

CHAPTER 3: RESOLVING NONPERFORMING LOAN

PROBLEM

Proper management and disposition of NPLs is one of the most critical and complex aspects of successful and speedy bank restructuring. To deal with the NPLs, the government's main objectives is to maximize the value of the NPLs in the system, minimize fiscal costs, and prevent credit discipline of borrowers from deteriorating. Various approaches can be adopted to achieve those objectives. NPLs may either be held and dealt with by the financial institutions themselves or sold to special companies or agencies created to handle bad assets. The optimal strategy for managing and disposing of NPLs has many variations, depending on factors such as the nature of the problem loans, their overall size and distribution, the structure of the banking system, the legal framework, and available management capacity in the banks and in the public sector.

3.1 PRUDENT CREDIT RISK AND COUNTRY RISK MANAGEMENT

More generally, credit risk management involves three key principles: Selection, limitation, and diversification.

(1) Clearly the careful choice of to whom to lend is a first requirement. But, however discriminating is a bank's credit management, there remains the risk of unforeseen changes in the economic fortunes of companies, of industries, of geographical areas or even of whole countries;

(2) The second principle is to have a system of limits for different types and categories of lending. Different banks will set credit limits in different ways and at different levels, but the essential requirement is that there be clearly established maximum amounts that may be loaned to any one borrower or group of connected borrowers, and to any one industry or type of economic activity. It is also desirable that loans should be classified by size and limits put on the proportion that large loans bear to total lending. Other specific limits are possible, but enough has been said to show the importance of limiting the bank's exposure to losses from loans to any one borrower or to any group of borrowers whose economic fortune are related. A different kind of limit, but also important, is a general limit on all risk assets. Banks normally observe a maximum ratio of risk assets to total assets. Put another way, this means holding a minimum proportion of assets, such as cash and domestic government securities, whose default risk is zero or negligible.

(3) The third principle of credit management is diversification. To a certain extent, this is implied in the principle of limitation – avoiding concentration of lending. But over and beyond this minimum implied diversification, it can be said that the more a bank is able to spread its lending over different types of borrowers, different economic sectors and different geographical regions, the less likely it is to encounter serious credit problems. This gives an advantage to size. Large banks are more able to diversify by geography, and also, maybe, by economic sectors, than are small banks (Harrington 1987: 101).

The concept of country risk relates to the probability that political, legal, social or economic events in a country might prevent the debtors from fulfilling their external obligations. As with all kinds of risk exposure in bank business, an essential condition is that it should not be excessive in relation to a bank's capacity to meet losses. In this context, therefore, the stress is on the responsibility of bank management for making an adequate appraisal of the risks connected with country exposure, leaving to bank supervisors the tasks of ensuring that the assessment of the risk is carried out in the most appropriate manner and of assisting banks by facilitating the dissemination of information that banks can use in this monitoring and control of country exposure (Pecchioli 1987: 77).

The banks must involve in the assessment of the present and future economic performance of countries, and of the stability and character of their governments. Such assessments are now made by virtually all-large banks, and in many cases substantial resources are committed to providing and maintaining country risk evaluations. Various attempts have been made to develop more formalized systems of credit-ratings for countries. In addition, in line with the basic management, credit limits should also be set for lending to individual countries, and also for particular regions of the world, as experience shows that when the credit-standing of one country deteriorates, leaders, rightly or wrongly, become less willing to lend to neighboring countries (Harrington 1987: 102).

Prudent risk management can significantly increase the chances of a bank surviving an extreme shock outside its control, even one of the magnitude of the collapse of the New England real estate market (Jordan 1998: 35).

According to the Basle Committee on Banking Supervision (1998), a bank should adopt a sound system for managing credit risk.

