to provide additional financing to the AMCs in the future. Third, without government guarantees, the AMC bonds could not achieve a zero risk weight according to the 1988 Basel Capital Accord to improve the capital base of the big four banks. Fourth, given the entire NPL transfer has been almost entirely debt-financed, the accrued interests of the four AMCs on their bonds and PBoC borrowing stand at RMB 28 to 30 billion a year at the prevailing one-year official deposit rates, which far exceed their combined annual cash recovery. Therefore, some AMCs could come under liquidity pressure if they are to honour their interest obligations in the absence of additional cash injections from the MoF or the PBoC.

1.4 NPL resolution

Of the RMB1.4 trillion in distressed assets acquired by the four AMCs, through December 2002 only some RMB300 billion have been resolved (Table 1.2), after having been in operations for nearly four years.[3] This figure might be open to interpretation since it includes such resolution techniques as seizure of underlying collateral, as opposed to only including actual disposition. One important reason for the relatively slow pace of NPL resolution by the four AMCs thus far might be the time-consuming debt-for-equity swaps in their first two years of operation.

The four AMC have managed to recover RMB 100 billion from asset resolution, with a total recovery rate of 33% over the book value of the resolved assets (Table 2). This recovery performance is reasonable, given the challenges the four Chinese AMCs face (see below). However, actual cash recoveries were only RMB 68 billion, implying an average cash recovery rate of about 22%. The remaining RMB 33 billion are non-cash, probably in the form of physical assets at book value, which could be much larger than their underlying market values. The methods of NPL resolution mainly include debt collection, portfolio sales, auctions, joint ventures, debt-for-equity swaps and leasing out the underlying assets. Two of the four AMCs have just announced the first ever asset back securities deals in China, one with Deutsch Bank and other with a domestic securities firm, further breaking grounds for asset resolution.

The Chinese AMCs face several major hurdles in their huge task of resolving the problem assets and maximising recovery. First, the absence of an efficient legal system in China that allows the owner of the debt to take action against the borrower. The adoption of a new and better bankruptcy law remains in doubt, and the AMCs would have to live with an outdated and flawed old bankruptcy law. Many of the state-owned enterprises and other borrowers can apply pressure on the legal system that forestalls or prevents decisions by the court. Related to this point is the enforcement of any legal decision or judgement that the court system may deliver. Prospective investors or buyers of AMC held assets, especially foreign investors, might discount their bid prices to compensate for the legal risk associated with collecting assets in China.

The second problem is a social one. Selling a large state-owned enterprise to an investor that may eliminate non-core activities or even take the firm into bankruptcy (such as it exists) could be imposing unbearable social consequences on some cities and towns, where large portions of the local workforce may become unemployed and without health-care, pensions, access to schooling for their children, etc, given a nascent and under-funded social safety net in China. The government may wish to keep unemployment from rising too fast in the short term, as the Chinese economy is adjusting to the new WTO environments. Hence, the AMCs face obvious political and social constraints.

The sheer volume of problem assets that must be resolved presents a demand and supply problem and as a consequence, realized sales could be at low values that would result in large losses to the AMC, given that assets were transferred from the big four banks to the AMCs at book value. At the same time, the internal NPL departments of the big four banks are also unloading some of their remaining distressed assets. Therefore, supply of distressed assets is likely to expand substantially in the coming years. The lack of a deep and developed capital market would further hamper asset

3 The data on resolved assets exclude the debt-for-equity swaps. While the recovery performance is reasonable, the pace is a concern, as at the current pace, it may take another 13 years for the four AMCs to resolve all the transferred assets.

disposals. Both supply and demand factors thus tend to put pressure on the market prices of the distressed assets, adversely affecting the pace of resolution and recovery potentials for the AMCs.

Table 1.2

China: resolution progress and recovery performance

Cumulative as of December 2002, in billions of RMB

	Orient	Great Wall	Cinda	Huarong	Total
Book value of assets assumed	267.4	345.8	370.0	407.7	1390.9
Of Which: debt-for-equity swaps	40.0	12.3	167.8	101.9	321.9
Equity as a percent of assets	15.0	3.6	45.4	25.0	23.1
Book value of disposed assets	45.5	106.0	86.8	63.8	301.4
As % of total acquired assets	17.0	30.7	23.3	15.5	21.6
Actual recoveries	20.6	19.9	33.6	27.3	101.3
Of which: cash	11.2	9.8	26.6	19.8	67.5
Of which: non-cash	9.4	10.1	7.0	7.5	33.8
Overall recovery rate (in percent)	45.3	18.7	38.7	43.2	33.6
Cash recovery rate (in percent)	24.7	9.3	30.7	31.3	22.4

Note: The cash (overall) recovery rate is computed as the ratio of cash (cash and non-cash) recovery to the face value of the resolved assets.

Source: PBoC, IMF and BIS estimates.

Information about the assets acquired by the AMCs available for sale or resolution is yet another hurdle. In many cases, the bank does not have books and records of each borrower that enable the AMC to effectively collect the loan, let alone sell it to a third party for collection. In the case of China Great Wall Asset Management Corporation (Great Wall), which serves as the AMC for Agriculture Bank of China, its loans are to borrowers that are mostly small farmers spread across the entire country. Great Wall has some RMB345 billion in loans to nearly 2 million debtors, of which 1.4 million are natural persons. To make things worse, after the dismantling of the commune system and establishment of the family farming system during the 1980s, many original debtors such as the production teams and communes have long vanished!

Finally, the general asset quality of the portfolio acquired by the four AMCs also points to a less optimistic outlook on recovery. First, most of the loans taken over by the AMCs are truly non-performing, in contrast to the US Resolution Trust Company in the early 1990s, which handled both performing and non-performing assets of troubled institutions.[4] Second, most of the assets acquired by the AMCs by now have been identified as non-performing for more than four years already, even according to the very loose definitions of the old Chinese loan classification system. Therefore, their collectability is very much in doubt. Third, the NPLs related to real estates are only 7% of the overall asset pool held by the four AMCs, which tend to be more collectable.[5] Finally, most of their NPL portfolios are not secured, and those with corporate guarantees sometimes mean very little in terms of

4 There might be some “performing loans” related to the debt-for-equity swaps. However, by international loan classification norms, such loans should have been classified as non-performing (See Ma and Fung (2002)).

5 The NPL portfolios of the four Chinese AMCs differ a great deal in terms of their quality and characteristics. The real estate portion of Cinda’s portfolio is much higher compared to the general NPL portfolio, reaching 16%. This may explain in part why Cinda has managed a higher cash recovery so far. More generally, the noticeable differences in the recovery performance across the four AMCs have been mostly shaped by the quality of the problems assets they have inherited from the big four banks.

effective collection, in part because those companies providing guarantees are not in good financial shape themselves, and in part because of the aforementioned weak legal environment.

However, despite all these daunting challenges and headwinds, the reported 22% cash recovery rate so far by the Chinese AMCs should be regarded as a hard-won achievement. Certain government policies have been supportive to AMC recovery efforts. For example, the Chinese AMCs enjoy certain tax advantages in their disposition operations, as they are exempted from value-added tax, business tax, real estate tax, stamp duties and land registration fee. And the government has been offering incentives of cash bonus to AMCs for their cash recovery from resolving their acquired NPLs.

Lately, we are seeing some signs of strengthened momentum with regard to asset resolution. China Huarong Asset Management Corporation (Huarong) has recently completed the first two international auctions of distressed assets in China.[6] The sale of assets by Huarong through international auctions is significant for several reasons. First, it represents a significant realisation of cash by an AMC when resolving distressed assets, notwithstanding the controversy over the actual recovery performance of the auction. Second, the auction was won by international investors, evidencing their interest in China, despite the problems mentioned above. In sum, the general success of Huarong's auction has captured the interest of several other AMCs. For instance, Great Wall and Orient Asset Management Corporations are currently closing their own deals of international bundled loan sales.

1.5 Supervisory environments and corporate governance

Oversight and supervision of the four AMCs have been carried out by a number of governmental agencies, mostly notably the MoF, PBoC, and China Securities Regulatory Commission (Graph 1.1). From April 2003 onward, the four AMCs will be supervised directly by the newly set up China Bank Regulatory Commission (CBRC), which took over the bank supervisory and regulatory functions from the PBoC. The AMCs have to report their operations to the MoF and the PBoC on a monthly basis. And the PBoC conducts regular onsite inspections of the AMCs. Therefore, the PBoC has played the role of not only an important financier to the AMCs but also a key supervisor, whose role is being taken over by the CBRC.

Unfortunately, the initial executive order issued by the State Council regarding the AMCs was not quite clear on the division of duties among the aforementioned institutions. In fact, most government regulations pertaining to the AMCs are vague and require interpretation, which sometimes differs from one agency to the other. This in turn could hamper the coordination among different government agencies, which is much needed to compensate for an already weak legal environment.

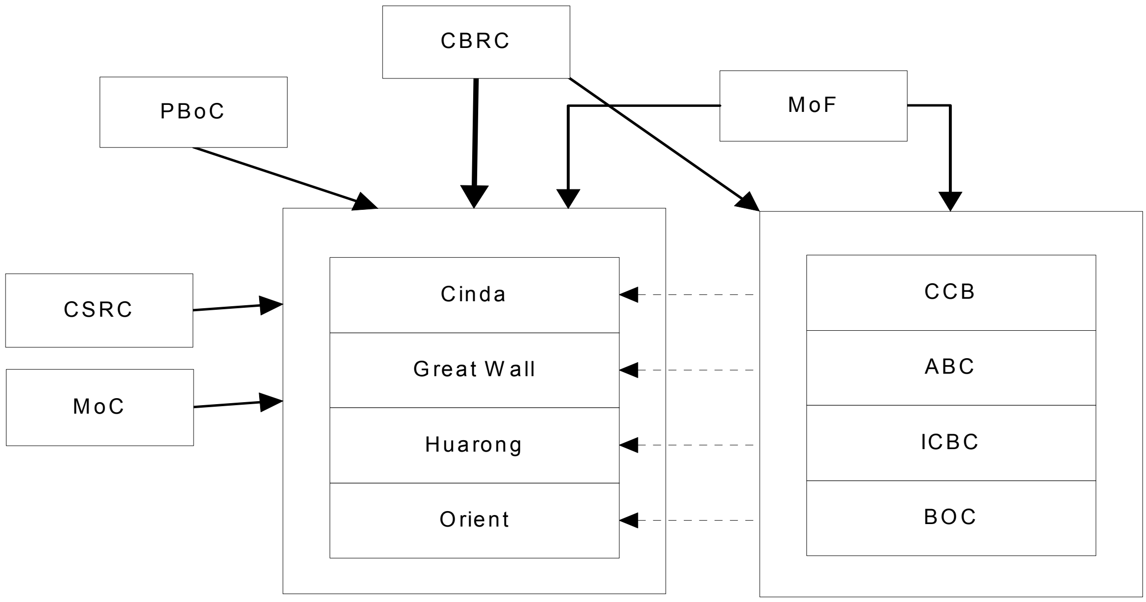
A better defined relationship between the four AMCs and their matched big four banks could also help enhance the efficiency of the AMC resolution operations. Although government regulations stipulate that the State Council directly appoints the presidents and vice presidents of the four AMCs, the president of each big four bank is also the party secretary of the designated AMC in every instance, offering an unusual link between the AMCs and the big four banks. Some AMCs and their matched big four banks are still debating over how to evaluate parts of the AMC equity, officially injected by the MoF but actually provided by the banks. Moreover, most of the AMC staff, averaging around 3,000 for each AMC, come from the big four banks that produced the problem assets to begin with. In short, there is room for greater transparency regarding the AMC-bank relationship.

As a consequence, corporate governance, public disclosure, staff quality and other norms are sometimes not ideal. So far, none of the four AMCs has formally published its detailed balance sheet or income statement, audited or otherwise. And their published statistics seem to be less than clearly defined. There appears to be no systematic external auditing for the four AMCs, though internal supervisory committees have been established within all the AMCs. On the other hand, all AMCs seem to be quite transparent regarding their resolution operations such as information regarding public auctions. Recently, there is a renewed effort on the part of the Chinese government to provide more updated and consistent information on the progress of asset resolution.

[6] A consortium led by Morgan Stanley was the successful bidder for a pool of RMB10 billion in loans. A second pool of RMB 2 billion in loans was won by Goldman Sachs. The International Finance Corporation (IFC), the private arm of the World Bank Group, has agreed to provide financing to the qualified bidder(s) who prevailed in the auction. In Morgan Stanley's case, they may potentially receive a USD30 million loan from the IFC to finance their acquisition of the loans from Huarong.

Graph 1.1

Regulatory Environment facing Chinese AMCs



Note: The arrows indicate ownership and/or supervisory control. CBRC is China Bank Regulatory Commission. CSRC is China Securities Regulatory Commission; SETC is State Economic and Trade Commission; MoC is the Ministry of Commerce. CCB is China Construction Bank; ABC is Agriculture Bank of China; ICBC is Industrial Bank of China; BOC is Bank of China.

2. Indonesian Bank Restructuring Agency (IBRA)

2.1 Background

Following the outbreak of the Asian financial crisis in mid-1997, Indonesia experienced its worst economic crisis in recent history. The collapse of the rupiah exchange rate and the sharp rise in interest rates caused nearly the entire corporate sector to default. As a result, a large number of banks experienced liquidity shortage and insolvency. Subsequently, many of them were closed or taken over by the government, including all the state-owned banks. In 1998, GDP shrank 14%, inflation spiked to 45% and interest rates shot up to nearly 70%. Over five years have passed, but the economy is still struggling to recover from the crisis.

As of end 2002, there were 141 commercial banks in Indonesia, down from 237 in mid-1997. Total bank assets have risen steadily since 1998 to 1112 trillion (69% of GDP) in 2002, with the four state-owned banks taking a share of 48.5%. While just over one-third of the assets were bank credits, over 40% were government bonds. Therefore, banks' operating revenues have relied heavily on interest income from bonds. While bank lending has picked up gradually, it is still well below its pre-crisis level, suggesting only slow recovery in bank intermediation. Official gross NPL ratio (without allowing for reserves for write-offs) dropped to 8.1%, compared to over 50% at the peak of the banking crisis.

2.2 Key features of IBRA

Establishment

IBRA was established based on the Decree of the President of the Republic of Indonesia No. 27 dated 26 January 1998, after the government decided to provide a blanket guarantee or full protection for depositors and creditors in response to the banking crisis.[7] IBRA was set up to administer the blanket guarantee and to restructure the banking sector. With the implementation of the Law No. 10 of 1998 (Banking Law), the legal basis for IBRA operational activities became more solid. The Banking Law specifies three main duties of IBRA: to restructure banks transferred to IBRA, to recover bank assets, and to recover state funds formerly disbursed to the banking sector.

In order to prevent the banking system from collapsing, the government issued a huge amount of bonds (IDR650 trillion) to support banks. A large portion of the bonds (IDR431 trillion) was issued to recapitalise banks ("recap bonds") that had their capital being wiped out, except joint banks and foreign bank offices. The recap banks were required to transfer all bad loan assets (category-5) to IBRA. Some controlling shareholders were not able to contribute their share of the capital required for recap and as a result, these banks were taken over by the government. Other banks that were ineligible for the recap program and were not viable were closed or frozen. All of the assets of the closed or frozen banks were subsequently transferred to IBRA. Some IDR144.5 trillion of bonds were used in the form of liquidity assistance by the central bank ("BLBI") to provide emergency loans to banks that suffered liquidity problem during the height of the Asian crisis.[8] The remaining amount of IDR73.8 trillion was used for the guarantee program.

Structure

IBRA is an autonomous agency of the Ministry of Finance, which also provided the funding for IBRA. All cash recovered from IBRA's operations, after the deduction for its expenses, is transferred to reduce the state budget deficit. IBRA is expected to operate for only five years until February 2004.[9]

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[7] The blanket guarantee was for both banks' liabilities and deposits, except those belonged to shareholders and holders of subordinated debts. To administer the blanket guarantee program, IBRA registers claims, verifies eligibility, and settles verified claims. This is particularly difficult in verifying domestic interbank liabilities. IBRA is to administer the Government's Guarantee Program until a new deposit agency is established.

[8] However, many of the banks that received BLBI failed afterwards and the government disputed how much of the losses to be borne. This put the Bank Indonesia at risk of bankruptcy. Recently, the government has announced a resolution of the issue by issuing perpetual promissory notes to the central bank to cover its losses.

[9] The question is then why a lifetime of only five years given the scope of the problem. It seems almost certain that IBRA will not be able to complete its tasks. The answer provided by IBRA was that nobody knew the extent of the problem at the time and that IBRA's presence was a constant reminder of the country in crisis. As such, the sooner it ceases existence the better.

