CHAPTER 4: NONPERFORMING LOANS IN MALAYSIA, INDONESIA AND SOUTH KOREA

This study examines the NPL problem in Malaysia, Indonesia and South Korea from 1980s to the present. These three countries are chosen to shed light on the nature and magnitude of the NPL problem as well as the different measures that have been used to resolve them.

Compared to other South-East Asian countries (e.g. Indonesia and Thailand), Malaysia is actively reforming its banking industry. To deal with its NPL problem, it has adopted institutional reform program that is distinctively different from the IMF's prescription. During the 1980s and the recent financial crisis, Indonesia undertook a large devaluation of its currency and underwent a severe economic depression. Consequently, its banking system faced greater problems compared to Malaysia and Thailand. Indonesia is chosen in this study to examine the severity of its NPL problem and its method of resolution. South Korea is another interesting country to study because of the presence of heavy government intervention in the banking sector. Tight government control was claimed to bring about the NPL problem in South Korean's banking and financial system. Therefore, the dimension of the problem in South Korea is rather different from that of Malaysia and Indonesia.

4.1 MALAYSIA

4.1.1 Overview

The traumatic events of the 1985/86 economic crisis were as much a shock to bank management, as to their borrowers. Throughout the preceding two decades, the Malaysian banking system had enjoyed a period of arising profits, with pre-tax profits peaking at nearly RM 1 billion in 1984. In a period of uninterrupted growth and rising property values, bad loans were negligible, and as late as 1983, specific and bad debt provisions averaged only 1-1.5% of total loans. Foreclosed property could then easily be sold at values higher than loans outstanding. However, with RM 37.3 billion wiped off stock market capitalization and property prices falling under selling pressure, the banks began to face the specter of rising NPLs and bad and doubtful debts in 1985/86 (Sheng, 1989: 11).

However, the Malaysian banking system strengthened considerably following the crisis of 1985-88, owing to very rapid economic growth, buoyant share and property prices, and the enactment of strict prudential regulations. Asset quality improved substantially – the ratio of NPLs to total lending fell from a peak of 35% in 1987 to 3.6% by mid-1997 (World Bank 1997).

Beginning with the emergence of the financial crisis in Thailand in mid-1997, Malaysia experienced increasing turbulence in financial markets. The prolonged financial crisis and subsequent contraction of the economy led to some deterioration in the quality of the asset portfolio of the banking institutions, with the net NPL to total loans ratio increasing to 8.9% as at end-June 1998 (BNM Annual Report 1998).

Data on NPLs to total loans and total provision to NPLs are available only from 1998. The IMF (1998) stated that the peak of NPLs in financial sector between the year 1985 and 1988 was 33% (as a percent of total loans). The ratio declined gradually from 1988 to 1997, but increased again in 1998 (see Table 4.1 below).

Table 4.1: Malaysia: Outstanding Loan Provisions and NPLs of the Banking System*

End of period	Ratio of NPLs to Total Loans (%) [1]	Ratio of Total provisions to NPLs(%)[2]
1988	30.1	47.6
1989	24.8	60.3
1990	20.0	65.2
1991	15.4	68.6
1992	14.5	65.8
1993	12.3	72.3
1994	7.8	79.2
1995	5.5	85.1
1996	3.7	96.6
1997	4.1	151.4
1998	8.2	142.0
1999	7.9	182.8
2000	6.6	207.7

*Based on 6-month classification
[1]Total Loans = Outstanding gross loans (including housing loans sold to Cagamas Berhad)
[2]Four months' average (until April 2000)
Source: Monthly Statistical Bulletin, BNM (2000)

4.1.2 Factors Contributing to the NPL Problem under 1985/86 Economic Recession

4.1.2.1 Over-exposure to the Property Sector

The deterioration in asset quality from the economic crisis had been compounded by the banking industry's over-exposure to the property sector (which rose from 26.4% in 1980 to 35.9% in 1986 as a percentage of total loans). This deterioration in asset quality was partly due (given the policy mix) to the unsustainable pace of expansion of the non-traded goods sectors, poor management and even fraud.

4.1.2.2 Inadequate Guidelines for Suspending Interest and Specific Provisions on NPLs

Guidelines for suspending interest and making specific provisions on NPLs were adopted only from the mid-1980s. In the absence of these guidelines, the resultant over recognition of interest income and under provisioning in the first half of the 1980s, aggravated the problem of NPLs and hence the banking crisis when the new guidelines were adopted from the mid-80s (Thillainathan 1997: 48).

4.1.2.3 Moral Hazard Problem

From the mid-1980s, the government has ensured, with very few exceptions, that there were no rescues of shareholders or managers of insolvent banks. However, depositors have always been rescued. This has meant that the Malaysian banking industry has been exposed to the problem of moral hazard, namely of bankers having an incentive to engage in more risky lending (Thillainathan 1997: 44). This meant possible encouragement of NPLs in the banking and financial system.

4.1.2.4 Effects of High Interest Policy

The bank restructuring exercise of tightening monetary policy by raising interest rates had the effect of worsening the NPLs of the banking system, as private sector borrowers could not service the high real interest rates from current cash-flow (Sheng, 1989:17).