- (1) Effective risk management and control policies and practices are essentially related to sound and timely accounting and valuation.
- (2) To be able to prudently value loans and to determine appropriate allowances, it is particularly important that banks have a system in place, whether established by the institution itself or by the supervisor, to reliably classify loans on the basis of risk. A credit risk classification system may include categories or designations that refer to varying degrees of credit deterioration, such as substandard loans, doubtful loans, and irrecoverable loans. A classification system typically takes into account the borrower's current financial condition and paying capacity, the current value of collateral, and other factors that affect the prospects for collection of principal and interest.
- (3) Accounting and valuation processes must be complemented by effective internal controls commensurate with the size, nature and complexity of the bank's lending operations. The board of directors has ultimate oversight responsibility for establishing and maintaining a system of effective internal controls that, among other things, should ensure that lending transactions are promptly

recorded, loan documentation is complete and internal loan review procedures are effective.

The bank considers the following factor to be important in determining country risk for foreign lending (SEACEN 1983:16).

- (1) Loans should be made on the basis of future earnings prospects of the country;
- (2) Banks should be wary when lending to countries whose economy is dependent on one or two main commodities, whose adverse price fluctuations could cause some balance of payment difficulties for the country;
- (3) Banks should assess the political stability of the country;
- (4) Banks should assess the commitment of the leaders of the country to restructure its economy, if necessary.

3.2 LOAN GUARANTEE

To resolve the NPL problem, in line with achieving certain policy objectives, government frequently provides private lenders with loan guarantees that cover some or all of the risk that the borrowers will be unable to repay the loan. Such guarantees are extremely valuable, and their value increases with the riskiness of the underlying asset or credit, the size of the investment, and the duration of the loan.

Today, especially in developing countries, governments are increasingly using guarantees to stimulate private lending for infrastructure projects. Partial guarantees (or guarantees targeted to specific policy or regulatory risks inherent in infrastructure

sectors) mitigate those risks that the private sector cannot evaluate or will not bear (Mody and Dilip 1996).

The main purpose of a guarantee is valuable to a lender because, if the borrowers fail to repay the debt, the guarantor pays the lender. This presumption holds when there is no risk that the guarantor will default on the commitment. In practice, no guarantee is completely free of the risk of default, and its value depends ultimately on the creditworthiness of the guarantor. To the extent that governments are more likely to honor their obligations (although governments can renege on commitments).

3.3 MONITORING AND SCANNING THE BORROWERS

Before making a loan, all lenders need information about borrowers due to the risk that the loan might not be repaid. To determine the creditworthiness of a borrower, a lender gets information about the borrower's character, financial strength, business prospect, management skill, and any other factors that might affect the likelihood of repayment. After collecting the information, the lender then decides whether the loan is worth the risk.

After a loan is made, the lender must monitor the borrower because of the likelihood that repayment can fail. For example, the borrower's business prospects or financial condition may deteriorate, or the borrower may engage in activities that decrease the likelihood of repayment. By monitoring the borrower, the lender can recognize these

events and can call the loan or refuse to renew it when it matures (Beckett and Morris 1992: 71-72).

3.4 FACTORS TO CONSIDER FOR LENDING DURING HARD TIMES

In recessions, the probability of bad economic outcomes is higher than at other times, and inefficient, costly bankruptcies and liquidation are more likely. Unless lenders have established procedures for commanding cash flows from troubled borrowers, they will be unable to lend profitably during recessions, when cash flows become more questionable. This will give rise to the NPL rates.

Nakamura (1991) suggested several points to consider for lending during a recession:

- (1) More collateral will be required to further ensure repayment, although this makes borrowings more difficult.**

During a recession, the increased risk that collateral will fall in value means that lenders will lend larger amounts of it to maintain the borrower's incentive to repay. Inevitably, more potential borrowers will find that they lack the collateral necessary for the loan they are seeking.

- (2) More documentation will be presented, and past lender-borrower relationships will be more important.**

Lenders should attempt to know more about borrowers during recessions because defaults are more likely —and more expensive—when lenders are relatively ignorant. This makes it doubly hard on borrowers whose normal lenders

themselves become cash constrained; for borrowers to exchange a lender who know them well, for one who does not, will be expensive, if not impossible. Detailed and accurate record keeping may make the difference in whether new finance is obtained.

(3) Noncredit terms on loans will be tighten.