IBRA is organised in a way that reflects its major tasks. Besides the chairman and vice chairman, there are now 7 deputy chairmen in charge of IBRA's various major responsibilities. The tasks of the three main units of IBRA are as follows:

- Asset management credit (AMC) – to restructure and dispose of loans and other (non-core) assets transferred to IBRA from closed (frozen) and recapitalised banks.
- Asset management investment (AMI) – to manage and dispose of industrial and real estate assets transferred to IBRA from bank shareholders in settlement of outstanding liabilities.
- Bank restructuring unit (BRU) – to restructure the banking system and to dispose of the equity stakes in banks managed by IBRA.

The current chairman, Mr Syafruddin Tumenggung, was appointed in April 2002. Like most of his predecessors, he held various senior government positions before joining IBRA. Other senior officials tended to come from the government, state-owned enterprises or from the private sector, especially commercial banks. As of April 2003, IBRA employs nearly 2000 people and about half of them are from commercial banks of which 30% are from closed banks. IBRA offers a fixed salary and benefits that are above market. IBRA has improved its transparency by publishing various reports related to its financial position and operations, including an annual report since 1999. It has published a monthly report since April 2000 that provides information on asset sales and other operations.

Regulatory environment in which the AMC operates

Figure 2.1

IBRA's governance structure

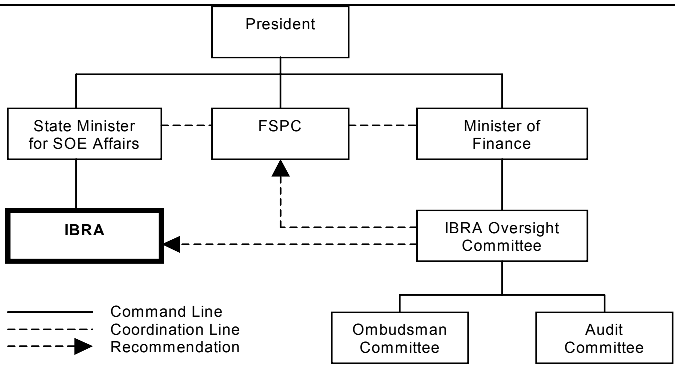


Figure 2.1 shows the governance structure of IBRA. Both the Minister of State-Owned Enterprises (previously the Minister of Finance) and the Financial Sector Policy Committee (FSPC)[10], are responsible to oversee IBRA. The Oversight Committee (OC), set up by and reports to the FSPC, monitors the overall performance of IBRA and provides independent review of IBRA restructuring. It has nine members, chaired by Ma'rie Muhammad, former minister of finance under President Soeharto. Other members include the secretary of FSPC, chairman of IBRA, and representatives from the private sector and academics. The OC meets at least once a week to make recommendations on issues related to transparency, external auditor, shareholder settlements and asset disposals. These recommendations are not binding and are not always adopted by IBRA or the responsible Minister. The Audit Committee, a standing committee of the OC, was set up to enhance the standard of financial reporting by IBRA and to ensure standards of corporate governance and control. It has five members who are independent professionals. Internal audit was formed in late 1998 to ensure the transparency and accountability of IBRA as a public institution. IBRA employed independent public accountants to audit its financial statements.

[10] FSPC is a state body chaired by the Coordinating Minister of Economy to decide and coordinate government policies on the financial system. Its members include the Minister of Finance, Minister of Trade and Industry, State Minister of National Planning Development and the State Minister of State Owned Enterprise.

2.3 Asset acquisition

IBRA acquired a wide range of assets from closed (BBO/BBKU) and taken over banks (BTO), as a result of the government guarantee program and the subsequent recapitalisation of banks. These assets are categorised as:

- Core assets – non-performing loans transferred from banks taken over and state banks as well as all loans taken over from closed or frozen banks, which are managed by the AMC.
- Non-core assets – buildings and other properties such as cars and office equipments acquired in the process of liquidating closed banks, which are also managed by the AMC.
- Shareholder assets – assets pledged by former bank shareholders in settlement of claims related to their violation of prudential norms, which are managed by the AMI.
- Equity holdings – equity stakes in banks recapitalised by IBRA, managed by the BRU.

Table 2.1

IBRA asset holdings as of end 2000 and 2001
In IDR trillion

	2000			2001
Assets	**Face value**	**Fair value**	**Expected recovery rate (%)**	**Face value**
AMC: Loans	401.2	88.3	22	283.8
AMI: Settlement assets	126.4	26.6	21	120.1
BRU: Equity holdings in banks	117.0	52.7	45	101.8
Total	644.8	167.7	26	505.7

Source: IBRA 2000 and 2001 Annual Reports

These assets were transferred to IBRA at zero value but the government in effect paid the face value for them by providing a full guarantee to depositors and creditors and recapitalising the banks. The book value of IBRA's assets is very large at IDR506 trillion or 34% of GDP as of end 2001 (Table 2.1). In its 2000 Annual Report, IBRA estimated the fair value of these assets to be 26% of the face value.[11]

Table 2.2

Loan classification by category/size
as of 16 April 2003

Category	Assets transferred to IBRA				Outstanding			
	# Acct	**Debtors**	**Principal**	**%**	**# Acct**	**Debtors**	**Principal**	**%**
Corporate	55,532	2,887	328,606	83.86	45,344	905	144,463	90.82
Commercial	8,288	2,737	33,390	8.52	2,599	961	13,564	8.53
SME/ Retail	310,373	291,317	29,871	7.62	11,707	10,350	1,037	0.65
Total	374,214	296,941	391,867	100.00	59,650	12,216	159,064	100.00

Note: Exchange rate IDR7,000/USD and loan principal only. SME/Retail (loan amount < IDR 5 bn), Commercial (5 < loan amount < IDR 50 bn), SME/Retail (loan amount > IDR 50 bn)

Source: IBRA 2001 Annual Report

[11] Fair value reported by IBRA is defined as the value of the assets that would be realised in the market according to appraisal data and/or the latest sales data available to IBRA.

As of 16 April 2003, a total of IDR392 trillion of bank loan assets belonging to 296,941 debtors was transferred to IBRA. This consisted mainly of bad debts (category-5) that originated from 11 recap banks and 7 state banks (account for 50% of the loan assets) as well as assets from the frozen or closed banks. In terms of outstanding balance (see Table 2.2), almost 84% are corporate loans (principal > IDR50 billion), around 9% are commercial loans (principal between IDR5 and IDR50 billion) and the remaining 7% are SME/retail loans (principal < IDR5 billion). In terms of number of accounts and debtors, retail loans account for the bulk of the loan assets. About half of the loans are denominated in foreign currency, mainly US dollar.[12]

2.4 Asset resolution

Rapid asset disposal is key to the success of IBRA in recovering state funds, returning assets to the real sector and privatising banks under its management. IBRA has four means of assets disposal, namely through the private placement of corporate assets, the public offering of shares and loans, the sales of financial assets and the securitisation of assets. Despite being set up in January 1998, IBRA began asset disposal only in mid-1999. There were delays in the process of transferring the loans to IBRA from closed and frozen banks owing to documentation problems. Many of the loans were poorly administered and often had inadequate collateral. In addition, the vast majority of these loans are category-5, which have been difficult to sell.

AMC

IBRA has focused on the disposition of loan assets using different methods depending on the size of the loan. At the same time, it is also engaged in loan restructuring of the largest debtors. From 1999 to 2002, IBRA disposed of IDR135 trillion of loans through loan auctions. The total proceeds of the asset disposal programs were IDR41 trillion, suggesting a respectable recovery rate of 30% (Table 3).

- *Corporate loan sale* – So far, IBRA has carried out five batches of corporate loan sale through open auction, but the recovery rate was declining. The largest sale so far was through its Loan Asset Sales Program (PPAK) in 2002, involving IDR135 trillion of loan principal ATK value from 2583 debtors. Nearly two-thirds of the loans were unrestructured corporate loans and the rest comprised of both restructured corporate and commercial loans. Over 200 investors (50% local and 50% overseas) bid for 82% of the loan principal and IBRA succeeded in selling IDR82 trillion of the loans. Nearly 70% of the successful bids were from local investors, raising some doubts that these assets might eventually find their ways back to the original owners. In any event, IBRA received from this sale IDR17.4 billion in cash and IDR4.7 billion in bonds, achieving a recovery rate of 27%.
- *Outsourcing for commercial loans* – Loan outsourcing program is a program to sell commercial loans through a selected third party (servicing agent).[13] The program, implemented from mid-2000 to mid-2002, has shown some encouraging results. However, in order to expedite the disposal process, the outsourcing program was later included in the Loan Asset Disposal Program.
- *Small and medium enterprise (SME) and retail loans* – IBRA also has a large number of debtors with insignificant amount of loans (face value below IDR 5 billion). For these loans, which make up of approximately only 4% of the total assets managed by AMC, IBRA chose to sell the loans through open tender auction. This was followed by the crash programs, which started in year 2000, that offered flexibility for the debtor to settle their debts by providing a 100% discount on interest and penalty as well as 25% discount on principal for productive loans only. As of 31 December 2002, IBRA was able to settle IDR 25.8 trillion worth of loans for 363,856 accounts or 93% of the total principal amount.

[12] Thus the value of loan assets sometimes varies depending on the exchange rate used.

[13] These agents included Bank Danamon, BNI consortium, Bank Bukopin and Bank Artha Graha.

Table 2.3

Asset disposal programs
1999 to 2002, in IDR billion

Disposal Method	Year	Program	ATK	Proceed	(%) Recovery Rate
Auction	**1999**	*Credit Card Disposal*	**76,00**	**39,00**	**51,3%**
	2000	CLS I	1.024,84	621,96	60,7%
		CLS II	2.179,17	891,28	40,9%
		ADP (SME *Disposal*)	4.290,80	1.387,40	32,3%
		Total 2000	**7.494,81**	**2.900,64**	**38,7%**
	2001	CCAS III	3.011,15	1.003,40	33,3%
		CCAS IV Batch I	8.182,49	2.075,93	25,4%
		CCAS IV Batch II	2.659,00	554,00	20,8%
		Direct Selling	3.885,59	5.695,44	96,8%
		Total 2001	**19.738,29**	**3.079,33**	**47,3%**
	2002	CCAS IV Batch III	2.787,09	727,89	26,1%
		CCAS V	3.000,17	670,57	22,4%
		CULS	9.517,41	2.375,05	25,0%
		Direct Selling	1.393,45	986,85	70,8%
		PPAK*	75.141,54	21.317,96	28,4%
		PPAK-PPL*	310,00	220,00	71,0%
		P3AK*	15.828,65	2.834,69	17,9%
		Total 2002	**107.978,31**	**29.133,10**	**27,0%**
Total			**135.287,44**	**41.401,57**	**30,60%**

Note: * Face Value

ATK = Asset Transfer Kit, CLS = Corporate loan sales, CCAS = Corporate core asset sales, CULS = Corporate unrestructured loan sales, PPAK – Loan asset sales program

Source: IBRA

In addition, several new asset disposal programs have been introduced to speed up the loan sale process.

- *Asset to bond swap program* - Eligible investors can use government recap bonds as payment for IBRA's assets. This program could speed up the redemption of outstanding recap bonds and also enable banks to use the recap bonds to increase their holdings of other income-generating assets.
- *Unrestructured loans* - IBRA also sold IDR9.5 trillion of unrestructured corporate, commercial and retail loans (CULS) in 2002.
- *Collateralised debt obligation (CDO)* – IBRA planned to securitise a diversified portfolio of restructured loans and loans in the MOU stage with a face value of IDR50 trillion in late 2002. This CDO represents the first transaction of this type in Indonesia using the domestic market.

In contrast to loan sale, IBRA does not perform well in loan restructuring. As of June 2002, IBRA has successfully restructured around 17% of the loans (restructuring proposal implemented, fully repaid or disposed). Given IBRA's limited resource and time, it has focused on the larger deals, namely the largest 21 debtors, by carrying out restructuring itself. Table 4 reports that almost 98% of the loans to the top 21 obligor groups are at the late stage of restructuring or have completed restructuring. In contrast, less than 40% of the loans to the 51 largest debtors and beyond have the restructuring in late stage or completed. Progress in loan restructuring of the top 21 obligors got a big boost in 2000, with over 80% of the loans near the late stage of restructuring. Since then, however, the progress from the late stage to completion is limited.

Table 2.4

Status of IBRA loan restructuring based on grouping of obligors
As of June 2002, in %

Obligor group	Early stage	Middle stage	Late stage	Completed	*Total (IDR trillion)*
Top 21	0.2	4.3	75.6	19.9	*99.5*
Next 22-50	3.5	10.4	63.7	22.4	*53.5*
Remainder (51 onward)	4.6	15.4	25.4	13.9	*200*
Total debtors	3.2	11.6	45.2	16.8	*353*

Note: Early stage includes restructuring not initiated; initial negotiation; or standstill agreement. Middles stage includes assignment of advisors; due diligence; or restructuring negotiations. Late stage includes finalisation of a workout MOU or legal action in progress. Completed includes loans that are in stage of implementation, full payment or disposal. Figures exclude identified shareholder settlement, non-resident debtors, retail loans, interbank claims, and derivatives & marketable securities.

Source: IBRA and authors' calculation

With the issuance of the FSPC decree No. Kep. 01/K.KKSK/05/2002 dated 13 May 2002, all restructuring agreements are required to be completed in 6 months. For debtor whose restructuring process is not completed as required, the loan will be transferred to the disposal program. However, IBRA is still conducting loan restructuring only for loans with principal amount above IDR 750 billion. Table 5 below describes the loan restructuring progress for loans above IDR 750 billion.

Table 2.5

Loan restructuring progress
As of 17 March 2003

Restructuring Process	Number of Debtor	Principal (IDR trillion)	%
Initial Stage	10	0.73	1.30
Under Restructuring	13	13.96	24.95
Restructuring Completed	45	41.26	73.74
Total	**68**	**55.96**	**100.00**

Source: IBRA

AMI

The main task of AMI is to maintain the shareholders liabilities settlement. The shareholder liabilities settlement program ("PKPS") constitutes the framework by which the recovery of the state fund that had been disbursed to banks under care of IBRA is maximized, by assigning accountability for the losses incurred by these banks to their respective shareholders. This program represents an out-of-court settlement, which can be expected to yield better and more optimal result than if the matters were pursued in court. Through this program, it is expected that these shareholders will be able to settle their liabilities in cash. Otherwise, they have the option of settling by way of pledging their corporate assets (equity, buildings, estate etc) or signing a debt memorandum equal to the amount of their liabilities. By the end of 2002, IBRA collected IDR 17.7 trillion out of IDR 35.7 trillion of the acquisition value of assets pledged by the shareholders or 49.7% recovery rate.

The main impediments to recovering as much values from these assets include the slow recovery of the Indonesian economy as well as IBRA's lack of managerial control and the legal authority to initiate changes in these companies. These have led to a significant deterioration in the value of some of these assets. In some cases, IBRA failed to enforce shareholders' compliance, resulting in assets that were not transferred or transferred at less than the agreed amount.

BRU

By mid-2002, BRU has already over achieved its 2002 target of collecting IDR4.3 trillion as a result of the successful divestment of its equity holdings in several banks, including the Bank Credit Asia (BCA). After much delay, a 51% stake of BCA was finally sold to Farallon Capital, a U.S. investment firm, in March 2002 for approximately IDR5.6 trillion. IBRA also sold 51% of Bank Niaga to Commercial Assets Holding Bhd. of Malaysia in September 2002 for USD110 million. In May 2003, IBRA finalised the sale of 51% of Bank Danamon to the consortium of Asia Financial Indonesia (Temasek Holding and Deutsche Bank AG). From this transaction, IBRA expects to receive about IDR3.1 trillion.

Table 2.6

IBRA revenue targets for 2001-2003
In IDR trillion

	2001		2002		2003		
	Target	**Realised**	**Target**	**Realised**	**Target**	**Realised (1Q 03)**	
AMC	14.7	14.2	32.9	26.5	15.6	0.7	(5%)
AMI	10.7	9.8	3.6	5.5	6.4	0.5	(8%)
BRU	2.3	0.9	6.6	7.1	4	0.0	(0%)
Others	1.8	2.8	0.6	0.7	0.0	0.1	(458%)
Total cash	29.5	27.6	43.7	39.9	26	1.4	(5%)
Bonds	10.0	10.6					
Total cash and bonds	39.5	48.7	43.7	39.9			
Proceeds to government							
Cash	27.0	28.0	35.3	35.3	18	3	(17%)
Bonds	10	20.5	7.5	7.5	8	2.9	(36%)

Source: IBRA 2000 and 2001 Annual Reports and IBRA Monthly Reports January and April 2003

The government sets the annual revenue target for IBRA and decides the distribution between cash (to reduce the budget deficit) and bonds (to reduce the bonds outstanding). IBRA can keep some of the bonds acquired (recycle bonds) for its operations such as further bank recap. Since its establishment in 1998 up to the end of the first quarter of 2003, IBRA had recovered a total amount of IDR140.8 trillion in cash and bonds to the government and contributed IDR112.7 trillion to the state budget. So far, IBRA has been able to meet most of the annual targets. For fiscal 2003, IBRA's target is to collect IDR18 trillion in cash and IDR8 trillion in bonds. In the first quarter of 2003, IBRA had collected IDR3 trillion in cash and IDR2.9 trillion in bonds, achieving 23% of its fiscal target. IBRA's 2002 Operation Report calculated the recovery rate of asset disposal to be 34%, which is close to the experience of other East Asian AMCs and higher than the 26% recovery rate estimated by IBRA in its 2000 Annual Report. However, going forward, the asset recovery rate may decline due to: (1) very poor quality of the transferred assets (category-5 loans) (2) overvaluation of pledged shareholder assets (3) the weak economy and the depressed property sector (4) depreciation of assets transferred to IBRA in part owing to poor management by IBRA.