4.1.2.5 Problem of Transparency

Many ailing financial institutions management were reluctant to recognize and report an accurate picture to the regulatory authorities once they began to face a deterioration in their performance, including disclosure of NPLs (Sheng 1989).

4.1.3 Resolution of the NPL Problem under 1985/86 Economic Recession

Major steps were taken during the 1980s towards the prudential regulation of the banking industry, to deal with mounting NPL problem.

4.1.3.1 Regulatory Changes to Strengthen the Structure of Banking System

The Central Bank put into place in 1985/86 a number of changes designed to strengthen the banking system and its own regulatory powers to prevent and control damage arising from the recession and to tackle the rising NPL problem. These including key changes to the banking law and regulation to achieve the following (Sheng 1989: 18):

a. Introduction of the ***minimum capital adequacy requirements*** to be maintained by the commercial banks. This had the effect of raising the average capital ratio of Malaysian banks from 7.4% of total assets at the end of 1984 to 8.1% at the end of 1987 (Sheng 1989: 18). In line with the Bank Capital Accord of July 1988, the new guidelines required local and foreign banks to maintain a risk-weighted capital ratio (RWCR) of 8% and 10% respectively by end of 1992 and attain an intermediate target of 7.25% and 9.25% by end of 1990 (Thillainathan 1997).

b. ***Restriction of bank credit to single customers*** to not more than 30% of shareholders' funds, to prevent the over-concentration of loans in any particular sector or customer.

c. Introduction of ***guidelines on suspension of interest on NPLs and provisions on bad and doubt debts*** on November 1 1985. This was to ensure that the financial community followed sound, consistent and prudent lending policies, and to standardize the accounting treatment of income from overdue loans and provisions. The default period for classifying a loan as nonperforming was 12 months (BNM 1989). Until the end of 1989, the guidelines required that the interest be suspended only if the loan had been nonperforming for 12 months. However, on all such NPLs, the guidelines required a claw-back to day one of interest income which had been recognized but had not been collected. With effect from 1 January 1990, the claw-back requirement was abolished, but interest had to be suspended on all loans which had been nonperforming for 6 months or more. The default period for classifying loans as nonperforming has been lowered from 12 months to 6 months (BNM Annual Report 1998).

The required loan loss provision (in respect of all loans outstanding in excess of the market value of the assets pledged) was set at zero for a substandard loan, 50% for a doubtful account and 100% for a bad account. The period of default beyond which a worse-off classification (i.e. bad loan) was required was set at 12 months for a substandard loan and 24 months in respect of a doubtful account (BNM 1989).

d. Establishment of a Central Credit Bureau to ***monitor and improve credits information*** on bank and finance company customers on a consolidation basis.

e. ***Improved statistical reporting*** to the Central Bank, such as regular reporting on size of NPLs, exposure to share and property financing, loan margins, and bank productivity, through computerized data input.

f. ***Improved on-site bank examination capacity***, by strengthening the bank examination staff force and conducting more frequent bank examinations.

4.1.3.2 The Rescue of Problem Banks.

In general, the stance of the Central Bank (BNM) in a rescue package was as follows:

a. To require the ailing institutions ***to recognize all losses and interest in suspense immediately***, rather than attempting to stagger such losses by deferring the problem (Sheng 1989).

b. To ***change management***, by first revamping the Board of Directors and then appointing tested professionals to serve as chief executives, and thereafter to give more or less full discretion to the appointed Board to do whatever is necessary to stem the losses and turn around the institutions (Sheng 1989). Once the fortunes of the bank have been revived, then new shareholders can be found to take over the bank and thereafter repay BNM's loan (Thillainathan 1997:41). This approach helped to lessen the NPL problem.

c. To ***write-off NPLs***. The write-offs of NPLs in the banking system in 1986 have amounted to 22% of Gross Domestic Product (GDP).

d. To require existing shareholders to ***inject as much capital as possible*** through a rights issue, and to supplement such capital requirements through BNM; and

e. To ***tighten reporting requirements*** of the ailing institution in "intensive care" to the Central Bank through regular reviews and discussion, including follow-up inspections.

The legislative framework for the supervision of the banking institutions was further strengthened, following the review of the various banking legislation in the aftermath of the 1985-86 recession. The Banking and Financial Institutions Act 1989 (BAFIA), which came into effect in October 1989, provided a framework for an integrated supervision of the Malaysian financial system (BNM Annual Report 1998).

Although many financial institutions (FIs) made losses during the period of mid-1980s, the ailing FIs which had to be rescued through takeovers, mergers or soft loans were not many. Those that required to be rescued numbered 5 from amongst 37 commercial banks, 7 from amongst the 47 finance companies, and one from amongst the 12 merchant banks (Sheng 1989). Nevertheless, an asset management company was not set up to purchase the NPLs in 1980s banking crisis. This may be because the crisis did not cause widespread banking failures and severe corporate insolvency.