Tightening noncredit terms for borrowers may make it harder for them to qualify for loans, but at least lenders will be able to continue making profitable loans in hard times. For example, in a weak real estate market, lenders should require higher down payments on mortgages and be particularly wary of techniques home sellers may use to foist greater risk on the lender. In addition, lenders may demand more covenants to their loans. Loan covenants are legal conditions added to the loan contract that permit the lenders to declare loans in default. Some covenants constrain managerial discretion; others specify standards of continued creditworthiness. Covenants increase the lender's ability to seize collateral while it retains much of its value.

3.5 PRUDENTIAL REGULATION AND SUPERVISION

Initiatives have been taken to improve prudential regulation and supervision of international creditors in their home countries (Malaysia, Thailand, Indonesia and South Korea). All countries took initiatives to strengthen prudential regulation and supervision. The nature and directions of these initiatives was similar in all countries: To bring domestic standards closer to internationally accepted practices.

Bank regulation and supervision are intended to minimize bank failure by prohibiting excessive risk-taking and by identifying management problems with sufficient lead-time to permit corrective action.

Prudential regulation and supervision could reduce the risk of failure by limiting banks' exposure to external shocks or by better insulating banks from external shocks (Berger and DeYoung 1997: 868).

3.5.1 The Role and Scope of Banking Supervision

A few examples will be given below regarding mismanagement aspects that could be prevented, limited, or remedied by banking supervision (de Juan 1991:12-13):

- (a) If entry on the market is regulated and supervised, that is to say, if a supervisory institution (the Central Bank or Superintendency of Banks) is able to control who to become a banker (setting up a new one or buying control of an existing one), the danger for bank mismanagement may be considerably reduced.
- (b) If a bank is required to send adequate periodic and detailed information to the supervisory on their balance sheet and income statement, analysis of such information would permit them to identify the remedial actions without the need for any public intervention.
- (c) If banks are required to disclose publicly their accounts in a reasonably desegregated form, stockholders and the public would press the management for remedial action without the need for any public intervention.

- (d) If the bank's accounts and assets are required to be audited by external auditors and their report is required to be sent to the supervisor and even published, this kind of verification would make hiding difficult.
- (e) If the legislation establishes rules that limit loan concentration to a given proportion of capital, as well as connected lending, and if compliance is properly verified by the supervisor, the major risk of insolvency would be barred.
- (f) If a minimum level of capital versus assets was set, over extension and protracted under capitalization would be limited risks.
- (g) If rules are set for the bank to properly classify its assets as good or bad, and provision and accrual requirements are met, again with adequate verification, the state of health of the bank can be closely followed up and remedial action can be taken in due time.
- (h) If proper penalties are established for mismanagement, lack of compliance of regulations or fraud, such as fine, replacement of management or legal actions, the room for mismanagement would again be limited.
- (i) Last but not least, if proper mechanisms were in place to ensure capital injection and to restructure or rehabilitate banks or insure deposits in case of closure, the deteriorating situations could be stopped in time and avoid spirals of market distortions and losses, that, in the end would have to be covered by someone, most probably by the State.

All countries have made efforts to upgrade their supervisory capacity and strengthen the powers of supervisors. Supervisors can now demand additional loan-loss provisioning from banks, corrective actions when problems are detected, and more

support from banks' external auditors. The use of memoranda of understanding to enhance the supervisory authorities' and performance benchmarks of financial institutions has become common (Lindgren, Balino, Enoch, Gulde, Quintyn and Teo 1999: 43).

The Basle Committee on banking supervision's core principle for effective banking supervision, introduced in 1988 and modified in 1997, recommended that an effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking organizations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place. Some of the prudential regulations and requirements set by the Basle Committee are shown in Appendix A (Basle 1997).

3.5.2 Loan Classification

Regulations concerning loan classification and provisioning have been brought closer to compliance with international best practices (Table 3.1 and 3.2). Loan classification rules were strengthened in all the four South-East Asian countries (Indonesia, Malaysia, South Korea, and Thailand). The period overdue for interest

suspension was shortened to three months in Indonesia and Thailand. All the countries tightened their specific loan-loss provisioning requirements and introduced or tightened their general provisioning requirements. All the countries have also made required loan-loss provisions tax deductible.