2.5 Summary and other issues

IBRA reflects the cost of the crisis in Indonesia or the cost to salvage the nation's banking system. The interest payments for the recap bonds, estimated to be IDR60 trillion for 2002, add a serious burden to the state budget, which has a deficit of over IDR40 trillion or 2.5% of GDP. On the one hand, the need to maximise the recovery of funds to reduce budget deficit leads to IBRA's pragmatic approach towards asset disposal and helps to clear political hurdles in expediting the sale of assets. Parliament has been unwilling to see important assets sold to foreign investors and suspicious of the deep discounts needed to entice investors. But parliament finally approved the sale of BCA and other banks. On the other hand, the pressure to reduce the budget deficits raises concerns that these assets will go back to the hands of their original owners. Parliament has been trying to prevent previous owners of recap banks from buying back assets they pledged to the government until they have repaid their dues.

The relationship between BI, the bank supervisor, and IBRA, who owns most of the banks, is an important issue. While BI does not supervise IBRA, the two institutions work closely together and meet regularly to discuss bank restructuring. However, it remains somewhat ambiguous as to who actually is supervising banks owned by IBRA. BI claims that it supervises IBRA banks the same way as other banks, except in the case when a IBRA bank is short of capital, it will be given more time to raise capital above the 8% level if IBRA is considering to merge the bank. Private observers argued that even when BI finds problems with IBRA banks, it is not sure who is responsible for fixing them. Worse still, they argued that IBRA failed to monitor the banks under their control as an owner.

The lack of independence, especially from the political process, has been one major constraint to IBRA's operations. This is evident by the fact that there have been seven chairmen in less than four years and a very high turnover of senior staff. The delay in the sale of government equity stakes in banks also suggests political disagreement on how to divest the bank investment. The broad mandate of IBRA that gave it a wide range of responsibilities is also a concern. IBRA is an asset management company, an agent to carry out recapitalisation, an agent for the blanket guarantee, a manager/supervisor of almost 80% of the banking system, and a restructuring agent of the banking system through, e.g. merging banks. It is also a major source of revenue to reduce the state budget deficits. As such, it does not have a very clear vision of its role. In relation to its many tasks, IBRA is also subject to the influence of many parties - the minister overseeing IBRA, FSPC, OC, Parliament, or even the donor organisations, thus often appears to be reporting to different bodies for different purposes.

3. Japan's Resolution and Collection Corporation (RCC)

3.1 Overview

After the burst of the asset price bubbles in the early 1990s, growth in the Japanese economy slowed substantially. The average trend growth rate is just one percent a year in the 1990s, a marked slowdown from 4% in the 1980s. Worse still, consumer prices have been falling since late 1990s, raising concerns of a deflation spiral. While the Bank of Japan (BOJ) cut interest rates from 6% in mid-1991 to zero in 1999, growth has not picked up and deflation has shown no sign of abating. At the same time, Japanese banks have seen their profits dropped sharply and their balance sheets deteriorated as a result of a rising number of NPLs. This has raised doubts about the proper functioning and viability of the banking system, which has dominated the domestic financial system with total assets of about 150% of Japan's GDP.

Partly in response to these concerns, the Financial Supervisory Authority of Japan (FSA) performed in 2001 special inspections of 13 major banks to obtain a more current assessment of the level of credit risk in these institutions, which, in total, account for almost 50% of total loans in Japan. The aim of the inspections was to assess the credit quality and to ensure an appropriate classification of loans to large borrowers in four industries - construction, real estate, wholesale and retail - that accounted for about 75% of the NPLs in these banks as of end March 2002. More specifically, the inspections focussed on an appropriate classification of borrowers as well as sufficient level of write-offs and provisioning on a timely basis, reflecting the borrowers' business conditions and market signals against them.[14] While the overall capital adequacy ratio (non-consolidated) according to the financial reports of the major banks and the results of the special inspections still stood well above 10%, the overall NPL ratio increased to 8.4% from 6.2% a year earlier The increase in the NPL ratio is attributable to a worsening of global and domestic economic conditions and a stricter application of the criteria for classification of loans used in the special inspections. The FSA requires banks to dispose of 50% of loans newly classified as " in danger of bankruptcy" or below within one year and roughly 80% within two years.[15] In addition, any loan that is currently of lower risk but deteriorates such that it subsequently falls into these two highest risk categories must be removed from the bank's balance sheet within three years.

The extent of the problems in the banking system is also reflected in the increase in the NPL ratio during the 10-year period from FY1992 to 2002 (Table 3.1). However, the latest figure for NPLs as of end-September 2002 is JPY40.1 trillion, a reduction of JPY3.1 trillion. Expressed in terms of total loans, the NPL ratio rose almost four times from 2.5% to 9.3% and in terms of GDP, the NPL ratio tripled from 2.6% in 1992 to 8% in September 2002.

Looking forward, two recent developments may further impact the banking system. First, the Japanese authorities are in the process of lifting the blanket guarantee for most of the deposits (see 3.2). For example, time deposits are now covered up to a maximum principal of JPY 10 million plus interest only. Ordinary and specified deposits will remain protected in full until 31 March 2005. Only deposits used for payments and settlements, such as current accounts, will continue to be fully covered even after 2005. Second, beginning in fiscal year April 2001, banks were required to use new mark-to-market accounting standards on their equity holdings. With equity prices remain depressed, the resulting deduction of paper losses from retained earnings, could lead to a decline in banks' capital adequacy ratios to below the 8% regulatory minimum.[16]

[14] The classification scheme for borrowers provided by the FSA is as follows. A "normal borrower" is one that shows no weaknesses. A "needs attention borrower" already has problems with lending conditions. In practice, this class is further subdivided in "special attention" and "other borrowers". The next higher risk category is "in danger of bankruptcy" in which a borrower is facing real business difficulties. A "de facto bankrupt" borrower is not yet legally bankrupt but is having serious loan repayment problems. The last and the highest risk category is "bankrupt", meaning that a borrower is legally and formally bankrupt.

[15] The announcement "Measures for Developing Stronger Financial System" was made on 12 April 2002.

[16] According to the Asian Wall Street Journal on 22 January 2003, Mr Maeda, the president of Mizoho Holdings, said that the bank's capital ratio could go under 8% if Nikkei fell below 7200. Nikkei tumbled by nearly 80% from its 1989 peak to 8363 at the end of February 2003.

3.2 Deposit Insurance Corporation of Japan (DICJ)

During the 1990s, the Japanese authorities have introduced various measures, including the revision of the Deposit Insurance Law, to respond to the bursting of the bubble economy and the increasing number of failures of financial institutions. The Deposit Insurance Corporation of Japan (DICJ) which was established in 1971, was given a new start in August 1996 after the revisions of the Deposit Insurance Law[17] in 1996 and then in 1997. In 1998 the Financial Revitalization Law[18] and the Financial Function Early Strengthening Law[19] were enacted to address the increasing distress of the financial sector. These two laws affected the DICJ in two key manners: first, they introduced a blanket guarantee for deposits and other claims; and second, the Resolution and Collection Corporation (RCC) was created and incorporated. As a result, the DICJ has expanded both in size and importance. The number of staff has increased from only 15 in 1995 to over 400 in 2002, with more than half of the staff seconded from the government.

Table 3.1

Non-performing loans (NPLs) and GDP in Japan
fiscal year-end value, in trillions of JPY

	NPLs all banks[1]		GDP	Total bank loans	Total bank assets	NPL / GDP %	NPL / total loans %	NPL / total assets %
	A		B	C	D		A/C	A/D
1992	12.8	–	482	452.7	739.4	2.7	2.8	1.7
1993	13.6	–	488	511	739	2.8%	2.7%	1.8%
1994	12.5	–	492	509	736	2.5%	2.5%	1.7%
1995	28.5	(21.9)	504	513	750	5.7%	5.6%	3.8%
1996	21.8	(16.4)	517	512	754	4.2%	4.3%	2.9%
1997	29.8	(22.0)	521	514	788	5.7%	5.8%	3.8%
1998	29.6	(20.3)	514	503	779	5.8%	5.9%	3.8%
1999	30.4	(19.8)	511	493	768	5.9%	6.2%	4.0%
2000	32.5	(19.3)	515	475	759	6.3%	6.8%	4.3%
2001	43.2	(27.6)	503	454	759	8.6%	9.5%	5.7%
2002	40.1[2]	(25.1)[2]	501	432	732	8.0%	9.3%	5.5%

[1] "All banks" refer to all domestically licensed banks, City Banks, Long-term credit banks, Trust Banks, Regional Banks and Regional Banks II. For 1995-96, figures are composed of loans to borrowers in legal bankruptcy (LBB), Past due loans (PDL) and restructured loans. For 1992-94, figures are composed of LBB and PDL. Figures in parentheses refer to the amounts of City banks, Long-term credit banks and Trust Banks.

[2] The NPL number for all banks is as of September 2002

Source: Financial Services Agency, Bank of Japan

3.3 The RCC

The RCC is a wholly-owned subsidiary of the DICJ that was established on 1 April 1999 to deal with the growing NPLs in Japan. The RCC, which has a banking license but is not currently involved in any

[17] The amendment of the Deposit Insurance Law came into force in June 1996 to improve the safety net of the financial system.

[18] In October 1998 the law concerning emergency measures for the reconstruction of the functions of the financial system, "Financial Function Reconstruction Law" or "Financial Function Revitalisation Law" was legislated.

[19] The Financial Function Early Strengthening Law complements the Financial Function Reconstruction Law as a means for providing financial assistance.

lending, was the outgrowth of a merger between Housing Loan Administration Corporation (HLAC)[20] and Resolution and Collection Bank (RCB)[21], following amendments to both laws to strengthen the financial system and the Jusen Law[22]. The DICJ provided the RCC's initial capital of 212 billion by mainly issuing government-guaranteed bonds. The current president of the RCC, Mr A. Kioi, was a former head of the Japan Bar Association and a bankruptcy trustee. It employs some 2500 staff in the head office, 27 branches and 16 offices. No sunset date has been set for the RCC.

The RCC's main objective is the quick and efficient collection of NPLs using fair and transparent means while at the same time minimizing the use of public funds. The RCC's core business activities include: (1) the recovery of loans transferred from former Jusen companies; (2) the purchase and collection of NPLs from failed as well as sound financial institutions; (3) subscribing to bank-issued shares in an attempt to enhance the capital adequacy of financial institutions; and (4) the pursuit of civil and criminal liabilities of former executives and debtors of failed financial institutions. The RCC has since its inception managed the transferred NPLs from seven former Jusen companies, failed financial institutions, as well as other loans purchased in line with Article 53 of the Financial Revitalization Law. RCC's purchase of Article 53 NPLs must be approved by the FSA[23].

Over time, RCC's position has been strengthened. In June 2001, the RCC was given another three years to purchase NPLs from viable financial institutions under the amendment of the Financial Function Reconstruction Law. On 11 January in 2002, RCC also was allowed to increase its purchases of NPLs from banks and to bid at market price for loans, including participating in loan auctions. At the same time, the Japanese government began to stress the need for a faster resolution and disposition of NPLs as a key element in strengthening the financial system. This, however, does not mean that the RCC is expected to dispose of most of the NPLs, but rather to serve as a catalyst for a domestic NPL market, emphasising the need for having an efficient secondary loan market.

The RCC has moved from a pure NPL collection centre to include a broader corporate restructuring role. For example, the RCC is now involved in deciding the fate of insolvent corporate borrowers and the revitalisation of struggling firms. To carry out these functions, the RCC established a new revitalisation division of 62 experienced staff members. In its operation up to February 2003, the RCC has dealt with 105 companies and is currently reviewing another 173 cases. In addition, the RCC was allowed to purchase shares in banks under the Early Strengthening Law, which is now obsolete. Since April 2001, the RCC is in agreement with the Agricultural & Fishery Cooperative Savings Insurance Corporation to become the collector of NPLs from their associated institutions. In August 2001, the RCC received approval for trust business.

3.4 NPL acquisition and purchase by the RCC

The RCC has acquired and managed three types of assets. First, assets assigned to the former HLAC from seven housing loan companies under the Jusen Law. As of yearend 2002, such assets amounted to JPY 10,048 billion, purchased at a price of JPY 4,656 billion. Second, assets purchased from failed financial institutions including banks, classified in the doubtful category and below, under the former RCB. The principal amount for these assets amounted to JPY 21,437 billion and the purchase price was JPY 4,748 billion. Finally, assets classified in principle in the doubtful category and below purchased from sound financial institutions under Article 53 of the Financial Revitalization Law. The total amount purchased as of September 2002 was JPY 1,994 billion, which compares to JPY 3,392 billion at the end of fiscal year 2002 reflecting a dramatic increase. However, the assets were purchased on average at a low purchase price of only JPY 261 billion.

[20] The HLAC was created in the early 1990s based on 'The Jusen Law' to acquire assets from the failed "Jusen" (housing loan corporations). These non-bank financial institutions were founded in the 1970s to complement the bank's housing loans.

[21] In December 1994 the Bank of Japan and private banks established the Tokyo Kyoudou Bank to assume business from two failed institutions, which in turn was reorganised in June 1996 into the RCB. RCB gained later a wider role for assuming failed credit cooperatives and could also buy NPLs from failed financial institutions.

[22] Law Concerning Special Measures for Promotion of Disposal of Claims and Debts of Specific Jusen Companies.

[23] Until the merger of the FRC into the FSA in January 2001, the governing body was the Financial Reconstruction Commission.

Table 3.2

NPLs acquired by the RCC
As of fiscal year 2002, in billions of JPY

	Former HLAC[1]	Former RCB[2]	Article 53 purchase
Principals	10,048	21,437	3,392
Transfer or purchase price	4,656	4,748	261
Transfer price as % of principal	46,3	22,1	7,7

[1] Established July 26, 1996. [2] Reorganised on 2 September 1996.

Source: The Resolution and Collection Corporation

When assessing the contribution of the RCC and its efforts to resolve the NPL problem in the banking system, the assets purchased under Article 53 are of most interest. Under the Article 53 of the Financial Revitalization Law, the RCC is allowed to purchase assets from sound financial institutions managed in the Financial Reconstruction Account beginning FY1999. A system to determine the purchase price for transferred assets has been introduced, which considers, amongst others factors, the risk that these assets may not be recoverable, administrative costs during the purchase and during the recovery of the assets and other expenses. A Purchase Price Examination Board, comprising three external experts (a lawyer, a certified public accountant and a real estate appraiser), was set up to advise the DICJ in this matter.

The low purchase price paid by the RCC for assets, about 8% of the book value, in acquiring loans under Article 53 has drawn criticisms, that the offers made by the RCC were well below market prices. While the low price does reflect the self-imposed no loss policy of the RCC, banks are not obliged to sell to the RCC. In fact, there are many private companies bidding for banks' NPLs in the open auction market, thus enabling the banks to sell to the highest bidder. In any event, the low offering price provides an indication of how overvalued certain assets may have been during the height of the bubble. For example, land prices have declined nearly 90% from their peak. Overall, the acquired assets appear to be of relatively low quality, making their recovery particularly difficult.

Table 3.3

NPLs acquired under Article 53 by type of financial institutions
fiscal years, in billions of JPY

	FY 1999-2001			FY 2002			Cumulative until FY 2002		
	No. of FI	Principals of Claims	Purchase Price	No. of FI	Principals of Claims	Purchase Price	No. of FI	Principals of Claims	Purchase Price
City, Long-term credit and trust banks	14	552.2	25.9	12	1,867.6	184.8	12	2,419.8	210.7
Regional banks	54	309.5	17.1	36	137.9	12.9	57	447.4	30.0
Members of Second Association of Regional Banks	33	346.4	6.4	24	50.5	3.3	38	396.9	9.8
others	39	95.4	5.5	38	32.5	4.7	63	127.9	10.2
Total	140	1303.5	54.9	110	2,088.5	205.7	170	3,392.0	260.6
% of principals			4.2			19.9			7.7

Source: Deposit Insurance Corporation of Japan

Given expanded authority and responsibility with the "big-boned policy" in June 2001, the RCC has stepped up the purchase of NPLs and begun to play an increasingly important role in the Japanese

NPL market. In the twelve months ended March 2002, the RCC purchased almost JPY 2.1 trillion of NPLs, amounting to almost two thirds of the total purchases in all four years combined. Two factors may have contributed to the sharp rise in loan purchases. First, the RCC paid a higher price for more recent loan purchases, an average price of almost 10% compared to the 4.2% paid over the FY1999-2001 providing more incentives for banks to sell their assets. Second, the RCC began to participate in bank-held public auctions of NPLs in 2002 and has won approximately 25% of the biddings.