4.1.4 Factors Contributing to the NPL Problem: Mid-1997 Financial Crisis

Malaysia experienced from late 1997 a severe and unexpected recession after consistent and very strong growth for more than a generation. The devaluation of the Thai Baht in July 1997 triggered recurrent rounds of currency depreciation affecting the Malaysian economy during the remainder of the year. Unprecedented slump in output and corporate profitability put the banking system under severe stress. The proportion of loans that have become impaired during the banking crisis has increased substantially. The following are some of the factors contributing to the NPLs during that period:

4.1.4.1 Banks' Exposure to Property Sector: Excessive Credit Expansion

The most prominent area of banking troubles, especially the NPL problem, is the property sector (See Table 4.2 for comparison with other countries). However, it is not simply the size of the banks' exposure to the property sector, but the basis on which these loans have been extended. Banks have much too often judged the creditworthiness of a property loan by the perceived value of its collateral rather than the economic vulnerability. Moreover, the valuation of collateral has often been too optimistic and the loan too generous given the downside risk to the collateral's value. On this score, banks in Malaysia are clearly in trouble (Eschweiler, 1998).

Table 4.2: Malaysia: Banking Risk

	Malaysia	Indonesia	South Korea	Thailand
Property sector risk	High	High	Moderate	High
Exposure(% of total loan)	30-40	25-30	10-15	30-40
Loan/collateral (%)	80-100	80-100	60-100	80-100

Source: Eschweiler, J.P.Morgan, 1998

increased substantially. The following are some of the factors contributing to the NPLs during that period:

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Source: Eschweiler, J.P.Morgan, 1998

4.1.4.2 Structural Vulnerabilities.

The combination of the economic slowdown, decline in asset values (particularly property and stock market securities), rising interest rates and the depreciation in the ringgit severely affected credit performance and bank profitability. Tight liquidity conditions and segmentation of the interbank money market also contributed to narrow interest spreads, especially for finance companies, and eventually caused a growing level of NPLs in many financial institutions (FIs) (Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 39).

4.1.4.3 Too Much Powers to the Ministry of Finance

One area of uncertainty in the implementation of the prudential framework related to the fact that BAFIA provided broad exemption powers to the Ministry of Finance (MoF)—albeit formally at the recommendation of BNM—with regard to individual prudential regulations, such as lending to connected parties and large exposure limits. There are, however, no reports of systemic or widespread use of this power (Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 81).

4.1.5 Resolution of the NPL Problem : mid-1997 Financial Crisis

4.1.5.1 Prudential Measures: Amendment on Loan Classification and Provisioning Guidelines

With effect from financial year beginning January 1998, regulations pertaining to the classification of NPLs and provisioning requirements were tightened. The classification period for NPLs was shortened from 6 months to 3 months, an acceleration of the classification of "doubtful" loans from 12 months overdue to 6 months, and "bad" loans from 24 months to 12 months; the minimum requirement on general provision was increased from 1% to 1.5% of total outstanding loans (including accrued interest), net of interest suspended and specific provision for bad and doubtful debts. In addition, banking institutions were required to provide 20% specific provisions against uncollected portion of substandard loans.

However, the prolonged financial crisis and the subsequent contraction in economic activities had created strains in the intermediation process. The tightening of the NPL classification period at times when uncertainties were rising, coupled with higher interest rates led to many banking institutions over-focussing on managing the rising NPLs as well as erosion in their capital. To address the structural distortions brought about by the untimely tightening of the NPL classification revision, in September 1998, the earlier tightening of the classification of loans as nonperforming was relaxed to 6 months. Nonetheless, other prudential requirements relating to the suspension of interest, provisioning requirements as well as classification of NPLs as bad were retained (BNM 1999).

Effective March 24, 1999, BNM amended its loan classification and provisioning guidelines again. The results are shown in the table below:

Table 4.3: Malaysia: Loan Classification and Provisioning 1999

Classification	Period of default	Specific Provision
Substandard	6-9 months	20%
Doubtful	9-12 months	50%
Bad	Over 12 months	100%

Source: BNM 1999

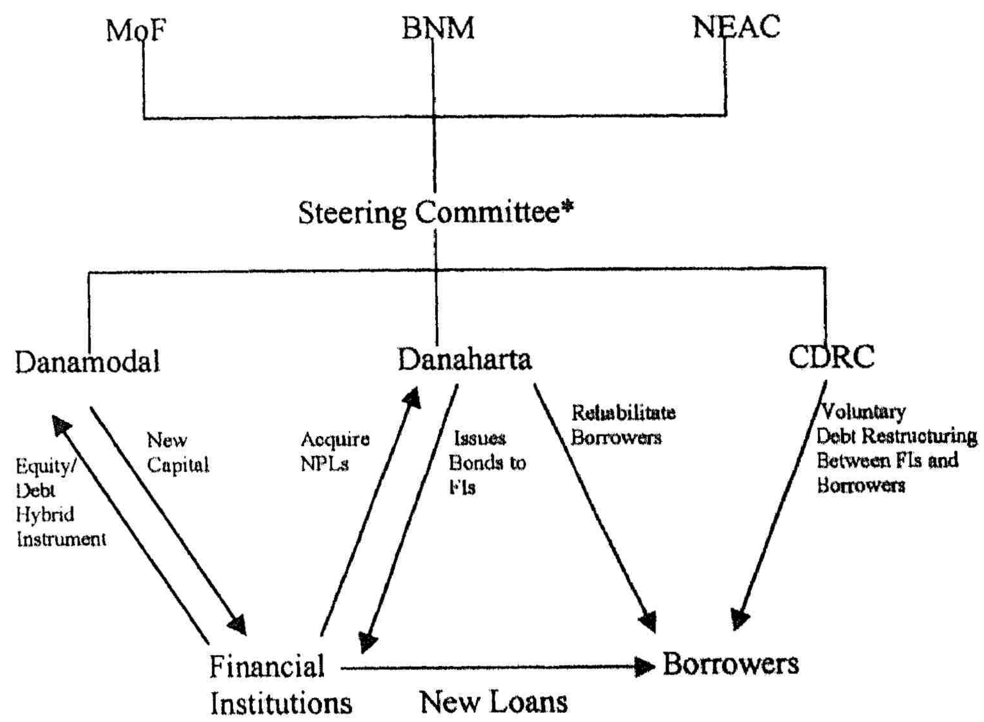
4.1.5.2 Institutional Reform in the Malaysian Banking Sector.