Tightening provisioning requirements on NPLs is essential to ensuring that banks remain liquid during economic downturns. Many countries (including Argentina, Brazil, Chile, Columbia, Mexico, Peru, and Venezuela) divide loans into five categories. Normal loans are first category. NPLs (generally defined as loans between 30 and 90 days past due) are divided into four categories; the provisioning required increases with the length of delays in loan repayment. In many cases, this framework allows for significantly lower provisions on secured loans or different provisioning levels for certain types of loans, such as consumer loans (Rennhack 2000).

Table 3.1 : Indicators on accounting and prudential standards

	Non-performing loans (NPL) definition (Number of months overdue)	General provision (percent loans)	Loss provision (percent of NPL)*	Capital-asset ratio (percent)
Malaysia	3	1.5	20, 50, 100	8 now; 10 by year 1999
Indonesia	3 by year 2001	1.0	15, 50, 100	4 now; 12 by year 2001
Korea, Rep. Of	3	0.5	25, 75, 100	8
Thailand	3 by year 2000	1.0	2, 25, 50, 100	8.5

substandard, doubtful, loss provision standards.
Source: World Bank staff. (1998)

Table 3.2: Time Period for Overdue Criteria for Interest Suspension and Loan Classification

Country	Period Overdue For Interest Suspension	Substandard	Doubtful	Loss
Indonesia				
Old ¹	1-12 months	1-12 months ²		21 months ³
New	3 months	3 months	6 months	9 months
South Korea				
Existing	Immediately when past due	Normally not classified until 3 months past due unless declared bankrupt		
Proposed	No changes currently proposed	3 months	3-12 months	12 months
Malaysia				
Old	6 months	6-12 months	12 -24 months	Over 24 months
New ⁴	6 months	6-9 months	9 -12 months	Over 12 months
Philippines⁵	3 months	3 months (unsecured) ⁶	6 months (unsecured)
Thailand				
Old	6 months ⁷	6 months (unsecured) 12 months (secured)	Over 6 months (unsecured) Over 12 months (secured)	Over 6 months Over 12 months
New	3 months	3-6 months	6-12 months	Over 12 months

Source: IMF; national authorities; Central Banks.

¹Varies by type of credit and installment period²Credit exceeds overdue criteria for substandard but is considered collectible and the value is not less than 75 percent or credit cannot be collected but value of collateral not less than 100 percent.³Refers to 21 months after a credit has been classified as doubtful and there is no repayment.⁴Effective March 1999⁵New rules issued October 1997, which tightened overdue criteria for classifying loans depending on number and amount of arrearages, refer only to installment loans.⁶A loan previously classified as substandard in the last examination is reclassified as doubtful if principal has not been reduced by at least 20 percent during the preceding 12 months.⁷Effective January 1998 irrespective of collateral; previous limit (since July 1995) was 12 months for secured loan.

3.5.3 Public Disclosure

Most countries have taken measures to improve transparency and disclosure, as well as the quality of data disclosed. Quality of data has been improved by new loan classification and provisioning. This is expected to enhance discipline over time and to resolve the NPL problem more effectively and more speedily.

Some of the more important guidelines on public disclosures, given by the Basle Committee on Banking Supervision are reproduced in Appendix B (Basle 1998).

3.5.4 Capital Adequacy and Provisioning

Requiring banks to hold a minimum amount of capital is intended to limit moral hazard by putting bank owners' money at risk. It can also help bank weather economic slowdowns and make problem banks easier to sell. The Basle Committee on Banking Supervision's capital accord, introduced in 1988 and modified in 1997, recommended a risk-weighted capital-asset ratio of 8 percent for banks in developed financial markets and a higher ratio for banks in more vulnerable economies. It defined a system of weighted assets by credit and market risk to avoid penalizing banks for holding low-risk assets (Rennhack 2000).