3.5 NPL collection and disposition

Given that the RCC was originally set up as a collection centre, it has been focusing primarily on the collection of NPLs that it acquired. The DICJ has assisted the RCC in the collection process by making full use of its investigative powers to uncover hidden assets of debtors that may be used to repay its obligations. These powers include penal provisions, onsite inspection of debtors and their related premises, and questioning of debtors and related parties. In fiscal year 2001, the DICJ investigated 272 cases and uncovered hidden assets worth JPY 53.2 billion in the process.

The RCC has performed well in recovering either of the first two types of assets under its management, but the progress in the recovery of assets purchased under Article 53 is hard to tell. There is no report of any recovery of the Article 53 assets, suggesting that these assets may have been simply warehoused in the RCC. As of December 2002, the RCC collected more than JPY 2.6 trillion from the JPY 4.66 trillion it purchased from the former Jusen companies, resulting in a collection ratio of 57%. The recovery ratio for assets under the former RCB is even higher at 67%. In total, the RCC collected almost JPY 6 trillion out of more than JPY 31 trillion in book value of claims, achieving an average collection ratio of about 60%.[24]

Table 3.4

NPLs collection by RCC in Japan

fiscal years, in billions of JPY

	Former HLAC		Former RCB		
	Cumulative total collected	**Collection Ratio (%)[1]**	**Cumulative transfer price**	**Cumulative total collected**	**Collection Ratio (%)**
1996	276	2.9	384	34	8.9
1997	916	19.7	597	86	14.4
1998	1550	33.3	2017	348	17.2
1999	1981	42.5	3140	953	30.4
2000	2298	49.4	3823	1893	50.0
2001	2549	54.7	4180	2729	65.3
Dec 2002	2672	57.4	4932	3318	67.3

[1] Based on the purchase price of JPY 4656 billions

Source: The Resolution and Collection Corporation, DICJ

The RCC has relied on either voluntary repayment or legal procedure for its collection efforts. The RCC is also expected to diversify its methods of disposal[25] to expedite the disposal within three years and to revitalize debtors with a prospect to survive. To achieve these, the RCC has considered methods such as bulk sale, asset securitisation and revitalisation of firms. As of September 2002, 146

[24] The estimated collection ratio can be seen as a floor as it does not include the collection from the acquired article 53 assets.

[25] To the extent possible, the RCC, based in large part upon guidance from foreign consultants and investment banks, has sought to resolve assets through securitisation strategies.. By using trust schemes, on 22 February 2002, the RCC completed its first securitisation transaction in collaboration of Goldman, Sachs, Mitsubishi Trust & Banking Corp. and Asahi Bank.

cases had been resolved through asset sales, including mini-bulk sale, yielding a total of 539 billion yen. With respect to asset securitisation strategies, two issues amounted to JPY 83.3 billion were successfully launched and a third issue is under consideration. Since May 2002, the RCC has shifted its focus to the revitalisation of firms. For this, the RCC has established the first "reorganisation of firm's fund" (Fund) that includes individual private companies in order to identify the parties involved. The role of the RCC comprises the composition of the Fund, drawing up the reorganisation plan, co-ordinating amongst creditors and implementing the plan and the strategy accordingly.

3.6 Role of the Bank of Japan

While the BOJ does not directly finance the RCC's operations, it will provide liquidity if needed. In evaluating the extent of the NPL problem, the BOJ has stressed the issue of newly generated NPLs in the banking system. With a very thin lending margin and the decline in the value of bank shareholdings, the BOJ supports the "Takenaka Plan" which contains various measures to accelerate the disposal of NPLs. The plan is seen by the BOJ as a crucial component of a strategy to prevent a financial crisis. The strategy is built upon three main bases: first and perhaps the most important, a more realistic evaluation of NPLs via a determination of their economic value; second, a quick disposal of NPLs; and third, an increase in the earning power of banks and companies.

3.7 Issues and developments

So far, the RCC has made slow but steady progress in acquiring and resolving the NPLs of Japanese banks that are still in operation. Until June 2002, the RCC purchased JPY 2 trillion of NPLs from banks, suggesting still a very long way to go with a resolution of even the most conservative official estimates of JPY 42 trillion in NPLs of all banks. Worse still, it is not clear how the RCC handles many of the acquired assets, which are likely just sitting in the RCC's warehouse. Another criticism of the RCC is that in focussing on collection and avoiding losing public money, it does not extend new loans to even viable borrowers, making banks more reluctant to sell assets to the RCC. Since allowing private companies to apply for licenses to purchase bad loans from banks in 1999, nearly 60 firms have set up operations to compete with the RCC in the NPL market, including foreign investment banks such as Goldman Sachs and Morgan Stanley. This raised questions about the role of the RCC. The DICJ argued that they would bid in every auction, thus in a sense supporting the auction price by providing a benchmark. With no specific date to wind up operations, the incentive for the RCC staff to finish the job might be compromised by the fear of losing their jobs.

There have been some recent developments in the authorities' approach to deal with the banking problems in Japan. The BOJ announced on 18 September 2002 its own plan to purchase equities from ailing banks. The official argument was to reduce sensitivity to market volatility. The underlying message of such a policy shift by the BOJ is that the government ought to adopt a more determined approach towards bad debt resolution, using public funds if necessary. Indeed, since the appointment of Economic Minister Takenaka to replace Hakuo Yanagisawa, who was seen as a barrier for reform, as the Minister for Financial Services, new proposals have been put forward.

One of the important components of the "Comprehensive Measures to Accelerate Reforms" is to establish the Industrial Revitalisation Corporation (IRC) in early 2003 to help revitalise viable companies that are facing difficulty in servicing their debts to the banks. While the details are still under consideration and will be subject to change, there are some major differences between the IRC and the RCC. First, the IRC will deal with loans to borrowers classified mainly in the second class of the FSA's manual, ie, "needs attention" (including "needs special attention"). In contrast, the RCC is still focusing in principle on the purchase of assets from borrowers classified in the two highest risk categories. Second, for those borrowers that are considered worth revitalising by the IRC, the IRC will buy the loans from all creditors, except a designated main bank. In addition, a fund manager will also play a role, which can be performed either by the main bank, the IRC or a third party. Third, the IRC will extend new loans to the debtor in order to revitalise the borrower but not the RCC. This extra financing could come from the private sector or from the IRC. While the RCC is owned by the DICJ, it has not yet been decided who will be in charge of the IRC. Again, as in the case of RCC, the success of the IRC will crucially depend upon the IRC valuate banks' assets and how quickly it will depose of its assets.

Many analysts are increasingly concerned about the health of Japanese banks. It is suggested that the unwillingness and inability of banks to lend may have impaired the monetary transmission mechanism despite very easy monetary policy. However, the progress in restructuring the banking system and resolving NPLs is still very slow. Banks are unwilling and cannot afford to sell their bad assets to the RCC because the system in place to resolve existing NPLs does not appear to be coherent. First, banks are still carrying assets at inflated values and so are reluctant to sell them. If the banks are forced to use tighter loan valuation standards, such as the discount cash flow approach that requires banks to take into account the future earning potential of troubled borrowers, many of them will see their capital decline sharply below the 8% supervisory standard. This may require the government injection of capital that, in turn, could force a change in the management of the banks. Second, the RCC has insisted on buying bad loans at market price to avoid making any losses. Banks, however, are not obliged to sell to the RCC and are not prepared to do so because such an action would require substantial write-downs, upon sale, to the market price. Obviously, banks can ill afford to do what would otherwise be a sound banking practise. Third, the government is not yet willing to use public funds to recapitalise the banks. As such, the deadlock among the banks, the RCC and the government inhibits the functioning of the AMC to meaningfully resolve NPLs in the Japanese banking system.

4. Korea Asset Management Corporation (KAMCO)

4.1 Overview

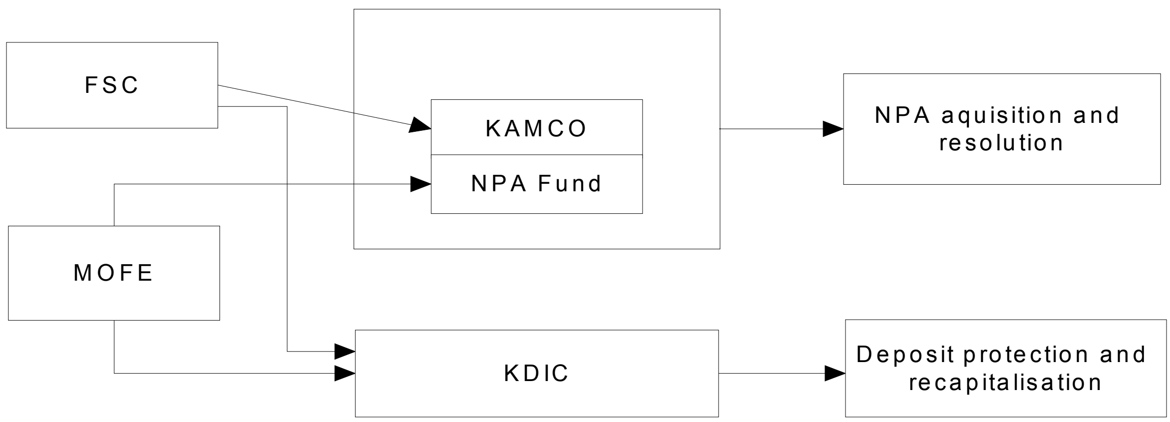
From 1997 through 1999, Korea was hard hit by the severe financial crisis that beset many of emerging Asian economies. Large current account shortfalls, a highly leveraged corporate sector, a heavy reliance on short-term external financing and serious currency mismatch for both debtors and creditors all contributed to a devastating financial crisis that caused the Korean economy to contract by nearly 7% in 1998 and the whole financial system to be shaken to its foundation. Korea's financial system - in terms of total assets - represents more than twice of its annual 2001 GDP and commercial bank lending amounts to some 60% of GDP. The estimated peak level of NPAs in the financial system are believed to far exceed KRW 100 trillion, equivalent to 8% of the overall financial system or 18% of GDP. Official and market estimates of non-performing loans as a ratio of loans outstanding for the commercial banks reached 8.3% and 15%, respectively, at the end of 1999 during the Asian crisis.

To stabilise the Korean economy and financial system, a large-scale IMF support package of some USD 60 billion, together with massive government financial resources, was put in place. The Korean government placed a heavy reliance on Korea Asset Management Corporation (KAMCO), the principal asset management corporation (AMC) that deals with non-performing assets (NPA) of financial institutions in Korea. KAMCO was initially established in 1962 as a subsidiary of the state-owned Korean Development Bank (KDB). Its original mandate was to serve as a conduit for the disposal of non-performing loans owned by KDB. With the onset of the Asian financial crisis, KAMCO's roles have been substantially reorganised and expanded through a series of new laws.

KAMCO is a centralised and public funded resolution agency that handles NPAs of all financial institutions in Korea. KAMCO has KRW 140 billion in initial paid-in equity capital and is 95% owned by the state. As shown in Graph 4.1, KAMCO is under the direct supervision of the Financial Supervisory Commission (FSC) and works closely with the Ministry of Finance and Economy (MOFE). The Management Supervisory Committee of KAMCO is composed of KAMCO's CEO as well as officials from the FSC, MOFE, KDB and outside professional organisations. It supervises KAMCO's operations, while the Public Fund Oversight Committee, led by MOFE, monitors the KAMCO transactions at the Non-Performing Asset Management Fund account (NPA Fund).

Graph 4.1

KAMCO's supervisory and regulatory environments



Note: KDIC is supervised through the Policy Committee comprising senior officials from the FSC, MOFE, Bank of Korea and several other related government agencies and professional organizations.

In addition to KAMCO, the Korea Deposit Insurance Corporation (KDIC) also played a key role in the stabilisation of the Korean economy. While KDIC concentrates on offering depositor protection and direct recapitalisation of troubled financial institutions, there is no formal mechanism for the coordination between KAMCO and KDIC. They do, however, complement each other in the overall restructuring in the financial system. For example, KAMCO has bought NPAs from the KDIC worth KRW 7 trillion; this represents 6% of the total NPAs acquired by KAMCO.

Losses from both KAMCO and KDIC represent overall fiscal costs of broader financial restructuring in Korea. Of the estimated injection of KRW 150 trillion (USD 120 billion) in public funds for financial restructuring in Korea so far, less than one third of the money was used to resolve troubled assets through KAMCO. The remainder was used for recapitalising financial institutions and insured deposit payments, primarily through KDIC. Some observers estimate that the expected total financial loss related to the restructuring of the financial sector could exceed 40% of the total injected public funds or 12% of 2001 GDP.

4.2 The NPA Fund and financing

As the designated operator of the NPA Fund, KAMCO carries out is responsibilities to function as an AMC for the financial sector by acquiring NPAs under the NPA Fund account. Established in November 1997, the NPA Fund has received approximately 95% of its financing from bonds issued by KAMCO. Therefore, KAMCO bonds have been the principal source of funding for the NPA Fund and are mainly issued to banks selling NPAs to finance the purchases of NPAs. KAMCO bonds typically have a maturity of one to five years, fix-rate and floating coupons and yield market interest rates, which at one point reached double digit levels at the height of the Asian crisis. Both, principal and interest of the NPA bonds are fully guaranteed by the Korean government. Therefore, with a zero percent risk weight for regulatory capital calculation purposes, NPA bonds issued by KAMCO for the NPA Fund allowed the selling banks to improve their capital base and to meet the minimum 8% capital adequacy ratio within a short period of time.

The Bank of Korea, the central bank, did acquire about 10% of the total NPA bond issuance at a fairly favourable interest rate of 5% in 1998 compared to the then prevailing double-digit market rates, mainly to assist the NPA fund in meeting its initial cash needs. Nevertheless, Bank of Korea does not have direct financial exposure to operations of the NPA Fund, since the repayments of the NPA bonds issued by KAMCO are fully government-guaranteed. The Bank of Korea does not directly supervise KAMCO's operations and would affect the functioning of KAMCO mainly through its joint banking inspections with FSC.

4.3 NPA Acquisition

Since the establishment of the NPA Fund, KAMCO has taken over a substantial amount of distressed assets from both viable and non-viable financial institutions. In 1998, KAMCO was mandated to take over half of the estimated KRW100 trillion in NPAs of Korean financial institutions at that time. As of December 2002, cumulative acquisitions on NPAs by the NPA Fund have exceeded KRW 110 trillion in face value. This figure represents 9% of Korea's entire financial sector's assets or some 20% of 2002 GDP. It should be noted that most of these purchases, however, took place between 1998 and 2000 with acquisition figures dropping off significantly since that time (Table 1). Of KAMCO's NPA purchases, some 60% have been acquired from commercial banks and another 20% from trust and investment companies. By November 2002, KAMCO stopped NPA acquisitions via the NPA Fund account, signalling the winding down of KAMCO's principal mission — operating the NPA Fund, though it continues to acquire NPAs on its own book such as the latest purchase of bad debts from the troubled credit card companies.

The methodologies employed by KAMCO to acquire NPAs and to establish an appropriate acquisition price differ across loan categories and have evolved over time , depending on the prevailing market environment. Typically, after a due diligence process, KAMCO decided the timing, amount and from which financial institutions to purchase NPLs. However, requests for assets to be purchased by KAMCO from financial institutions would come from the financial institutions themselves, which in turn came under intense government pressure to bring down their NPA levels and to reach the required 8% capital adequacy ratio within a short period of time in order to survive.

The pricing of NPA acquisition evolved over the market cycles. In the early stage of the Asian crisis (1997-1999), under intense pressure to stabilize the system, KAMCO acquired assets through so-called "bulk purchases" with ex post individual settlement agreements to speed up NPA transfers to KAMCO. The ex post individual settlements were in effect a kind of put/call options that were a central feature of the bulk purchase approach. These option-enhanced agreements allowed KAMCO to rapidly transfer large volumes of NPAs under extremely chaotic market conditions while retaining the option for either KAMCO to put or the selling bank to call the stripped-out assets in case the initial bulk purchase prices and the eventual resolution or evaluation prices turned out to differ substantially. Such a methodology raises the question of whether the balance sheets of the selling financial institutions remained exposed to the supposedly stripped-out NPAs. Such options helped inject capital into the banking system at time of extreme turbulence.