- **Institutional Framework.**

In January 1998, the Malaysian government set up the National Economic Action Council (NEAC) to prepare the National Economic Recovery Plan to supposedly guide the country out of the deepening financial crisis and towards recovery (Danaharta 1998).

In order to restructure and revitalize the banking system, Pengurusan Danaharta Nasional Berhad (Danaharta) and Danamodal Nasional Berhad (Danamodal) were established in June and August 1998 respectively, whereas the Corporate Debt Restructuring Committee (CDRC) was established about concurrently (in August 1998) to restructure the distress corporate debts. Operating framework of these three agencies is attached in Chart 4.1 and outlined below:

Chart 4.1 – Malaysia: Overview of Institutional Framework



* Coordination of activities undertaken by Steering Committee in BNM

Source: Danaharta 1998

- FIs restructure NPLs on their own or through CDRC.
- If voluntary restructuring under CDRC cannot obtain consensus among the FIs, Danaharta will assist in buying over NPLs from dissenting FIs.
- FIs rejecting sales of NPLs to Danaharta are supposed to write down collateral value immediately.
- FIs to be recapitalized by Danamodal must sell their NPLs to Danaharta to reduce their NPLs ratio to below 10%.

- All capital injection, which could take the form of equity, preference shares, subordinated loans or a mixture of any combination of the three, requires BNM's approval.
- After off-loading delinquent loans and strengthening share capital, FIs are supposed to be able to grant loans to sound borrowers and support the economic recovery (Lui and Tam, 2000).

The major operations of the agencies are described in the following sub-sections:

a. Corporate Debt Restructuring Committee (CDRC)

The CDRC was created with BNM's sponsorship to facilitate debt restructuring with major borrowers. CDRC was set up to provide a platform for both the borrowers and the creditors to work out feasible debt restructuring schemes without having to resort to legal proceedings.

CDRC – Workout Progress:

The CDRC has successfully completed, as at 2 May 2000, the restructuring of 21 cases involving debts worth RM 16 billion, whilst the restructuring schemes for another 25 cases with debt worth RM 16.2 billion are still being worked out (BNM 2000).

Table 4.4: Malaysia: Operations of Corporate Debt Restructuring Committee (As at 2 May, 2000)

Application	Number of Cases	Amount (RM million)
Received	69	36,928.6
Withdrawn/Rejected	14	2,945.5
Transferred to Danaharta	9	1,813.5
Resolved	21	15,951.0
Outstanding	25	16,218.6

Source: BNM Press Release, 2000

b. Danaharta

In view of the NPL problem in the banking sector, the Government established Danaharta, as an asset management company (AMC), to purchase NPLs from the financial system and to enhance recovery values of impaired financial assets through proactive asset management. Danaharta is modeled after Sweden's AMC—Securum. The life cycle of Danaharta comprised four phases: (i) establishment (ii) acquisition (iii) loan and asset management (iv) exit phase (loan and asset disposal). Danaharta is expected to have a life span of 7-10 years (BNM Annual Report 1998).

Establishment:

During the establishment phase, the government resolved pushed through legislation that gave Danaharta special powers outlined below:

The Danaharta Act (1998) confers on Danaharta two special powers:

a) to buy assets through statutory vesting which allows Danaharta to step into the shoes of the selling bank, take the same interest, and enjoy the same priority as the selling bank, subject to registered interests and disclosed claims.
b) to appoint Special Administrators ("SA") to take over the control and management of distressed companies without court permission. In order to preserve assets, a 12-month moratorium immediately takes effect. No creditors may take action against corporate borrowers. Subsequently, the SA will prepare a workout proposal for an Independent Advisor to review the positions of all

creditors and shareholders. The proposal is for the approval of Danaharta and creditors thereafter.

NPLs Acquisition:

Backed up by the special regulatory power, Danaharta is able to acquire and manage NPLs as well as assets in an efficient, economical and effective manner.