The Basle capital adequacy ratio represents an attempt to *explicitly* and *systematically* relate the capital funds (or net working funds) of a bank to a major part of its activities which give rise to risk exposure for that bank. For example, in Malaysia, this is done in two steps:

- a. All the assets in a bank's balance sheet are categorized into five groups, each being given a weight of 0%, 10%, 20%, 50% and 100% respectively. For example, cash being a riskless assets, is placed under the first group bearing the risk weight of 0%; claims on discount houses are in the group bearing a 10% risk weight; loans secured by mortgages on residential property are in the group with a 50% risk weight; and loans and advances to the private sector are generally in the group bearing a risk weight of 100%.
- b. Contingent risks connected with a bank's off-balance-sheet activities are then taken into account. Such activities are first converted into on-balance-sheet equivalents (credit equivalents) via the relevant credit conversion factors established for the various off-balance-sheet activities. The credit equivalent of each such activity is then allocated to one of the five groups (for categorizing assets in) with risk weights. These are then totaled up with the risk-weighted assets of the balance sheet for purpose of the capital adequacy ratio. To obtain the Basle capital adequacy ratio, the total capital funds (net working funds) of a bank is then divided by this total of the risk-weighted assets form the balance sheet plus the risk-assessed off-balance-sheet activities (Lee 1992: 259).

The operational significance of the capital cushion is that it is a potential line (or component) of defense against abnormal financial pressures that may occasion a sudden and relatively high level of realized losses. Freeman (1952) was the first to recognize explicitly this specialized function of capital adequacy. A bank's capital adequacy position is part of the overall prudential constraint system that should help

dictate the level and kind of risk exposure a bank may safely assume throughout the period of its financial plan (Gardener 1986: 235).

Adequate capital is essential to allow banks to withstand significant losses arising from their lending and other activities and to limit the potential liabilities of public agencies in the event of failure of an institution in the United States. Bank supervisors have, therefore, continued their coordinated efforts to reverse the decline in capital adequacy level, which had been evident in the late 1970s in many national groups of banks. Together with market pressures, these supervisory initiatives have resulted in a substantial increase in the capital and reserves of many banks (Ye 1992: 9).

Capital is a bank's most important source of funds because it is the buffer against any loss that might occur. At the same time, it is free from any obligations. However, the adequacy of bank capital is a dynamic concept. Capital adequacy is influenced by the prevailing and expected economic conditions of the entire economy and of the specific areas served by the bank, the quality and liquidity of the bank's assets, and by the quality of the bank's management. If a bank operates in a flourishing economy and its assets are of excellent quality, possesses adequate liquidity in relation to deposit volatility, and its management is sound, then, a small amount of capital would be adequate for the maintenance of solvency. However an unfavorable change in any of these factors would increase the possibility of insolvency and thereby necessitate additional capital.

The underlying philosophy behind bank capital adequacy is usually based on three aspects, namely, (a) strengthening the institution's structure, (b) protecting the depositors against the risks and potential losses to which the bank may be exposed, and which cannot be covered in other ways such as through current profits or central bank liquidity, and (c) maintaining a general confidence in the banking system. Out of these three functional roles, the second and the third functions of bank capital are really the core of the capital adequacy debate. There is practically unanimous agreement that the most important and basic functions of capital adequacy are to provide a "cushion" against unexpected losses for the protection of depositors and to maintain a general confidence in the banking system.

Most of the countries in the South-East Asian Central Banks (SEACEN) region also view capital as a long-term zero interest cost fund, which can support and cushion the financial institutions against a large proportion of non-interest bearing assets, such as fixed assets and NPLs. It is also viewed as a cushion against contingent losses. Accordingly, the philosophy of bank capital adequacy in some of the SEACEN countries is based on the concept of "free capital" defined as the shareholders funds less commitments in fixed assets (Adhikary 1998: 2).

In many banks, general provisions against losses (i.e., provisions made not in respect of specific known or expected losses but on account of possible future losses) have also been increased. In most countries, such general provisions are included as part

of bank capital but specific provisions are not (Harrington 1987: 71). The provisions are made against anticipated losses, such as the NPLs.

3.5.5 Reserve for Loan Loss

Closely linked with the assessment of banks' capital adequacy is the valuation of banks' assets. While current profits are a first protection against losses, banks also need adequate reserve to withstand potential losses, including those arising from cross-border exposure. While increasing their general capital and reserves, banks in many countries have also reserved against exposure to individual debtor countries. In Canada, Switzerland and the United States, supervisors are involved in setting mandatory provisioning levels. There are instances where some banks build up their reserves beyond such levels.