As Korea's financial market and economy regained some composure by mid 1999, both KAMCO and the selling institutions have gained more time and better market information to assess transactions related to the earlier NPA transfers, and KAMCO sensibly adjusted its purchasing methods from the option-enhanced bulk purchases to one of fixed-rate purchases. Under this approach, the acquisition price for NPAs established and agreed upon between KAMCO and the selling financial institution will be final for both parties.

KAMCO has also adjusted its pricing criteria along with market conditions over time (Appendix). Thus far, it has paid, on average, some one third of the face value for NPAs (Table 4.1 and 4.2). Initially, the payment to the selling financial institution was made in both cash (one-third) and bonds (two thirds). However, since mid-1999, KAMCO has paid for its assets purchases entirely through bonds.

Table 4.1

NPA acquisition via the NPA Fund (in trillions of KRW)

Year	Face Value	Purchase Price	Ratio (%)
1997	11.06	7.14	64.6
1998	32.83	12.26	37.3
1999	18.29	4.46	24.4
2000	32.97	12.92	39.2
2001	6.00	1.95	32.5
2002	8.96	1.06	11.9
Cumulative	110.11	39.79	36.1

Sources: Corporate Planning Department and Corporate Policy and Strategic Management Office, KAMCO.

Total KAMCO payments for NPA acquisitions via the NPA Fund account have reached some KRW40 trillion, nearly double the total amount of the authorized funding of the NPA Fund but representing less than one third of the total injected public funds for financial restructuring. How could KAMCO acquire assets representing twice the NPA Fund's authorised funding? There are two main reasons. First, the government itself, as opposed to KAMCO, made the interest payments on the NPA bonds, thereby releasing KAMCO from a rather significant financial obligation. Second, KAMCO used monies from the collection or sale of NPAs to acquire additional NPAs from financial institutions.

KAMCO has taken over more than 300,000 loan accounts, of which less than 3,000 accounts represent more than 90% of the amount of NPLs acquired. The NPAs assumed by KAMCO can be broadly classified into two categories: corporate restructuring loans and ordinary loans. The former are loans under court reorganisation while the latter mostly comprise loans to consumers and small and medium sized companies that are overdue thee-months or more. In addition, KAMCO took over half of the total loans outstanding to the Daewoo group under special private workout terms. Of the total assets acquired by KAMCO, approximately 40% were collateralised, a positive factor facilitating KAMCO's asset recovery.

Table 4.2

Cumulative NPA acquisition by type of financial institutions
as of December 2002, in trillions of KRW

Type	Face value (A)	Purchasing price (B)	Purchase price ratio, B/A (%)
Banks	61.82	24.72	40.0
Merchant banks	3.50	1.62	46.3
Guarantee insurance	7.06	1.75	24.7
Life insurance	0.30	0.07	22.6
Securities	0.14	0.08	52.7
Mutual savings	0.53	0.21	39.4
Foreign financial institutions	5.01	2.10	41.9
Financial resolution entities under KDIC	6.78	0.84	12.4
Investment trust companies	22.30	8.39	37.6
Others	2.66	0.01	0.4
Total	110.11	39.79	36.14

Source: Corporate Planning Department and Corporate Policy and Strategic Management Office, KAMCO.

4.4 NPA Resolution

To date, KAMCO's record of NPA resolution has been quite impressive, having resolved some 60% of its acquired NPAs and achieving a recovery rate of almost 50% of book value (Table 3). Of total recoveries, only 3% is reportedly non-cash. In addition, KAMCO managed to recover more than it had originally paid, as its recovery rates has so far exceeded its acquisition prices. The put options might have played an important role in KAMCO's impressive recovery performance, since they allowed KAMCO to avoid making large financial losses through recourse and cancellation in case the bulk purchase prices paid by KAMCO far exceeded the actual market prices. By the same token, as Korea's financial conditions return to normality, selling financial institutions called back their sold assets, putting pressure on KAMCO to improve its asset recovery efficiency, otherwise, the selling institution may exercise its call option.

Thus, these put/call options have helped keep the acquisition prices close to market clearing levels and keep KAMCO under competitive pressure to dispose of NPAs efficiently. Exercising such embedded options results in cancellations or recourses in resolution, which have accounted for one third of the overall resolution. However, it is not clear whether exercising such options should be treated as genuine NPA disposition from the perspective of the whole Korean financial system. While exercising put options would allow KAMCO to remove the acquired assets off its balance sheet, doing so will only return the stripped-out assets back to the book of the original selling institution. Nevertheless, even after taking away all the recourse and cancellation, KAMCO still manages to have achieved a 44% recovery rate measured against the book value of the resolved assets. An alternate view of the put/call options might suggest that they may have provided the much-needed capital to Korea's financial system during a crisis period.

Table 4.3

NPA resolution via the NPA Fund
in trillions of KRW

Year	Face Value	Purchase Price	Amount Retrieved	Recovery Rate (%)
1997	-	-	-	-
1998	5.06	2.33	2.37	46.8
1999	15.76	8.35	9.65	61.2
2000	24.86	8.09	8.93	35.9
2001	11.07	4.48	5.32	48.1
2002	7.88	3.22	3.99	50.6
Cumulative	64.63	26.48	30.27	46.8

Note: Recovery rate is the ratio of the total recoveries to the resolved NPAs measured at book value.

Sources: Corporate Planning Department, and Corporate Policy and Strategic Management Office, KAMCO.

KAMCO's general approach to NPA resolution could be viewed as a combination of rapid disposition and medium-term debt workout and restructuring. KAMCO's basic recovery strategy is fast disposition of assets that have limited value-enhancing prospects. At the same time, KAMCO utilises workout and restructuring strategies for assets where they believed that the recovery value could be increased. The debt restructuring and workout approaches are deemed necessary, given the dominance of highly leveraged corporate conglomerates (the chaebols) in the Korean economy. The main resolution methods adopted by KAMCO have varied over time with market conditions and broadly include the following four general approaches (Table 4.4).

Table 4

Cumulative NPA resolution as of the end of December 2002
in trillions of KRW

Resolution methodology	Face value of NPAs	Purchasing price	Amount retrieved
International bidding	6.06	1.31	1.60
ABS issuance	8.02	4.22	4.14
Foreclosure auction and public auction	8.30	2.63	3.22
Sales to AMC	2.58	0.66	0.92
Sale to CRC	1.84	0.36	0.67
Individual loan sale	2.59	0.64	0.96
Collection and payment by schedule, etc	12.65	4.27	5.93
Daewoo	3.28	2.24	2.67
Sub-total	**45.36**	**16.32**	**20.11**
Recourse & cancellation	19.27	10.17	10.17
Total	**64.63**	**26.48**	**30.27**

Note: Recourse and cancellation are related to ex post individual settlements after initial bulk purchase.

Source: Corporate Planning Department, and Corporate Policy and Strategic Management Office, KAMCO.

(1) **Bulk loan resolution**. This involves international bidding for NPA pools and the issuance of asset-backed securities (ABS), with the former being partly motivated to attract foreign currency inflows. Both outright sales and profit sharing schemes have been included in the NPA pools and ABS. For ABS, selected NPA pools are transferred to special purpose vehicles, which in turn issue debts backed by the underlying assets. KAMCO, however, may be in a first-loss position due to its issuance of subordinated bonds to provide credit enhancement for the ABS issuances.

(2) **Foreclosure and public auctions, and individual loan sales**. Through courts (foreclosure) or KAMCO, either the NPAs or their underlying assets are auctioned and/or sold individually.

(3) **Joint venture partnerships**. KAMCO enters into joint ventures with foreign investors, typically on a 50%-50% basis, to manage and dispose of real estate in the case of AMCs joint ventures or to enhance corporate values in the case of corporate restructuring joint venture companies (CRCs). The latter are partly through debt-for-equity swaps between the CRCs and the corporate debtors.

(4) **Collection and payments by rescheduling**. This methodology involves debt workouts conducted outside of the legal system or restructuring under the court ordered programs. The final agreement with the debtor may involve an amendment of loan terms such as payment rescheduling, partial forgiveness of loan principal or accrued interest, and debt-for-equity swaps.

4.5 Outlook

KAMCO's acquisition and disposition of NPAs have peaked and will be gradually wound down as the Korean banking system is nursed back to health. Indeed, as of November 2002, it ceased additional NPA acquisitions via the NPA Fund account. The NPL ratio of commercial banks has fallen from double-digit levels to some 3% as of year-end 2002 With NPA ratios at relatively low levels and the broader economic recovery underway, banks have often preferred to deal directly with their remaining and new NPAs through their internal resolution departments.

KAMCO will continue to dispose of the remaining acquired NPAs under the NPA Fund account and also to purchase NPAs on its own account. Moreover, KAMCO is actively searching for a new role into the future, mainly through offering international consulting and training services to other countries by leveraging its NPA resolution know-how and skills. Its role may be revived again lately, as currently, KAMCO has been again involved in taking over sizable problem assets from troubled credit card companies, which have facing the challenges of a turbulent bond market, higher delinquent ratio credit, more stringent provisioning rules and easing credit and economic cycles.

Appendix

Table A4.1

KAMCO's NPA purchase and pricing methods

(A) Restructured corporate NPAs

Period	Price Criteria		Purchasing method
	Secured Loan	Unsecured Loan	
Nov 97 – Jul 98	70% - 75% of face value	20% - 60% of face value	Bulk purchase and settlement
Sep 98 – Jun 99	45% of collateral value **		

Jul 99	*Assets authorized by court* 46.53% of valid collateral price* *Assets unauthorized by court* 45.95% of valid collateral price*	*Assets authorized by court* 13.41% of principal face value *Assets unauthorized by court* 8.63% of principal face value	Purchase at fixed rate
Sep 99	*Assets authorized by court* 54.93% of valid collateral price* *Assets unauthorised by court* 52.60% of valid collateral price*	*Assets authorized by court* 13.91% of principal face value *Assets unauthorized by court* 9.03% of principal face value	

(B) Ordinary NPAs

Period	Price Criteria		Purchasing method
	Secured	Unsecured	
Nov 97 – Jul 98	70%-75% of valid collateral price*	***Doubtful*** 10%-20% of face value ***Assumed loss*** 1%-3% of face value	Bulk purchase and settlement
Since Sep 98	45% of collateral value**	3% of principal face value	Purchase at fixed rate

Note: 1. * Appraisal value – (senior lien, loan amount, mortgage amount). ** Appraisal value – senior lien. 2. Discount rate = Base rate + Credit risk + Maturity risk.

Sources: Legal and Research Department, and Corporate Policy and Strategic Management Office, KAMCO.

5. Malaysia Asset Management Corporation (DANAHARTA)

5.1 Overview

Tight fiscal and monetary policies adopted in late 1997 as a result of economic problems being experienced elsewhere in the region resulted in a sharp rise in interest rates and a rapid slowdown of economic activity. Evidence of this was the 6.7% decline in GDP in 1988 after 12 years of steady expansion averaging 7.8% per annum. The economic decline led to a similar deterioration in the asset quality of bank's balance sheets and an increase in non-performing loans (NPLs). As of 31 December 1998, NPLs as a percentage of total loans stood at 13.6 %, triple from the 4.1% figure only a year earlier. In spite of this, the risk weighted capital ratio was still at 11.2%, well above the 8% minimum. Table 1 helps to illustrate the seriousness of the problem. In response to the deepening problems, the Malaysian government adopted a four-pillar approach to restructure and to strengthen the banking sector well before the NPL ratio reached its peak in the Asian financial crisis.

The first pillar of the strategy was the establishment on 20 June 1998 of a national asset management company, Pengurusan Danaharta Bhd. (Danaharta). Danaharta's primary mission is to remove the non-performing assets from the system and manage them with the goal to maximise the proceeds from the recovery process. The other three pillars were: first, the establishment of Danamodal Nasional Berhad (Danamodal), a special purpose vehicle responsible for capital injection for viable banks; second, a Corporate Debt Restructuring Committee (CRDC); and third, a merger programme for banks, which had been implemented at the same time.

Danamodal, a wholly owned subsidiary of Bank Negara Malaysia (BNM), incorporated on 10 August 1998, was set up to facilitate the recapitalisation of banking institutions in cases where shareholders were not able to do so. Both institutions, Danamodal and Danaharta, are required to apply market based principles to avoid wasting public money. Especially in the case of Danamodal, the injection of capital into the banks is restricted to viable financial institutions only. In order to achieve this goal, international specialists were involved in the due diligence reviews of banks to confirm which ones were indeed viable. Based upon the conclusions, in 1998 Danamodal injected RM 6.15 billion, mainly as subordinated capital loans, into ten institutions. Undercapitalised banks that received capital injections were then required to sell all of their NPLs to Danaharta. As a strategic shareholder in the recapitalised bank, Danamodal would focus on the restructuring of the banks, including the implementation of sound risk management and good corporate governance.

The third pillar of the approach was to restructure corporate debts on a broader basis. To carry out this task, CDRC was created to provide a platform for the involved parties, both debtors and creditors that would result in debt restructuring in a manner acceptable to all concerned parties without the imminent threat of legal actions. Applying market-based principles was the policy of the CDRC's Creditor Committees, where the focus clearly was on a rapid recovery of the corporate sector and a strengthening of the banking sector. Only when creditors and debtors failed to reach consensus would Danaharta eventually make an offer to purchase NPLs from the affected banks.

The above three institutional bodies are complementary in terms of their objectives, and interdependent at the same time, representing a coherent approach to strengthening the banking sector. All three organisations face a finite lifetime: Danaharta will cease to exist in 2005, Danamodal had stopped its business already in December 2002 and CDRC in July 2002. The coordination of these organisations is provided by a Steering Committee, chaired by the Governor of BNM. The goal of the Steering Committee is to oversee and monitor the policies and procedures in place at the three institutions and to monitor their progress.

In addition to the institutional arrangements, the forth pillar came into force in January 1998 when the Malaysian government announced a merger program for banks and finance companies in order to consolidate and rationalise the banking industry. This was consistent with the long-term objective to create a core of domestic banking institutions, which currently comprises ten bank holdings, each comprising a former commercial bank and merchant bank as well as a former finance company.

Table 5.1

Non-performing loans in Malaysia
Year-end value, in millions of RM

		NPLs	GDP	NPL/GDP (%)	NPL/Total loans[1,2] (%)
1995		14,320	222,473	6.4	5.5
1996		12,480	253,732	4.9	3.7
1997		25,053	281,795	8.9	4.1
1998	3 months	76,953	283,243	27.2	13.6
	6 months	52,406		18.5	8.1
1999	3 months	65,540	300,764	21.8	11.0
	6 months	46,828		15.6	6.4
2000	3 months	64,256	342,157	18.8	9.7
	6 months	49,003		14.3	6.3
2001	3 months	76,801	334,589	23.0	11.5
	6 months	61,789		18.5	8.1
2002	3 months	71,693	361597–	19.8	10.2
	6 months	58,885		16.3	7.5

[1] Total loans = Outstanding gross loans (including housing loans sold to Cagamas Berhad). [2] Beginning December 1997, ratios are computed in a net basis. Non-performing loans = Non-performing loans – interest-in-suspense – specific provisions. Total loans = Outstanding gross loans – interest-in-suspense – specific provision.

Sources: Bank Negara Malaysia Monthly Statistical Bulletin, February 2003; CEIC.

5.2 Danaharta

Danaharta is a publicly funded AMC incorporated under the Companies Act of 1965. It is wholly owned by the Ministry of Finance, with a government equity injection of RM3 billion. Other financing sources include a maximum of RM2 billion loan from Employee's Provident Fund (EBF) and an investment arm of the Ministry of Finance (Khazanah) as well as public borrowings (including AMC bonds) of a maximum of RM15 billion, with the government guaranteeing all borrowings. Danaharta employs about 280 staff and can be seen as hermaphrodite between a rapid disposition agency and a warehouse agency. Its objectives are the removal of NPL's from bank's balance sheets and maximisation of the recovery value of the distressed assets so as to minimise the cost borne by the government. Danaharta principles have been a system wide carve-out of NPLs and a market-driven approach in valuation of NPLs, providing banks with the option to reject an offer made by Danaharta.

Many banks changed the NPL classification scheme at the end of 1998, moving from a three-month classification to a six-month scheme. This brought the NPL ratio down from the late 1998 level of 13.6% on the three-month scheme to below 8% on a six-month scheme. Danaharta's offer for NPLs is based on whatever scheme banks deemed as appropriate for each account when they submitted their NPLs to Danaharta. However, most loans were still based on the six-months NPL classification.