Funding Needs: Danaharta estimates its funding requirements to be RM15 billion

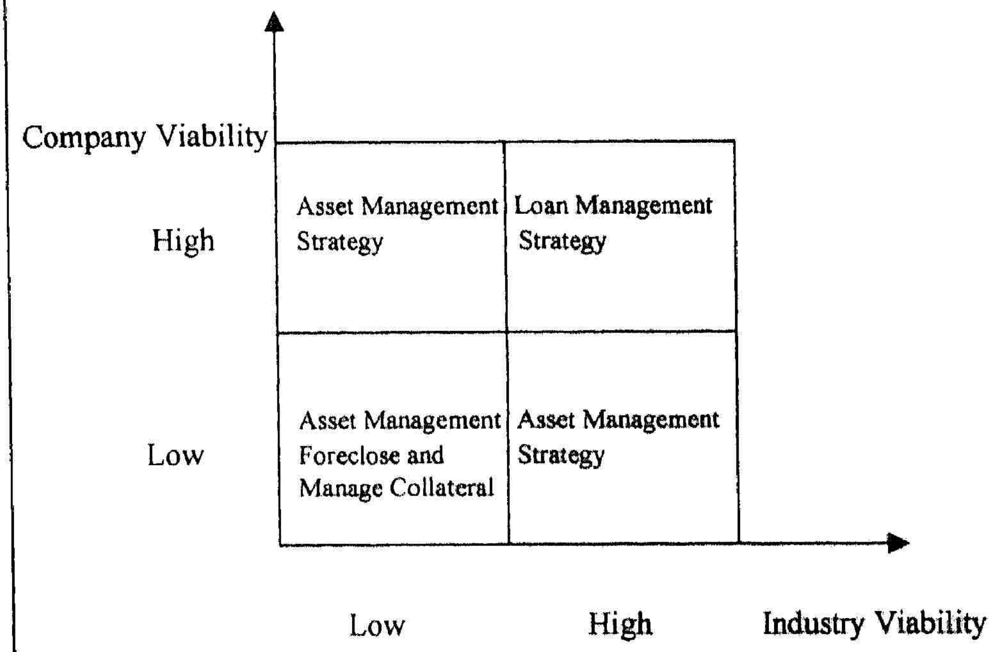
Valuation of NPLs: NPLs are valued based on current market values of collateral determined by professional appraisal reports in the case of secured NPLs whilst 10% of outstanding principals in the case of unsecured NPLs.

Profit-sharing: Any excess recovery of NPLs over acquisition cost will be shared by the FIs concerned and Danaharta on a 80:20 basis. Any banks declining an offer from Danaharta must make a provision that brings the NPL's value down to 80% of its offer price (Danaharta 1998; 1999).

Loan / Asset Management and Disposal:

When acquiring an NPL, Danaharta will first assess the viability of the loan in accordance with the viability of the underlying industry and corporation (Chart 4.2). For viable loans, Danaharta will undertake Loan Management strategies whereby it will seek to rehabilitate or restructure the loan by rescheduling or debt-equity swap. If necessary, Danaharta may further provide working capital to the distressed company to keep the viable business operating (BNM Annual Report 1998; Danaharta 1999). Where the NPL is not viable or if the Loan Management strategy fails, Danaharta will employ Asset Management strategies by either managing the distressed borrower or the underlying collateral.

Chart-4.2: Asset Management – Loan vs. Asset



Performance of Danaharta:

As at 31 March 2000, Danaharta had acquired and is managing NPLs with loan rights amounting to RM 46.6 billion from the banking system. The book value of the loans removed from the banking system amounting to RM 35.1 billion, constituted approximately 42% of NPLs in the banking system. As a result, the net NPL ratio of the banking system has declined to 6.5% on a 6-month classification as at end-March 2000 (BNM 2000) (Table 4.5), from the peak of 9% (based on 6-month classification) as at end-November 1998 (BNM Annual Report 1999).

Table 4.5: Malaysia: Capital and Net Nonperforming Loans Ratio of the Banking System

	End-1998	Dec-1999	March 2000
Capital **Core Capital (%)** **RWCR (%)**	8.7 11.8	10.0 12.3	10.4 12.8
NPL (6-month classification) **Net NPL ratio (%)** **Net NPL (RM b)**	7.5 29.3	6.6 24.3	6.5 24.4

Source: BNM Press Release 2000

c. Danamodal

Danamodal Nasional Berhad (Danamodal) was instituted as a Special Purpose Vehicle (SPV) in 10 August 1998 to recapitalize banking institutions in Malaysia. It is to assess the capital deficiency in the banking industry, then quantify the amount required for the banks to handle the crisis-caused ordeal. Afterwards, Danamodal assumes the role injecting new capital into the banking sector via trading of bonds.

With that in mind, the functions of Danamodal are four-fold: i) to establish methodologies and tools to assess recapitalization requirements; ii) to conduct due diligence and gather data to evaluate the net realizable asset value of banks; iii) to establish framework to assess capital needs; and iv) to quantify capital needs (Danamodal website 2000).