Banks' ultimate ability to absorb losses is not mainly a function of average national provisioning percentages. It depends among others on the scale and distributions of a bank's credit exposure, the total capital and available to withstand sudden market reactions (Ye 1992:10).

3.5.6 Adequate Bankruptcy Law

Although the insolvency laws of countries differ in important respects, most systems share two objectives. The first is to allocate risk in a predictable, equitable, and transparent way, thereby bolstering confidence in the credit system; the second is to maximize the value of the insolvent entity.

The first objective needs to be seen from a number of different perspectives. In terms of the creditor-debtor relationship, a creditor's right to initiate insolvency proceedings against a debtor as a means of enforcing his claims reduces lending risks and therefore results in an increase in available credit. The allocation of risk among creditors is also important—for example, by affording secured creditors special treatment vis-à-vis unsecured creditors, the law can protect the value of security, which, in turn, benefits those borrowers that cannot afford or obtain unsecured credit.

However, the allocation-of-risk rules set forth in insolvency laws will create confidence in a country's credit system only if they are applied in a consistent manner by the individuals and institutions charged with implementing them. Although countries make different policy choices as to how risk should be allocated, experience demonstrates that participants are able to manage this risk if the rules are applied predictably.

The allocation of risk must also be perceived as being equitable. Unlike secured-transactions law, an insolvent law is designed to address a debtor's inability to pay its creditors as a group, not individually. Because the application of the law sets in motion a collective proceeding, creditors must have confidence that they will be treated equitably vis-à-vis other similar situated creditors. The law should therefore address the problems of fraud and creditor favoritism that often arise.

The second objective, the protection and maximization of value, is most obviously pursued in rehabilitation proceeding, where value is maximized through the continuation of a viable enterprise. But it is also a primary objective of procedures that liquidate enterprises that cannot be rehabilitated. Liquidation proceedings can maximize value by imposing a stay on creditor actions so as to prevent premature dismemberment and appointing a liquidator whose primary duty is to maximize the value of the estate for the benefit of all creditors.

The pursuit of either objective often increases the likelihood that the other will also be achieved. For example, the authority given to a liquidator to nullify fraudulent or preferential transactions and transfers that occurred before the commencement of the proceedings both ensures that creditors are treated equitably and enhances the value of the estate (Hagan 2000).

3.6 RESTRUCTURING THE NONPERFORMING LOANS

Countries have pursued a variety of approaches to deal with NPLs.

3.6.1 The Role of Central Bank in Bank Restructuring

Dziobek and Pazarbasioglu (1997) have conducted a study on 24 selected countries to look at the lessons learnt from systemic banking restructuring. The designation of the central bank as the provider of liquidity support was limited in countries that were most successful in their systemic restructuring operations. This may partly reflect the fact that where there was a broad political consensus for comprehensive restructuring, it was carried out by specialized agencies to allow the central bank to

continue to focus on its main function of implementing monetary policy. In particular, the authorities that achieved the best results determined at an early stage that the problem was bank insolvency, not lack of liquidity, and they precluded extensive use of lender of last resort facilities. In contrast, all of the slow progress countries made extensive use of central bank instruments and in all of these countries the central bank was the only agency responsible for bank restructuring. Thus, it can be inferred that best practice policy is to minimize reliance on the central bank as a source of protracted liquidity support.

By contrast, the sample results also suggested that it was necessary for the *central bank to take the lead* in transition countries. It appears that this choice has been strongly influenced by the limited availability of skilled human resources. Given the scarcity of banking expertise in the public sector, the central bank may be the only agency capable of handling the technical details of bank restructuring.

Loan workout units (central bank-based or bank-based) played an important role in all countries that made substantial progress in resolving systemic banking problems while only about 70 percent of the slow progress countries established loan workout schemes. It can be inferred here, too the use of loan workout units appears to be an important element of best practices (Dziobek and Pazarbasioglu 1997: 26-27).

Many countries have established bank restructuring agencies to deal with NPLs, where the bank restructuring agencies can clean up loan portfolios and restructure bank management and operations.