In its early stage in 1998, Danaharta acquired and managed NPLs totalling RM15.1 billion or 20% of the total NPLs in the banking system. Since 2002, after completing its acquisition of NPLs, Danaharta has been in its final stage of its mandate: managing and disposing of the acquired assets. By year-end 2002, Danaharta's NPL portfolio reached RM47.76 billion, consisting of RM19.82 billion acquired from 66 financial institutions and RM27.94 million from two designated banks, where the NPLs are being managed on behalf of the Malaysian government and BNM[26], hence without causing any costs for

[26] NPLs from Bank Bumiputra Malaysia Berhad (BBMB Group) and Sime Bank Berhad (Sime Group)

Danaharta. The funding structure for Danaharta's operations comprised at year-end 2002 the initial capital of RM3 billion from the Government and RM11.54 billion other outstanding liabilities.

In November 1998, an oversight committee for Danaharta was established to approve appointments and terminations of special administrators and independent advisors including their recommendations. It comprises three members representing the Ministry of Finance, BNM and the Securities Commission, each appointed by the Minister of Finance. Danaharta endorses the Malaysian Code on Corporate Governance issued in March 2002. It therefore recognises and practises the need to conduct its business in a transparent and professional manner in line with international best practice.

5.4 Role of Bank Negara Malaysia

BNM fully owns Danamodal and has injected RM7.6 billion cash into ten banks in order to recapitalise them. As a consequence, BNM has an equity share of about RM3 billion in the 10 banks. By the end of 2001, BNM had recovered most of its investments through consolidation of the banking system. The Corporate Debt Restructuring Committee is run by a Steering Committee, with representatives from the BNM, the Ministry of Finance and the private-sector who have experience in accounting, banking and the legal areas. Furthermore, as noted above, BNM serves as the chair of the Steering Committee to oversee policies, procedures and progress of the three agencies.

5.3 NPL acquisition

The pre-emptive mission of Danaharta has allowed financial institutions in Malaysia to clean up their balance sheets at an early stage based on market-driven principle and to refocus on their lending activities. This early action has allowed the Malaysian financial system to survive relatively unscathed when compared to the financial systems of some of its Asian neighbours.

Danaharta has the power and ability to move quickly in transferring assets from a bank. Specifically, there is a two-week transfer time, and it can acquire loans without the borrowers' consent, although borrowers then have to deal with Danaharta directly. Acquisition prices are typically negotiated at an arm's length basis, using either the "net tangible asset" or the "discounted cash flow" method for the NPL evaluation. The transferred assets are then typically replaced on the bank's balance sheet with zero coupon bonds[27] that are government guaranteed. Therefore, with a zero percent risk-weight assigned to these bonds, banks' capital ratios are improved. The tenor of these bonds is five years, with a roll-over option for another five years. In principle, the bonds are tradable, but in point of fact, since the market is not very liquid, their marketability is drawn into question.

Danaharta employs three types of loan valuation techniques. First, in all cases, if a bank does not accept an offer to sell its NPLs to Danaharta, it is required to write the NPLs down to 80% of the offer price. Second, for secured loans, Danaharta offers the value of the underlying collateral based on an independent appraisal. For unsecured loans, however, the offer is simply 10% of the outstanding principal. Both approaches provide banks a profit-sharing feature providing the bank with 80% of any recovery in excess of Danaharta's associated direct recovery costs. Third, for certain large loans, Danaharta may pay either the nominal sum or a percentage of principal outstanding based on estimates, especially those where valuations are expensive and subject to much debate where it is difficult to determine initial purchase prices. These loans represent around 10% of Danaharta's portfolio and Danaharta has full recourse up to the purchase price if actual recoveries are less than the original purchase price. In the case of realised losses, unlike the profit sharing scheme, there is no loss sharing arrangement with the bank.

Given these participation structures, there is a strong incentive for banks to sell their NPLs to Danaharta. Most of the NPL portfolio represents loans in the property and manufacturing sectors which are typically large in size. In any case, for cost-efficiency reasons, Danaharta has only been involved in loans exceeding RM5 million, which account for more than 70% of system-wide NPLs.

As of December 2002, Danaharta has evaluated and made offers to loans in the size of RM56.44 billion, of which banks have rejected RM8.03 billion. This leaves Danaharta with the acquired NPLs of RM47.76 billion comprising 2905 individual accounts (Table 2). This includes RM27.94 billion with 2101 accounts from the Sime Group and BBMB Group managed on behalf of the government.

[27] Non-BAFIA financial institutions and Islamic banks receive cash

The NPL acquisition exhibited a face value of RM19.82 billion and the purchase price was RM9.03 billion, with an average discount of 54% (Tables 5.2 and 5.3).

Table 5.2

NPL Acquisition
cumulative as of 31 December 2002, in millions of RM

	Face Value	No. of Accounts	Purchase Price	Discount
20Jun - Dec 1998	8,11	202	3,15	61%
1999	19,13	770	8,35	56%
2000	20,39	828	9,22	55%
2001	19,82	805	9,03	54%
2002	19,82	804	9,03	54%

Source: Danaharta Operations Reports

Table 5.3

NPL acquisition by type of financial institutions
cumulative as of 31 December 2002, in millions of RM

Type	Face Value	Purchasing Price	Discount
Commercial Banks	11,412.0	4,434.4	61%
Finance Companies	3,867.0	1,889.5	51%
Merchant Banks	3,211.8	1,811.7	44%
Development Finance Institutions	1,161.2	749.1	35%
Offshore	123.1	104.7	15%
Others	42.7	42.7	0%
Total	19,817.8	9,032.1	54%

Source: Danaharta Operations Reports

5.4 NPL resolution

As Danaharta is neither a rapid disposition nor a warehouse agency, it employs two main approaches when managing and disposing of NPLs: (1) loan management; and (2) asset management. In the former approach, recovery is mainly through loan restructuring, foreclosure or disposal of the loan. The latter approach acknowledges the fact that in some cases, rapid disposition is not feasible and that for some assets obtained by Danaharta through the resolution process, such as real estate collateral and equity in the debtor’s company, ongoing management is needed to maximize the value of the asset.

Under the loan management approach, Danaharta distinguishes between viable and non-viable loans. Viable loans are placed under loan restructuring, which provides the borrowers the opportunity to restructure their loans, which carry a higher historical recovery rate. The resolution of these viable loans can be categorised into three types: (1) plain loan restructuring; (2) settlement of loans; and (3) schemes of arrangement. Plain loan restructuring includes rescheduled loans, partial cash settlement and asset disposal, and is carrying currently an expected fairly high recovery rate of over 75%. An even higher expected recovery of 76% might be realised in a pure settlement of loans with an outright disposal. (Table 5.4)

Table 5.4

Management per recovery method
1999 to 2002, in billions of RM

Recovery Method	I. 1999			2000			2001			2002		
	A	B	C	A[1]	B	C	A[2]	B[3]	C	A[4]	B[5]	C
Performing loans	3.1	3.1	100	2.6	2.6	100	–	–	–	–	–	–
Plain loan restructuring	4.4	3.9	89	7.1	6.5	93	11.6	8.0	69	9.5	7.5	79
Foreclosure	1.9	0.9	48	7.6	2.1	28	11.6	3.4	29	14	4.7	36
Settlement	–	–	–	6.3	4.7	77	6.9	5.2	76	7.3	5.7	77
Scheme of arrangement	1.7	1.4	81	6.1	2.1	83	9.2	7.0	76	10.2	7.6	75
SA – scheme approved	0.3	0.2	51	2.5	1.5	62	5.6	2.5	44	5.2	2.2	43
Pending full settlement	1.8	1.1	58	–	–	–	–	–	–	–	–	–
Fully settled	1.7	1.5	87	–	–	–	–	–	–	–	–	–
Others	–	–	–	2.0	1.1	55	4.1	2.5	60	4.6	2.5	56
Legal action	–	–	–	1.6	–	–	2.1	–	–	1.7	–	–
Sub-total	15.0	12.0	80									
SA – pending approval	2.6	–	–	–	–	–	–	–	–	–	–	–
Total	17.6			35.8	23.8	66	50.9	28.5	56	52.5	30.2	57

A: Loans outstanding; B: Expected recovery; C: Expected recovery rate (%)

[1] Including accrued interest of RM0.789 billion. [2] Comprising total LRA of RM47.69 billion and accrued interest of RM3.25 billion. [3] Assuming zero recovery on defaulted cases as at 31 December 2001. [4] Comprising total LRA of RM47.76 billion and accrued interest of RM4.76 billion. [5] Assuming zero recovery on defaulted cases as at 31 December 2002.

Source: Danaharta Operations Reports

Danaharta places non-viable loans under asset restructuring where the primary focus lies on recovering debts by selling either the business or the underlying collateral. In the special cases where borrowers are unlikely to fulfil their obligations, Danaharta may appoint special administrators (SA scheme) to oversee the borrower. At year-end 2002, the SA scheme has been carried out for 71 groups, with 40 borrowers still subject to the scheme. The expected recovery for SA scheme is 43%.

Another recovery method used by Danaharta is foreclosure. In foreclosure cases, Danaharta has been given special powers to foreclose on real estate or equity shares pledged as collateral. Thus far, 550 properties have been sold in primary sales in 7 nationwide and 5 specific tenders, which involves properties that are foreclosed and offered for the first time. The realisation rate was 106% as of the initial indicative value of RM983 million. For the remaining 195 properties secondary sales with an indicative value of RM460 million were sold, achieving a realisation rate of 76%. The primary focus of Asset Management is to increase the realisable value of the recovered asset. This encompasses active management of securities, which comprised RM 3.4 billion at the end of 2002 from mainly non-listed companies.

In December 2001, Danaharta securitised assets for sale for the first time and as such launched the first ever Collateralised Loan Transaction (CLO) in Malaysia The transaction ended up selling RM595 million of successfully restructured loan portfolio in a subordinated structure; RM310 million of

AAA senior notes (sold in a broad-based investor scheme) and RM285 million of unrated subordinated notes were kept at Danaharta's special purpose vehicle Securita[28]. The issue has been seen as a milestone in Malaysia's debt securities market in spite of a high level of built-in credit enhancement.

In sum, Danaharta obtains cash generated from direct loan sales, restructured loans as part of the viable loans scheme, as well as securities as a result of settlement schemes and properties. As of December 2002, Danaharta expected to receive RM30.19 billion[29], with RM12.31 billion already recovered in cash (Table 5.5). Including adjustments, mainly due to interest received on restructured loans and gains or losses on sale of foreclosed collateral and securities, as of December 2002 Danaharta has realised in cash RM 14.6 billion of its recovery. One of the incentives for banks to sell NPLs to Danaharta is that with the higher recovery rates achieved, they can benefit from the above 80%-20% profit sharing scheme. As of December 2002, Danaharta redistributed to FIs its surplus recovery of RM9.65 billion in cash and RM56 millions units in securities at par value. At the same time, the remaining balance of cash of RM6.14 billion is available for redemption of outstanding bonds with a face value of RM11.14 billion. This implies that currently RM5 billion of taxpayers' money are needed to close the operations of Danaharta.

Table 5.5

Breakdown of recovery received
2000 to 2002, in billions of RM

Asset Group	2000			2001			2002		
	Recovery received	Stock value	Realised in cash	Recovery received	Stock value	Realised in cash	Recovery received	Stock value	Realised in cash[2]
Cash	4.2	–	4.2	5.7	–	5.7	6.7	–	6.7
Restructured loans	6.7	5.5	1.3	7.0	4.4	2.7	8.1	4.3	3.9
Securities	0.6	0.6	0.0	1.8	1.7	0.1	3.4	2.1	1.4
Properties	0.5	0.3	0.1	0.7	0.4	0.3	0.7	0.3	0.4
Total	12.0	6.4	5.6	15.2	6.4	8.8	18.9	6.6	12.3

[1] Figures may not cast correctly due to rounding errors.
[2] Does not include adjustments, mainly due to interest received on restructured loans and gains or losses on sale of foreclosed collateral and securities

Source: Danaharta Operations Reports

In sum, Danaharta seemed to have served as a fairly effective policy instrument in removing and resolving NPLs and in asset recovery. The strong political backing, special legal powers, coordinated bank restructuring strategy and sufficient financial support all contributed to the efficient operations of Danaharta, which is set to wind down by 2005.

[28] The offer was very well received with an over-subscription of 3.5 times.

[29] For defaulted loans the assumption is a zero recovery.

6. Thai Asset Management Company (TAMC)

6.1 Background

During the roughly ten years prior to 1997, the Thai economy grew at an annual rate of almost 10%. The growth, resulting in a large current account deficit, appreciation of the real exchange rate, an increase in short-term foreign debt, and a weak financial sector, forced the Thai authorities to float the Thai baht on 2 July 1997. This single event, more than anything else, marked the beginning of the financial crisis in Thailand and indeed, in Asia. With the spreading of the crisis throughout Asia, the baht depreciated sharply and economic activity, investment, consumption, and export demand all declined. The impact of these factors and the crisis as a whole, had an immediate affect on the financial sector in Thailand.

Prior to the crisis, Thailand's financial sector consisted of 15 domestic commercial banks, 14 branches of foreign banks, 91 finance and securities companies, 7 specialised financial institutions and a variety of other smaller institutions including savings and agricultural cooperatives, mutual fund management companies, and pension funds. In total, assets in the financial sector amounted to THB8.9 trillion (USD212 billion) or 190% of GDP, of which commercial banks accounted for 64% of the total.

Commercial banks enjoyed a period of high profitability during the economic boom. This profitability, however, was realised in part because of imprudent lending practices that came back to haunt the banks in the form of NPLs. An overwhelming percentage of the commercial loans in Thailand are real estate secured. As the economy grew, the demand for real estate increased and as a consequence, real estate prices soared. To meet the apparently insatiable demand for commercial and retail space, bankers eagerly lent funds despite the fact that supply was rapidly outpacing demand.[30] As the financial crisis began to unfold, borrowers with loans secured by commercial real estate defaulted as did many other retail and consumer borrowers. The effect of this was to cause the level of NPLs in commercial banks to increase from 11.6%in May 1997 to 47.7% by May 1999.

There were several strategies employed by the Thai authorities in an attempt to reduce the level of NPLs in the banking system. Initially, a Corporate Debt Restructuring Agency was established to facilitate the restructuring of loans by banks and their borrowers. This was followed by a law that encouraged banks to establish their own private asset management companies (AMCs) as subsidiaries. Ultimately, however, the authorities followed the practice of many other Asian countries and established a government-owned and operated asset management company.

6.2 Creation and Mandate of TAMC

The Thai Asset Management Company (TAMC) was established by an Emergency Decree (Law) on 8 June 2001 as a state agency. The TAMC will consolidate the management of subquality[31] assets of financial institutions[32] and AMCs with the goal of restructuring the debts and/or reorganising the debtor's business operations in an effort to return the firm to profitability and enable it to repay its debts.The TAMC does not have the authority to acquire ownership interests in banks, it can only acquire their subquality assets. The vast majority of subquality assets transferred to TAMC came from state-owned banks and are obligations of larger borrowers involved in multi-creditor transactions.

The Law provides the TAMC with broad powers to manage its assets and improve their ultimate collectibility. Most importantly, the TAMC can restructure loans and lend additional money to borrowers, restructure the business operations of borrowers in an attempt to improve their financial operations and in turn, their ability to repay debts, and seize and dispose of collateral. One of the key differences between TAMC and other AMC structures, however, is that the TAMC does not have the power to sell loans to third-parties, it can, however, sell foreclosed real estate to third-parties. In other

[30] Compounding the problem were lax classification and provisioning, connected lending and other credit risk standards imposed by the Bank of Thailand (BoT), an inefficient legal system that made the foreclosure process lengthy and cumbersome, and accounting rules that did not conform to international standards. After the crisis, these rules and regulations were enhanced to be more in line with the international standards.

[31] Subquality refer to those assets that are classified loss, doubtful of loss, doubtful, or substandard according to the Bank of Thailand's regulation on the classification of assets, which is based on both quantitative (number of months overdue) and qualitative criteria. NPL refers to any loan for which the payment of principal and/ or interest is in excess of 3 months.

[32] Financial institution, according to the Emergency Decree, includes commercial banks, finance companies (including those that also undertake securities business), and credit foncier companies.

words, the TAMC will oversee the management of the loan until it is fully paid-off or the collateral is foreclosed upon and sold.

The TAMC has a sunset date twelve years from the date of the Law, or 7 June 2013, although there are several intermediary dates that may cause the TAMC to cease its operations earlier than the latest date allowed in the law. [33]

The initial capital of TAMC was one billion baht all owned by the Financial Institutions Development Fund (FIDF), a separate legal entity within the BoT, established in the 1980s, to provide liquidity and solvency support to financial institutions. Virtually all of the initial capital was invested in the BoT's repurchase market at an interest rate of about 2.5%. In essence, the BoT issued short-term notes to fund the initial capital of TAMC. The TAMC can increase its capitalisation through the issuance of shares to the public or any other person upon approval of the Council of Ministers. Any shares issued to increase the TAMC's capitalisation, but remaining unsold, will be purchased by the FIDF. The public offering of shares by the FIDF is not required to comply with laws regulating such activity.