By the end-March 2000, Danamodal has injected a sum of RM5.2 billion into the banking sector to accommodate the essential changes (BNM 2000).

d. Merger Exercise

The banking crisis in the mid-1980s had clearly highlighted the vulnerabilities of the weaker baking institutions which were not adequately capitalized to withstand shocks. Against this backdrop, BNM has always recognized the importance of and the need for consolidation in the banking sector in order to attain the critical mass to meet the demands of the changing domestic economic structure, future challenges and liberalization as well as to contribute towards sustainable economic growth. During the economic boom in the late 1980s and early 1990s, calls for rationalization and consolidation were often ignored. Voluntary mergers were not forthcoming. Since the mid-1980s crisis, only two market-oriented mergers were successfully implemented, between Kwong Yik Bank Berhad and DCB Bank Berhad and between Chung Khiaw Bank (Malaysia) Berhad and United Overseas Bank (Malaysia) Berhad (BNM Annual Report 1999).

The sooner the domestic banking sector in Malaysia undergoes a consolidation and rationalization exercise, the more well-placed will the domestic banking sector be to meet future challenges. In this regard, the merger program for the finance company initiated in 1998 was extended to the domestic banking sector as a whole in 1999 (BNM Annual Report 1999). BNM announced its previous merger plan in August 1999, calling for the country's 58 financial institutions (21 commercial banks, 12 merchant banks and 25 financial companies) to merge by April 2000 into six anchor banks. BNM decided on the anchor banks –on the basis of what it called "financial resilience" –and which banks were to be grouped under them. The six anchor banks are Malayan Banking Berhad, Multi-Purpose Bank Berhad, Bumiputra-Commerce Bank, Perwira Arrifin Bank Berhad, Public Bank Berhad, and Southern Bank Berhad (Jayasankaran 1999).

The government later revised the plan, giving banks the flexibility to form their own merger groups and choose their own leader in each group to lead the merger process and revert to BNM by end-January 2000. In response to this approach, approval was granted for the formation of 10 banking groups to be led by Malayan Banking Berhad, RHB Bank Berhad, Public Bank Berhad, Bumiputra-Commerce Bank Berhad, Multi-Purpose Bank Berhad, Hong Leong Bank Berhad, Perwira Arrifin Bank Berhad, Arab-Malaysian Bank Berhad, Southern Bank Berhad and EON Bank Berhad (Table 4.6).

To ensure that the industry consolidation exercise is not delayed, BNM has set the target date of end-December 2000 for the completion of the entire consolidation exercise (BNM Annual Report 1999).

To recap, the plans and objectives of these mergers are (i) to accommodate the need for a substantial reduction in the number of domestic banks from 54 institutions; (ii) To reap the maximum synergy from the merger so as to improve the profitability and efficiency; and (iii) to ensure that each banking group is of a sufficient size, i.e., each banking group will attain minimum shareholders' funds of RM2 billion and asset base of at least RM25 billion (The Star 15/2/2000).

Table 4.6 Malaysia: 10 Anchor Banks for Merger Program

Anchor Bank	**Banking Institutions in group**
Malayan Banking Berhad	Malayan Banking Berhad Mayban Finance Berhad Aseambankers Malaysia Berhad PhileoAllied Bank Berhad The Pacific Band Berhad Sime Finance Berhad Kewangan Bersatu Berhad
Bumiputra-Commerce Bank Berhad	Bumiputra-Commerce Bank Berhad Bumiputra-Commerce Finance Berhad Commerce International Merchant Bankers Berhad
RHB Bank Berhad	RHB Bank Berhad RHB Sakura Merchant Bankers Berhad Delta Finance Berhad Interfinance Berhad
Public Bank Berhad	Public Bank Berhad Public Finance Berhad Hock Hua Bank Berhad Advance Finance Berhad Sime Merchant Bankers Berhad
Arab-Malaysian Bank Berhad	Arab-Malaysian Bank Berhad Arab-Malaysian Finance Berhad Arab-Malaysian Merchant Berhad Bank Utama Malaysia Berhad Utama Merchant Bankers Berhad
Hong Leong Bank Berhad	Hong Leong Bank Berhad Hong Leong Finance Berhad Wah Tat Bank Berhad Credit Corporation Malaysia Berhad
Perwira Affin Bank Berhad	Perwira Affin Bank Berhad Affin Finance Berhad Perwira Affin Merchant Bankers Berhad BSN Commercial Bank Berhad BSN Finance Berhad BSN Merchant Bank Berhad
Multi-Purpose Bank Berhad	Multi-Purpose Bank Berhad International Bank Malaysia Berhad Sabah Bank Berhad MBf Finance Berhad Bolton Finance Berhad Sabah Finance Berhad Bumiputra Merchant Bankers Berhad Amanah Merchant Bank Berhad
Southern Bank Berhad	Southern Bank Berhad Ban Hin Lee Bank Berhad Cempaka Finance Berhad United Merchant Finance Berhad Perdana Finance Berhad Perdana Merchant Bankers Berhad
EON Bank Berhad	EON Bank Berhad EON Finance Berhad Oriental Bank Berhad City Finance Berhad Perkasa Finance Berhad Malaysian International Merchant Bankers Berhad
Source: The Star 15/2/2000	

4.1.6 Vulnerabilities of the Malaysian Model in Resolving the NPL Problem

4.1.6.1 Capital Control Discourages Foreign Capital

Capital control introduced in Sept 1998 poses difficulties in NPLs disposal and recapitalization of FIs as domestic funding has been dramatically dried up. Moreover, during the financial crisis, foreign capital may be reluctant to enter Malaysia for the worry on capital outflow.