The central bank must stand ready to provide liquidity support during restructuring to viable banks. Many countries used temporary or permanent reduction of reserve requirements, broad application of discounting facilities or short-term loans as a means of providing liquidity. The central bank should not provide long-term financing to banks, nor should it be involved in commercial banking activities, as this exceeds its financial resources and leads to quasi-fiscal costs.

3.6.2 Bank Restructuring Agencies

In developing a strategy for restructuring banks, the following issues are considered:

- (1) Arrangements for loan recovery and workouts and management of problem loans.
- (2) Decisions on who will do the valuation of assets, and on the valuation rules to be applied, including loan classification, loan-loss provisioning, and collateral valuation.
- (3) Methods to deal with the troubled institutions (liquidation, mergers, nationalization, use of bridge banks, or purchase and assumption operations)
- (4) Institutional and legal framework for the restructuring, including the allocation of qualified human resources, and
- (5) Timeframe for the different steps in bank restructuring.

The allocation of responsibilities for handling the restructuring was a crucial first step in the strategy. Governments may put in place a variety of institutional structures of bank restructuring agencies to deal with NPLs in the banking system (See Table 3.3).

Table 3.3: Comparison of Key Indicators and Policy Reactions in Four Asian Countries

	Malaysia	Indonesia	Thailand	South Korea
Latest NPL ratio (% of total loans)*	6.6% (Dec 1999)	57.0% (Dec1998)	38.5% (Dec1999)	8.2% (Sep 1999)
IMF assistance	Not applicable	USD 42.3 bn	USD 17.2 bn	USD 57 bn
Financial institutions closed, merged or nationalized	2 banks merged with stronger banks	66 banks closed; 4 state banks merged; 14 banks taken over by IBRA	56 financial companies and 2 banks nationalized	5 banks closed; 2 banks nationalized
Approach	Danamodal recapitalizes banks; Danaharta removes NPLs; CDRC facilitates corporate debt restructuring	IBRA handles restructuring and rehabilitation of banking sector, including bank recapitalization and NPL resolution	FRA disposed assets of closed financial companies via auction; Thai AMC acts as bidder of last resort; 10 banks (both state-owned and private) have set up their own AMCs	Korea Deposit Insurance Corporation recapitalizes the banks; KAMCO removes NPLs.
CDRC = Corporate Debt Restructuring Committee IBRA = Indonesian Bank Restructuring Agency FRA = Financial Restructuring Agency KAMCO = Korean Asset Management Corporation *Malaysia reports NPLs on a net basis while the others report on a gross basis. Source: Danaharta Annual Report 1999				

3.6.3 Separation of the Management of NPLs from the Originating Bank

One choice faced in a restructuring program is to separate the management of NPLs from the originating bank. A bank preoccupied with managing NPLs may become very risk-averse, with little time or inclination for new lending. It is easier to give separate transparent goals if different people are charged with the ongoing banking operations and the resolution of bad loans.

a. Sharing the Recovery of NPLs

One possibility is for a government agency to buy the NPLs from the bank but for the bank to keep managing them. The two will then share any value recovered. However, it is hard to devise such arrangements in a manner that gives the selling bank a strong incentive to pursue the borrowers very diligently (Hawkins and Turner 1999: 68).

b. Setting Up Asset Management Companies

The value of impaired loans may be better preserved through careful management and gradual sales by special institutions (which are referred to as asset management companies in this paper). The asset management companies set up in the countries badly hit by the Asian financial crisis in mid-1997 are:

- (1) Indonesia—Indonesian Bank Restructuring Agency (IBRA) became fully operational in April 1998 within Indonesia

- (2) South Korea—Korean Asset Management Corporation (KAMCO) was reconstituted as an asset management company in late 1997
- (3) Malaysia—Pengurusan Danaharta Nasional Berhad (Danaharta) was established in mid-1998
- (4) Thailand—Financial Restructuring Agency (FRA) was established on October 24, 1997, to deal with suspended finance companies. An asset management company was set up to act as bidder of “last resort” for assets of closed financial companies.