In summary, the TAMC was established not as a liquidation authority, but as a rehabilitation and restructuring agency. Its focus is on the revival and continuation of businesses to enable them to repay their debts and as a consequence, the strengthening of the economy. The Law encourages prompt resolution of the subquality assets in an environment that promotes cooperation and a continued relationship between debtors and creditors.

6.3 Organisation Structure and Oversight

The TAMC has a board of directors comprised of a Chairman and a maximum of 11 other members, all appointed by the Minister of Finance and approved by the Council of Ministers. Of the 12 directors, at least one must be a representative of the Federation of Thai Industries, another from the Thai Chamber of Commerce and a third must represent the Thai Bankers Association. By law, directors shall serve a term of six years and are prohibited from a political position or being an official of a political party during their term. The Chairman of the executive committee shall serve as an ex officio member. The board of directors has broad policy setting powers, including the setting of operational rules, regulations and procedures, and is responsible for supervising the general affairs of the TAMC.

The board of directors will appoint an internal audit committee, which is comprised of no more than five members and is responsible for auditing the TAMC and the performance of the Managing Director. Activities necessary to fulfil the aforementioned responsibilities have been outsourced to Pricewaterhouse Coopers. The external audit is performed by the Office of the Auditor General.

The board of directors shall appoint an executive committee comprised of a chairman and a maximum of three other members, each of whom shall have a term of four years. The Managing Director shall serve as an ex officio member. The board of directors also appoints the managing director to a four year term. The executive committee has the powers, duties and responsibilities to manage the subquality assets acquired from financial institutions. In this capacity, it approves and gives instructions pertaining to debt restructuring, business reorganisation of debtors, disposal of real property acquired through foreclosure and liquidation of debtors.

At inception and until mid-2002, the TAMC organisational structure included two asset management departments and one property management and business restructuring department. In anticipation of 60,000 new small balance debtor cases being transferred from state-owned banks, the number of the main departments was increased in 2002 from three to five, i.e. four asset management departments and one business restructuring department. The asset management departments are generally responsible for assessing the viability of borrowers and businesses and planning, implementing and monitoring debt restructuring schemes. The business restructuring department manages business restructuring plans to support the asset management and business restructuring processes.

Initially, the TAMC staff was approximately 110 persons most of whom are BoT employees. Staffing was increased to 200 in early 2002 and subsequently to 330. According to the Law, the board of

[33] Two years after enactment of the Law, the Minister of Finance will appoint a working group to evaluate the operations and performance of the TAMC and recommend whether the TAMC should be eliminated or allowed to continue its operations. In any event, the TAMC shall prepare to cease its ongoing operations after the tenth year and to liquidate all remaining assets no later than twelve years from the date of the Law. Any remaining assets and the books and records of the TAMC would then be passed to the Ministry of Finance.

directors, management and staff of the TAMC cannot be held liable for their actions provided they carry out their duties in good faith.

The Minister of Finance has the power of general supervision of the business of the TAMC, but has delegated this authority to the BoT. The BoT has not conducted an examination of the TAMC in the sense that it would a commercial bank, but it does monitor the activities of the TAMC and is frequent contact with it. The TAMC is audited by the Office of the Auditor General every six months, the results of which are provided to the Minister of Finance. In addition, an annual basis, the TAMC shall prepare and submit a business report summarizing its operations for the previous year and plans and expected results for the coming year. The annual report and audited financial statements are publicly disclosed.

6.4 Asset Acquisition

The rules governing the transfer of assets to the TAMC divide eligible financial institutions into two groups: those that are more than 50 percent owned by the government or FIDF and those financial institutions that are privately owned. Assets transferred from the first group of financial institutions will include both single and multiple-creditor loans and are expected to account for approximately 80 percent of total asset transfers. Privately owned financial institutions are only permitted to transfer multi-creditor NPLs. It is also important to note that the transfer of qualifying assets by government or FIDF owned financial institutions is obligatory while the transfer of assets by privately owned financial institutions is optional.

6.4.1 Asset Transfers

All subquality assets owned by government or FIDF owned institutions as of 31 December 2000, including assets where the financial institution and borrower are involved in a lawsuit to settle the debt and assets, but have not received any verdict from the court, must be transferred to the TAMC.

Private financial institutions may transfer subquality assets to the TAMC provided the asset meets certain conditions. The asset must (1) be a NPL as of 31 December 2000 and be secured, (2) the subquality asset must have two or more financial institutions as creditors, and the debtor must be a juristic person, (3) the aggregate book value of the borrower's debts to all creditors must be at least THB5 million, (4) within 30 days of the date the Law becomes effective, a restructuring agreement between the financial institution and the debtor cannot be entered into, and (5) prior to the effective date of the Law, the Bankruptcy Court can not have approved a rehabilitation plan that includes the NPL in question.

6.4.2 Transfer Price of Assets

The transfer price for assets acquired from government or FIDF owned financial institutions is the market value of underlying collateral whereas the price for assets transferred from private financial institutions is the lesser of the market value of the underlying collateral or the book value[34] of the transferred assets minus statutory reserves (provisioning) required by the BoT. It is expected that the later value should approximate the economic value of the asset.

The Law requires that the collateral value for the purposes of determining the asset transfer price, in cases where transferors are financial institutions, be appraised according to the Bank of Thailand’s regulations on Collateral Valuation and Appraisal. If transferors are private-sector AMCs, the collateral value shall be appraised in accordance with the rules specified by the TAMC Board of Directors.

The TAMC will pay for the assets it acquires from the financial institution with 10 year non-negotiable, callable debt instruments guaranteed by the FIDF. Annual interest payments on the bonds are made in the form of 1-year floating rate bonds that carry at a rate not to exceed the average rate for all types of deposits of five commercial banks as determined by the TAMC's board of directors.

6.4.3 Gain-Loss Sharing Arrangement Applied to Transferred Assets

TAMC and the transferring institution share in the gain and losses generated by the assets under management, but not on an equal basis. If a gain, measured as a recovery that is in excess of the

[34] Book value is equal to the outstanding unpaid principal balance at the time of transfer plus a maximum of 90 days of interest accrued, but unpaid, at the time of the transfer.

acquisition price, is recorded, any amount up to 20 percent of the transfer price of the asset will be shared equally between the TAMC and the transferring financial institution. Any additional gain will go, in entirety to the transferring financial institution, but when aggregated with the first 20 percent gain, shall not exceed the difference between the book value and the transfer price of the asset. Any gain above this amount will belong to the TAMC.

If a loss is suffered (i.e. the amount recovered from the asset is less than the transfer price), the first part, not to exceed 20% of the transfer price will be borne by the transferring financial institution. Losses equal to an addition 20% of the transfer price will be shared equally between the TAMC and the transferring financial institution and any further losses will be the sole responsibility of the TAMC.

6.4.4 Amount and Types of Transferred Assets

Assets will not be transferred to the TAMC on an ongoing basis. Instead, only certain assets will be taken at certain times. Through 30 June 2002, 4,631 cases with the total book value of THB718 billion in five tranches have been transferred to TAMC at an average transfer price to book value of 33.15%.

The first tranche of assets, transferred on 15 October 2001, consisted solely of single creditor loans with an individual book value in excess of THB50 million from government or FIDF owned financial institutions. The total book value of the 1,073 cases transferred to the TAMC was THB301 billion.

The second tranche of assets, restricted to the 300 largest multi-creditor loans from both private and state owned financial institutions, was transferred on 31 October 2001. In total, 226 cases with a book value of THB285billion were transferred to TAMC.

The third tranche consisted of lower value multi-creditor loans from both state and private financial institutions. In total, 3,171 cases were transferred with a book value of THB114 billion.

The fourth transfer occurred on 28 December 2001 and also consisted of multi-creditor loans from state and private financial institutions. 194 cases were transferred with a book value of THB17 billion.

Finally, a series of asset transfers comprising the fifth tranche began in June 2002. These assets are single-creditor loans with an individual book value of less than THB50 million from state-owned financial institutions. Preliminary estimates are that this tranche will contain some 60,000 cases with a total book value of approximately THB130 billion. As of 30 June 2002, 24 cases with the total book value of THB0.5 billion were transferred to TAMC in this tranche

Table 6.1
Transferred Assets
As of 30 June 2002, in million of THB

Transfer Tranche	State-owned finanicial institutions		Private financial institutions		Total	
	No. of Cases	**Book Value**	**No. of Cases**	**Book Value**	**No. of Cases**	**Book Value**
1st Tranche	1,073	301,359	0	0	1,073	301,359
2nd Tranche	205	201536	107	83,716	226	285,252
3rd Tranche	2717	73734	750	39,967	3,171	113,701
4th Tranche	66	3472	165	13,329	194	16,801
5th Tranche	24	543	0	0	24	543
Total	**4,083**	**580,644**	**992**	**137,012**	**4,631**	**717,656**
% to peak NPLs		10.52		49.63		29.03
% to total loans as of Sept. 2001		5.16		42.45		17.83
Transfer Price(% of book value)						33.15
Source: TAMC						

6.5 Resolution of Transferred Assets

The TAMCs ability to resolve and collect transferred assets is limited by the Law to certain strategies. In particular, it may restructure the debt, reorganise the business, or dispose/write off the asset and foreclose on the collateral.

6.5.1 Resolution of Debtor Cases

For the year 2002, TAMC set the half-year target for the resolved cases at THB200 billion and the whole-year target at 50% of the number of cases and 75% of the book value of transferred assets (around THB500 billion). In June 2002, it reached the half-year target by being able to resolve cases with the total book value of THB201 billion. The expected recovery rate from the cases resolved by debt/business restructuring and rehabilitation in the Bankruptcy Court as of June 2002 is 47.3% of their book value, which is higher than the average transfer price of 33.15%. Up until July 2002, TAMC has received cash repayment from its debtors in total of THB560 million.

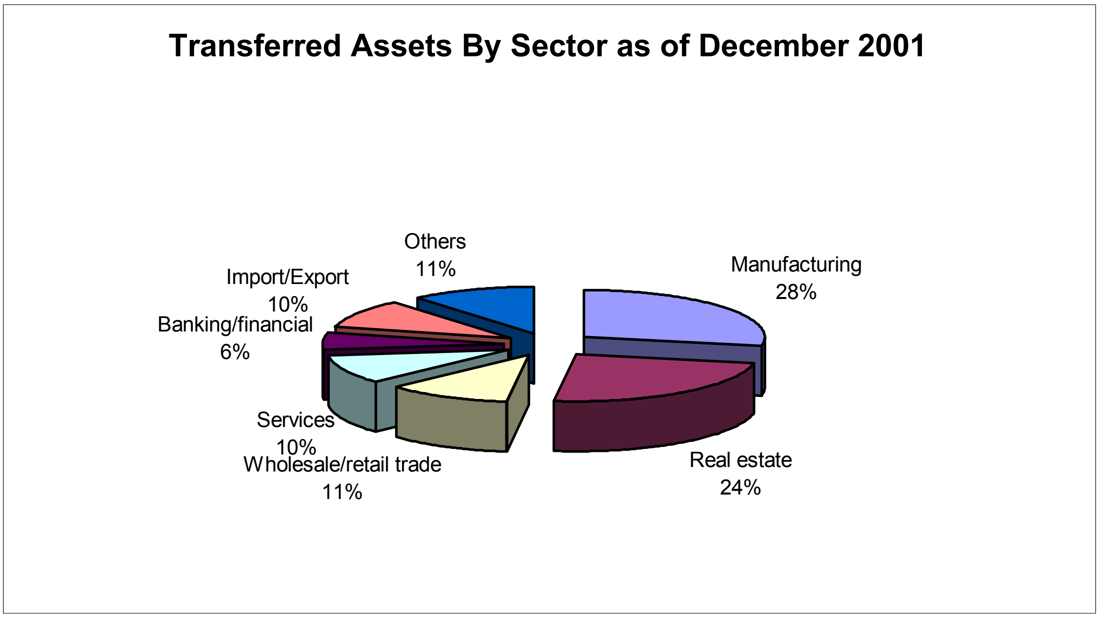
As of Aug. 2002, the number of resolved cases reached 800 with the total book value of THB293 billion. Of the total book value, 60.53% were approved for debt/business restructuring or rehabilitation in the Bankruptcy court while the other 39.47% were resolved by foreclosure of collaterals, final receivership of assets, or verdict by the Civil Court. Most of the resolved cases were in the real estate sector (31.7%) and manufacturing sector (28.47%). However, TAMC still needs to resolve debtor cases of at least THB50 billion each month, in order to meet the ambitious target of THB500 billion by the end of this year.

6.5.2 TAMC's Future Plans

TAMC established 4 main operation plans for the year 2002, i.e. to expedite the management process of the acquired subquality assets, facilitate the sectorial restructuring, develop connection/find funding sources, and increase public awareness and understanding about their operation.

TAMC aims to complete the resolution of all assets under its management within 2 years or by the end of 2003 and to spend 3 years after that (until the end of 2006) to monitor debt/business restructuring cases. In total, TAMC expects to finish its asset management process within 5 years, which is 3 years sooner than what it previously anticipated.

With regards to sectorial restructuring, TAMC Board of Directors appointed the Subcommittee on Sectorial Restructuring to give advice on business/sectorial restructuring. At the initial stage, TAMC chose manufacturing and real estate sectors as its first and second priorities, as 28% and 24% of transferred assets as of December 2001 fell under these two sectors, respectively.



Aiming to assist its potentially-viable debtors to find funding sources, TAMC will not only provide an incentive for banks to grant new credits to its debtors, but it will also coordinate with other specialized financial institutions. Other measures include its cooperation with the Fiscal Policy Office on the Matching Fund Project. With the initial funding of USD500 million, the Matching Fund will invest, mainly in the form of equity, in debtors' companies acquired by TAMC with a minimum investment in each company of USD5 million.

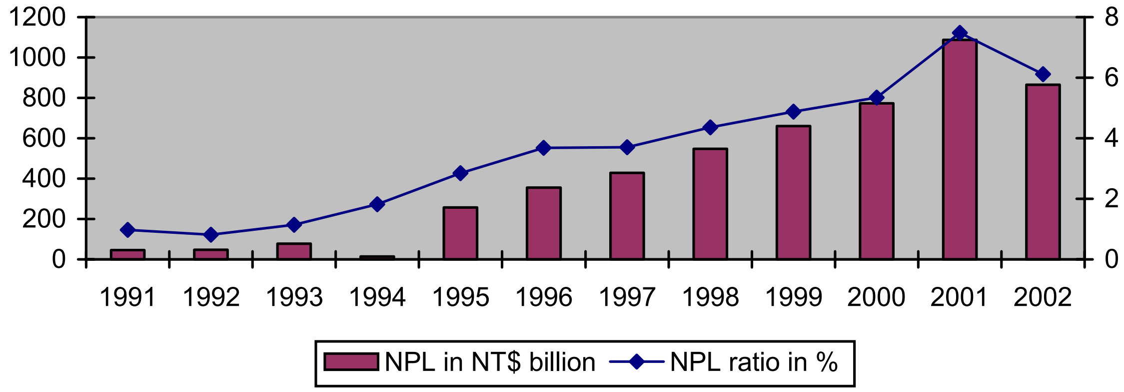
7. Taiwan's Asset Management Companies

7.1 Background

Despite being only mildly affected by the 1997 Asian crisis, in 2001 the Taiwanese economy experienced one of its worst recessions in 25 years. To wit, GDP shrank 2% and unemployment rose to above 5% during the year. Following the slowdown of the technology sector, exports have also declined. As a result, the economy has been experiencing deflation on-and-off since late 2001.

Taiwan has one of the most crowded and fragmented banking systems in the region, with 47 domestic banks, 36 foreign banks and over 300 community financial institutions serving a population of about 22 million. The banking sector is also very large with over NTD20 trillion in total assets at year end-2002, nearly double the economy's GDP of NTD9.7 trillion. To address this overbanking problem, the government plans to consolidate the banking sector and in an effort to do so, recently passed the Financial Holding Company Law that encourages bank mergers. The government has majority stakes in some of the largest banks in Taiwan, including (domestic rank in terms of asset size shown in parenthesis): Bank of Taiwan (1), Taiwan Cooperative Bank (2), Land Bank of Taiwan (3) and Central Trust of China (46). These banks account for approximately 27% of the total system whether measured in terms of assets, deposits or loans. Adding partial state ownership in other domestic banks, the government's share of total bank assets increases to almost 60%.

Non-performing loans and ratios in Taiwan 1991-2002



Source: Central Bank of China

The level of NPLs in Taiwan is high and also is rising until 2002.[35] The ratio of NPLs to total loans rose from just below 1% in 1991 to 7.48 % (11.4% of GDP) in 2001. At end-2002, however, the NPL ratio began to fall, dropping to 6.12% (8.9% of GDP). In any case, private sector analysts estimate NPLs to be higher. For example, S&P estimated the NPL ratio to be 15% while Goldman Sachs calculated to be 17.5%, with bigger banks and state-owned banks having even higher NPL ratios.