4.1.6.2 Under-developed Securitization Market

A wide and deep securitization market for Malaysian assets will surely speed up the off-load of the ultimate burden of Danaharta (loans and assets). However, the securitization market in Malaysia was mainly confined to mortgage loans, which were sold to Cagamas Berhad (National Mortgage Corporation) before 1998. Nevertheless, these were not strictly pass-through mortgage-backed securities as Cagamas had recourse to the sellers. Therefore, Danaharta will not effectively remove restructured assets from its balance sheet. Furthermore, after the financial turmoil, such "securitization market" has been adversely affected. Very few foreign investors are willing to take the currency risk of ringgit. Coupled with capital control, foreign investors are further deterred to enter the securitization market.

4.1.6.3 Inactive Market for Distressed Loans in the Asian Region

Relative to the U.S., the Asian market for distressed loans is far from matured. So far, access to the market is limited to quality and well-known borrowers with acceptable degree of credit rating and transparency. Therefore, it is uncertain that the NPLs acquired by Danaharta could be disposed of within a commercially viable timeframe and price range.

4.1.6.4 Credit Culture, Credit Assessment Standard and Credit Monitoring System

The framework of CDRC, Danaharta and Danamodal has done an exemplary job to reduce NPLs and recapitalize the entire banking system. However, it does not aim at cultivating credit culture, raising credit assessment standard and establishing an effective credit monitoring system of the banking sector. Until such credit management framework is fully developed, the NPL issue may not be fundamentally solved (Lui and Tam 2000).

4.1.7 Conclusion

With the interactive framework of CDRC, Danaharta, and Danamodal, ailing FIs are induced to sell their NPLs. Malaysia has thus effectively controlled the deteriorating asset quality of the banking system, significantly lowered the NPLs in the banking system, and successfully replenished the capital base of the banking sector within a one-year period. This institutional reform is expected to revitalize the Malaysia banking sector.

4.2 INDONESIA

4.2.1 Overview

In 1983, the banking industry in Indonesia was burdened by problem loans to the severely depressed textile and forest products sectors, but in 1986 both sectors rebounded (Hendrobudiyanto 1995). However, despite economic growth of over 6% annually since 1990, the problem of problem loans in the banking sector remains significant (Nasution 1995: 167).

According to the Central Bank Governor, total NPLs in the banking sector (comprising the "doubtful" and "bad" categories) amounted to 10.2% of total bank loans as of March 1994—a dramatic increase from only about 5% in 1991. The state banks, which carried the bulk of the NPLs, had no less than 13.5% of their loans in these categories; the private banks, only 5.7% (Habir 1995: 177).

Indonesia had by far the most severe banking crisis compared with all the other countries in the Asian region. It had the most number of banks in the region (238 before the crisis) and the highest level of NPLs (over 70% at its peak) during the crisis, and this was further compounded by persistent political turmoil. Indonesia had to take extreme measures to resolve the woes of its banking system (Danaharta 1999).

4.2.2 Factors Contributing to the NPL Problem: 1983-1994

4.2.2.1 Highly Concentrated Lending

The problem loans of state and private banks are concentrated on large firms, and conglomerates. Land is the main form of collateral for bank loans in Indonesia, and so the health of the banking system can be said to depend both on the capability and the willingness of these firms and conglomerates to repay overdue borrowings, and on the legal status and value of land used as security. Some of the conglomerates were facing financial difficulties, because deregulation has reduced their revenues (Nasution 1995: 152).

4.2.2.2 Tight Monetary Policy: High Level of Internet Rates.

The banking sector's rapid asset growth early in the period and the government's tight monetary policy in 1990-91 combined to bring about deterioration in bank asset quality. The tight monetary policy pushed up prime lending rates at the state banks from 20-21% per annum in 1989-90 to around 25% in 1991, and from 22-25% to over 28% at the larger private banks, placing severe financial stress on those sectors to which the banks were heavy lenders. As a result, total NPLs rose substantially from 5% in 1990 to 10.2% in 1994 (Habir 1994: 176).

4.2.2.3 Other Factors

Much of the bad loan problem—at the state banks in particular—has resulted from a combination of factors such as corruption, fraud and embezzlement, the weakness of borrower selection, the state banks' relative inability to administer and supervise loans and to recover overdue repayments (Nasution 1995: 152). NPL problem was also caused by poor bank management and improper credit assessment, resulting from strong competition in the banking sector following initiation of the deregulatory process (Hendrobudiyanto 1995: 167).