The asset management companies can be categorized into two types: Centralized and Decentralized asset management companies. The advantages and disadvantages of dealing with NPLs in a centralized and decentralized asset management company should be considered by each country before they choose to adopt one. The elaboration is addressed in Appendix C.

However, it is vital not to “park” severely impaired assets for years in asset management companies while waiting for an economic upturn. Such an approach may result in accrual of carrying costs and ultimately bigger losses. Poor management of the assets, on the other hand, may result in deterioration of their value. Thus, it is important to move the better quality loans to other operating institutions as fast as possible.

The final results of the various strategies will only be known when the process of recovering impaired assets has been completed. This process will take time. However, it would be unwise to undertake massive sales of assets in the midst of the crisis. Practical problems—such as the need to acquire proper legal title to collateral and to prepare an inventory of the assets—require time to be solved (Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 37). Nonetheless, sales of impaired assets have begun in South Korea, Malaysia, Thailand and Indonesia.

3.6.4 Merger and Purchase and Assumption (P & A) Arrangements

In a merger (or sale), all the assets and liabilities of the firm are transferred to another institution. Mergers can be voluntary or government assisted. A key issue is to avoid situations in which a merger of weak banks results in a much larger weak banks, or in which an initially strong bank is substantially weakened.

Domestic mergers and takeovers often constitute the least costly way of restructuring the banking system. In many cases, a consolidation of the banking system may be desirable even without the impetus of a crisis: the economy may be “overbanked” and some banks may be inefficient. Mergers alone can remedy isolated problems in small banks. A large well-capitalized bank can readily absorb any NPLs thus acquired; and the quality of management can be improved (Hawkins and Turner, 1999: 75-76).

The quality of loan portfolio could be raised by acquisition or merger. In the United States for example, the Federal Deposit Insurance Corporation (FDIC) removes the low quality credits from the loan portfolio and agrees to take bank loans that decline in quality after the acquisition is executed. In some other cases, the FDIC does not take any of the low-quality loans, but instead, provides the acquiring institution with sufficient resources to charge off the NPLs.

An acquiring bank can limit its exposure to low quality loans on the acquired bank's book. Often, the acquired bank is required to charge off troubled loans before the acquisition is executed. In other cases, the acquired bank establishes a collecting bank to hold the troubled loans. The collecting bank is capitalized by the shareholders of the acquired bank to isolate the effects of the problem loans from the acquiring bank or bank holding company (Clair 1992: 11-12). In the case of a merger between equals, the loan quality of the combined bank will be the average of the loan quality of the two banks, weighted by their relative sizes. In this case, loan quality is less likely to change substantially, and thus the NPLs can be better managed in a merged bank.

In a Purchase and Assumption (P & A) operation, a solvent bank purchases a portion of the assets of a failing bank, including its customer base and good will, and assumes all or part of its liabilities. In a publicly supported P&A operation, the government typically will pay the purchasing bank the differences between the value of the assets and liabilities. Variation of P&A operations could be a purchase of

assets, entitling the acquiring bank to return certain assets within a specified time period, or a contractual profit/loss-sharing agreement related to some or all the assets. P&A operates in the context of bank resolution can involve the liquidation or transfer of bad loans to an asset management company.

A variation of a P&A operation involves the use of a temporary financial institution—a bridge bank—to receive and manage the good assets of one or several failed institutions. The bridge banks may be allowed to undertake some banking business, such as providing new credit and rolling over existing credits (Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 17).

The FDIC of the United States has two basic resolution methods at its disposal: purchase and liquidations. With either method, the FDIC removes the effect of NPLs and other troubled assets from the bank. In a P&A transaction, which is used in most bank failure cases, a prearranged buyer takes possession of the good assets from a failed bank. The FDIC retains the failed bank's troubled assets, including NPLs. The buyer acquires a broad base of revenue-generating assets, thus improving the buyer's own prospects for profitability (Yeats 1991: 16-17).

3.6.5 Speed of Disposing NPLs

The strategy for managing and disposing of NPLs will need to consider the speed of disposition of the asset and whether to use a centralized or decentralized process and institutional framework. The speed of disposition is determined by the quantity,

quality, and type of assets; market demand for such assets; and whether the assets belong to a bank that has been closed or to one in operation (Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 35).