[35] According to the Central Bank of China, non-performing loans include loans with payments of principal not met for 3 months, repayment of interest past due for more than 6 months, and instalment repayment loans for medium to long-term past due six months or more. Recently, the Central Bank of China (CBC) began to report also loans under surveillance. At end-2002, loans under surveillance amounted to NT$386.8 billion, which include NT$103.1 billion for term loans overdue for 3 months but less than 6 months, NT$35.1 billion for other loans whose principal not overdue or has been overdue for less than 3 months but with interest payment overdue for more than 3 months but less than 6 months, and NT$248.5 billion for reached NPL standard but exempted from calculation with approval.

Table 7.1

Asset quality analysis of local banks
In NTD billion

	Dec 2001	Dec 2002
Non-performing loans	1,087.0	864.4
Total loans	14,527.4	14,130.7
Loans under surveillance	552.8	386.8
NPL ratio	7.48%	6.12%
Ratio of NPL and loans under surveillance to total loans	11.29%	8.85%

Source: Central Bank of China

There are several causes for the NPL problems in Taiwan. First, there is a history of lending to clients with political connections despite dubious business and poor credit histories. Second, owing to the overcrowded banking sector and the resulting competition among banks, many banks lower their lending standards in an effort to attract customers. Third, the substantial decline in asset prices led to considerable amount of NPLs in property-related loans and loans that are collateralised with equities. Among the NTD1.1 trillion of NPLs at year-end 2002, over 45% are loans to individuals, mainly in the form of mortgage loans. Another 16% of the NPLs are loans to construction and real estate sectors.

Table 7.2

Non-performing loans by sectors
In %

	Dec 2001	Dec 2002
Manufacturing sector run by the private enterprises	20.61	18.74
Commerce sector run by the private enterprises	11.14	9.74
Construction and real estate sectors run by the private	15.95	16.46
Individuals	45.77	47.76
Others	6.53	7.10

Source: Central Bank of China

7.2 Government involvement in NPL resolutions

The government has taken measures to address the NPL problems. Specifically, in February 1999 the government cut required reserves on deposits. In addition, the Ministry of Finance (MOF) reduced the gross business receipt tax (GBRT) from 5% to 2% and plans to eliminate it entirely by January 2006. Both of these measures were taken with the intent of increasing profits and freeing cash that would, in turn, allow banks to write off NPLs. The MOF's goal is to provide tax savings that could help the NPL ratio to fall below 5% by 2003. These two actions by the government have resulted in an increase in banks' profits by NTD93 billion in the past three years. During the same period, banks wrote off NTD536 billion of NPLs (NTD140 billion in 1999, NTD163 billion in 2000, NTD233 billion in 2001). Despite the aggressive actions being taken by banks to clean up their loan portfolios, NPLs remain high. This suggests that previously performing loans are turning bad almost as fast as the already identified NPLs can be written off. Referring to all financial institutions, the Taiwan Ratings Corp., a local partner of S&P, has suggested that it might cost the government as much as NTD950 billion (10% of GDP) to clean up the banking system.

Another government approach taken to address the NPL problem is to encourage bank consolidation through the passing of laws that offer tax breaks and other incentives for such activities; for example, the Financial Institution Merger Law in November 2000 and the Financial Holding Company Law in November 2001. Despite these initiatives, there has been relatively little progress in bank consolidation, with particularly little interest shown by foreign banks in acquiring domestic banks.

With the rising pressure to address the NPL problem more quickly, the government is considering expanding the role of the Financial Restructuring Fund so that it will also act as an asset management company. While there is not yet a government-sponsored AMC, there are several private AMCs, including the one set up by the Taiwanese Bankers' Association and others established through joint ventures between US investors and local banks.

7.3 Financial Restructuring Fund (FRF)

The Statue for the Establishment and Management of the FRF was enacted on 26 June 2001. The FRF is an entity established to facilitate the restructuring or liquidation of poor-quality assets of the banking industry, following the model of the US Resolution Trust. The FRF also has the power to require insolvent institutions to cease operations and exit the market. The initial motivation behind the establishment of the FRF was to solve the high NPL ratio of the community financial institutions. For example, the 300-plus credit cooperatives have a high NPL ratio of 16.4% at year-end 2001, whereas the ratio for domestic banks is lower at 7.5%.

The government will provide capital to the FRF in the amount of NT$140 billion: NTD120 billion from the existing 2% GBRT levied on FI over a period of 4 years, and the remainder from insurance premiums collected by the Central Deposit Insurance Corporation (CDIC) over 10 years. Other possible sources of funding are borrowings from the central bank and other banks as well as the issuance of FRF bonds. The FRF reports to the Bureau of Monetary Affairs, which is under the Ministry of Finance.

Thus far, the FRF's activities have been limited. On 10 August 2001, the Fund took control of 36 farmers' and fishermen's credit cooperatives, all of which had negative capital and suffered from poor management. These institutions were subsequently taken over by 10 major banks, following an unofficial policy of "no bank failure". According to the CDIC, about NTD80 billion of the FRF's funds were used to pay the banks for this operation.

The recent problems and still on-going resolution of several banks, such as the Chung Shing Bank and Kaoshiong Business Bank, which are of much larger size than the community banks, has required a larger amount of FRF funding than the aforementioned credit cooperatives. Instead of asking other banks to take over the insolvent banks, MOF is soliciting tender bids, with the FRF providing interim liquidity support.

In late August 2002, President Chen endorsed a plan to speed up the pace of financial reforms. The so-called "2-5-8 plan" is designed to reduce the NPL ratio to below 5% and to raise each bank's capital ratio to above 8% within two years. There is also a plan to increase funding to the FRF from NTD140 to NTD1,050 billion or 11% of GDP, which is still below the amount of government monies allocated to address collapsed banking systems in neighbouring countries. Under the proposed but unconfirmed plan, the FRF will operate more like the RTC in the United States, allowing it to purchase troubled banks' impaired assets for re-sale or to take ownership stakes in banks that have a capital ratio of below 8%. So far, the proposed plan has not yet obtained the legislative approval.

7.4 Taiwan Asset Management Corporation (TAMCO)

The Merger Law of Financial Institutions (MLFI) enacted on 24 November 2000 provides the legal framework for the establishment and the operations of TAMCO and the Taiwan Financial Assets Service Co. (TFASC). TAMCO is the first private, domestic AMC founded in Taiwan. Established by the Taiwanese Bankers' Association in May 2001, TAMCO began to operate in early November 2001. Its initial capital of NTD17.62 billion (USD500 million) came from shareholders consisting of 33 local financial institutions. Mr Lin Cheng-kuo, former Minister of Finance, is the first chairman of TAMCO. Apart from the participation of state-owned banks, there were no public funds involved in the establishment of TAMCO.

TAMCO has been very slow and cautious in addressing the NPL situation. It has, however, participated in public auctions of bank assets. The management of TAMCO believes that they have better knowledge and understanding of banks in Taiwan so that they can offer more competitive prices for bank assets than other investors.

In June 2002, TAMCO announced that it planned to help banks dispose of more than NTD50 billion (USD1.47 billion) in NPLs. It planned to buy NTD35 billion of NPLs directly from banks and act as an agent to sell another NTD15 billion in NPLs. So far, it has purchased only NTD1.8 billion from one local bank. Chang Hwa Commercial Bank and state-owned Taiwan Cooperative Bank have announced plans to sell NTD5 billion of NPLs each to TAMCO. In addition, TAMCO is negotiating with another 20 local banks to purchase portions of their problem loan portfolios and has signed MOUs with 10 banks for the sale of NTD30 billion of bad assets.

To address the issue that banks and AMCs often disagree over NPL pricing, an impartial third party, the Taiwan Financial Assets Service Co. (TFASC), was set up by the Taiwanese Bankers' Association to evaluate the pricing of NPLs. It has an initial capital of NTD1.5 billion coming from 30 local banks. It is a licensed auction entity to help financial institutions to liquidate non-performing assets, mostly real estate acquired in satisfaction of debts. It also appraises the value of real estate collateral. TFASC cannot deal with banks directly but banks can use TFASC through TAMCO.

So far, TAMCO has made only a marginal impact on the over NTD1.1 trillion NPLs in Taiwanese banks. Its small capital base of around NTD18 billion severely limited its role in NPL resolution. In addition, banks are reluctant to sell NPLs to TAMCO because the losses resulting from the sale would be realised immediately and would reduce their profits and adversely affect their financial performance. Notwithstanding the fact that under Article 15 of the Financial Institution Law, losses resulting from the sale of problem loans to AMCs can be written off over 5 years, banks are still reluctant to sell to TAMCO because of the low price that will be received. For example, First Commercial Bank sold NTD13.2 billion to a private AMC for NTD3 billion. The loss to First Commercial net of loan loss reserves amounted to almost NTD8 billion, which will substantially affect the bank's financial results even when being absorbed by earnings over the next five years.

7.5 Other private resolutions

Taiwan's finance ministry has encouraged financial institutions to set up private asset management companies to clean up their bad debts after the passing of the MLFI.For example, in March 2002, majority state-owned First Commercial Bank sold NTD13 billion (USD370 million) of bad loans to Cerberus Asia in an auction conducted by Pricewaterhouse Coopers at 20% to 25% of face value. This is the first open bidding for NPLs in Taiwan. The bank sold an additional NT56 billion of NPLs in July 2002. China Development Financial Holding (CDFH) is creating, in partnership with US-based Lone Star Investment, a private AMC, China Development AMC (CDAMC). Lone Star Investment will contribute 60% to 70% of the capital of NTD8 to 20 billion to establish CDAMC, which plans to purchase NTD4.46 billion worth of bad loans from CDFH at a cost of NTD2 billion. In total, sales of problem assets to private AMCs have amounted to roughly NTD27 billion, only a fraction of the Taiwan's over NTD1 trillion in bad loans.

8. Banking System in the Philippines

8.1 Background

Prior to July 1997, the Philippine economy was growing steadily as evidenced by the country's real GDP growth from near-zero in the early 1990s to about 6% in 1996. Unfortunately, however, the Philippines also suffered during the Asian financial crisis. The crisis caused real GDP growth to slide into negative territory in 1998, the real lending interest rate to increase to from 5.7% in 1996 to 10.3% in 1997, and the Peso to depreciate more than 50% against the US Dollar from PHP27 in June 1997 to PHP40 by December 1997.

Despite being affected by the Asian economic crisis, the Philippines has made considerable economic progress since the bottom was hit in 1997 and 1998. For instance, GDP has begun to increase with growth since 1999 being reported at an annual rate of about 3-4%. In addition, real lending interest rates decreased to 8.7% in 1998 with rates now in the rage of 6 – 7%. Conversely, the Peso has continued to depreciate against the US Dollar with a low of PHP50 in 2001.

Before the Asian financial crisis, the banking system in the Philippines consisted of 54 commercial banks, 124 thrift banks (savings banks, private development banks, stock savings and loans associations, and micro finance), and 832 rural banks. Although the rural banks and thrift banks are the greatest in terms of numbers, commercial banks dominated the banking system with roughly 90% of banking system assets. The concentration of assets in commercial banks continues to hold true today[36].

Like many other banking systems in the region, the Philippines' banking system was negatively affected by the Asian financial crisis, but to a relatively lesser degree. From July 1997 to the end of 1998, only one commercial bank and seven thrift banks - with combined assets of 0.41% of GDP - failed. Although NPLs did increase during the Asian crisis, it was from a low of 4.7% of total loans in December 1997 to a still relatively manageable 10.5% in August 1998. It should be noted that like many other Asian countries, lending during the height of the crisis did contract as banks became more concerned about credit quality and sensitive to losses.

Bangko Sentral ng Pilipinas (BSP), the Central Bank of the Philippines, claims that there are several reasons why banks in the Philippines possessed less NPLs and were relatively stronger than banks in other Asian countries[37]. They include a less reliance on capital inflows, dominance of private banks in the system and certain preventive measures that were put in place before the crisis. Preventive measures put in place before the crisis include an imposition by the BSP of a 20% limit on real estate loans to total loans outstanding and in 1996, an increase in the the minimum capital requirement for universal banks by 80 percent, for regular commercial banks by 60 percent, and for the bigger Metro-Manila based thrift banks by 67 percent. The higher capital requirements were required to be complied with by December 1998.

8.2 Measures to Strengthen the Banking System After the Financial Crisis

Since the government and BSP viewed the problems of the Philippines' financial system as relatively less severe than those in its neighbouring countries, they did not spend the enormous amounts of money on the clean up of NPLs and recapitalize the banking system that other Asian countries did. Principally, the BSP rescue measures were limited to providing liquidity support to the banks in the form of fully-collateralized emergency loans if and when a run on the bank was experienced.

With the long-term view of promoting a sound, stable, and competitive financial system, the BSP has implemented a number of banking reform measures since the crisis. These initiatives include

[36] In addition to banks, there were some 7,085 non-bank financial institutions as of December 1997. These included Investment Houses, Finance Companies, Investment Companies, Securities Dealers/Brokers, Pawnshops, Lending Investors, Non-Stock Savings & Loan Association, Mutual Building and Loan Association, Venture Capital, and Private and Government Insurance Companies. At the time, these non-bank financial institutions accounted for approximately 20 percent of the financial system's resources.

[37] Speeches of the former Governor Singson, "The Philippines: Capitalizing on sustained financial stability", 11 November 1998

measures to (1) further increase in minimum capital requirements ranging from 20 to 60% (depending upon the type of financial institution) over 1998 minimum levels (to be completed by year 2000), (2) make the loan classification and provisioning requirements more strict, (3) make the bank licensing requirements for stringent, (4) promote good risk management systems and practices, enhanced disclosure requirements, and good corporate governance, and (5) provide for consolidated and risk-based supervision. Moreover, mergers and consolidations among banks have been encouraged, aiming to create bigger, stronger, and more competitive banks.

To help accelerate the rule-upgrading process and to encourage a deeper reform, the BSP strongly supported the enactment of a new General Banking Act, which ultimately became law on 23 May 2000.

8.3 Recent Performance of the Banking System

Although considered less severely affected by the regional financial crisis, the Philippines' banking system has not yet fully recovered from the crisis. The number of banks in the Philippines has continued to decrease after the crisis due to the closure of problem banks and the merger and acquisition of surviving banks. More importantly, the ratio of NPLs-to-total loans in the banking system increased from 10.4% as of December 1998 to 18.1% as of June 2002.
With increasing asset quality concerns, banks in the Philippines have been more reluctant to extend credits, having chosen instead to invest their resources in less risky assets, particularly government securities. As a result, the total loans grew at an extremely slow pace during 1998 - 2000 and even contracted from PHP1.45 trillion in December 2000 to PHP1.38 trillion in August 2002.

Due to the shift in focus from generally higher yielding loans to government securities, it comes as no surprise that the return on assets and return on equity ratios of the Philippines' banking system decreased from 0.8% in 1998 to 0.4% in 2001 and from 5.7% to 3.2%, respectively. More recently, however, both ratios showed improvement with banks turning in performance numbers equating to 0.7% and 4.8%, respectively, for the first half of 2002. Capital adequacy ratios for the banking system remained high at 16.7% in May 2002.

8.4 Further Measures and Reforms

The high NPL figure remains a major concern of the Philippines banking system, the government and BSP. To combat the growth in NPLs, on 18 December 2002, the Philippine Congress passed a Special Asset Management Companies Law (SAMC Law), aiming to help accelerate the clean up process of the banks' non-performing assets. This bill permits the establishment of third-party, private sector owned AMCs, and allows them to purchase bad loans from banks. Importantly, the legislation prohibits banks themselves from owning more than 5% of any AMC that purchases bad loans and assets. To encourage the AMCs to purchase NPLs from banks, incentives are provided in the form of certain tax exemptions and fee privileges. Initial capital requirements for an AMC established under the SAMC Law is PHP500 million (USD9 million).

Along with passage of the SAMC Law, the BSP is implementing three initiatives to strengthen the Philippines' banking system. The first initiative is designed to strengthen the supervisory framework through the implementation of consolidated and risk-based supervision. The second is to further reform the local banking system to achieve greater safety, efficiency and competitiveness. In this regard, the main focus of the reform has been on the promotion of fewer but stronger and more competitive players in the banking industry by encouraging mergers and acquisitions and allowing the entry of strong foreign players. The third initiative is designed to enhance the banks' corporate governance and enhance the role of market discipline. These measures aim to ensure that banks are well-managed and operated with good risk management system, efficiency and transparency.

The BSP has made significant progress on these three main areas. The General Banking Law, which is the legal ground for the reforms, was enacted in May 2000. Several rules and regulations have been revised and issued. What lies ahead is implementation of these reform measures. Full recovery of the banking system will depend heavily on the success in implementing these measures and the acceptance of the private sector led AMCs.

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