4.2.3 Resolution of the NPL Problem: 1983-1994

Several important steps have been taken to resolve the NPL problem, as discussed below:

4.2.3.1 Close Monitoring of the State Banks' Biggest Problem Loans

A State Bank Credit Supervision Committee was established in July 1993 to monitor the 50 largest borrowers from the state banks. This committee met on a monthly basis to review the progress of loan recoveries from these borrowers (Hendrobudiyanto 1995: 167)

4.2.3.2 Special Task Forces

In a further effort to tackle the problem loans, in March 1994, Bank Indonesia (BI) identified a group of banks with severe loan portfolio difficulties, and required each of them to establish a bad debt workout team (*Satu Tugasan Khusus*, or STK). These special teams are considered as temporary working groups, which would be dissolved at such time as BI determined that the NPL problem was properly under control. Each of the banks in the STK program has been requested to submit a report to BI detailing its efforts to improve existing documentation and the perfection of collateral in support of its problem loans (Hendrobudiyanto 1995: 168).

4.2.3.3 Active Monitoring of Loan Recovery Efforts

Special teams have been established in the bank supervision department within BI, to monitor the settlement of problem loans of the commercial banks. These loans were being analyzed and reviewed in order to determine the probability of their repayment or the potential for workout. When these data have been reviewed, BI and the Ministry of Finance would then take specific actions with respect to the most appropriate remedy (Hendrobudiyanto 1995: 168).

4.2.3.4 Recapitalization and Problem Loans

A need for recapitalization of banks was a practical implication of the new prudential standards. As the minimum capital required is directly linked to the quality of assets, the need for banks to raise capital has risen with the increasing volume of their problem loans (Nasution 1995: 149).

4.2.3.5 Prudential Regulations

New prudential regulations, the most extensive of which were introduced in February 1991, attempted to control the various risks assumed by banks. The capital adequacy ratio was required to be kept no lower than 8%. In addition, banks are required to provide reserves against losses for all loans (depending on their classification as to collectibility), and they are subject to a maximum loan to deposit ratio (LDR) and to legal lending limits (LLL) (Nasuation 1995: 143).

4.2.4 Factors Contributing to the NPL Problem: Mid-1997 Financial Crisis

4.2.4.1 Structural Vulnerabilities: Loan Concentration in the Real Estate Sector

There had been a sharp increase in real estate and property-related lending, which increased to about 20% of total outstanding loans in early 1997. In Indonesia, the danger of loan concentration was heightened by difficulties in seizing and realizing collateral (Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 55). The East Asian crisis has been brought about by "financial excess and then financial collapse", involving asset price bubbles and then collapses. Consequently, NPLs started to mount substantially.

4.2.4.2 Lack of Transparency in Bank Balance Sheets

The value of bank assets may actually be less than stated due to lack of transparency of balance sheets. This problem has been raised by international credit agencies (Chan 1995), which have stated that the adequacy of bank loan-loss provisioning is difficult to assess. The possibility also exists that some NPLs have been restructured into performing loans, but that these restructuring may hide poor quality assets, and further deteriorate the loan quality (Montgomery 1997).

PERPUSTAKAAN UNIVERSITI MALAYA

4.2.4.3 Inadequate Loan Classification Standards and Provisioning

Even when problem loans were identified, loan classification standards in Indonesia remained inadequate because it was easy to restructure loans to reduce the size of reported portfolio problems. Moreover, Indonesian standards allowed a bank to reclassify loans back to performing status as soon as one payment was made, irrespective of the anticipated future payment stream on the loan (Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 55). This has exacerbated the NPL problem.

4.2.5 Resolution of the NPL Problem: Mid-1997 Financial Crisis

When Indonesia requested IMF assistance in early October 1997, teams from the IMF, the World Bank, and the Asian Development Bank worked jointly to review the condition of the banking sector to provide support on financial sector issues. The following are some of the measures being adopted:

4.2.5.1 Strengthening the Prudential and Regulatory Framework

Substantial progress has been achieved in reviewing and strengthening the prudential and regulatory framework on a number of critically important issues, as follows:

a. **Loan classification, loan provisioning, the treatment of debt restructuring operations, and regulations on lending**

Amendments to the Banking Act in Indonesia gave the central bank responsibility for licensing, regulating and supervising banks. BI has issued new regulations on loan classification and provisioning (Hawkins, 1999: 200). New regulations on loan classification, loan provisioning, and the treatment of debt restructuring operations became effective at the end of December 1998. Five loan categories are defined, namely, pass, special mention, substandard, doubtful and loss, with respective provisioning of 1%, 5%, 15%, 50% and 100% (Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 62). The NPL classification was fixed at 3 months for substandard loans, 6 months for doubtful loans, and 9 months for loss (Hawkins and Turner 1999: 25).

b. Disclosure of Financial Statements

Banks are now required to publish their financial statements quarterly, beginning April 1999 (Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 62).

4.2.5.2 Restructuring and Rehabilitation of Banking Sector

The Indonesian Bank Restructuring Agency (IBRA) was formed by emergency decree in January 1998, as a sub-division of the Ministry of Finance, with two main functions (Bank Indonesia Annual Report 1997):

(i) To supervise banks in need of restructuring, and

(ii) To be the asset management agency for the assets that it acquires in the course of the bank restructuring

IBRA has set for itself a strategic, but flexible, four-year target to dispose the NPLs. IBRA's task is all-encompassing and there are three asset types that IBRA is handling—banks, financial assets, and "Holdco" assets (corporate assets transferred to holding companies by bank shareholders).

a. Managing NPLs

In Indonesia, the Asset Management Credit Unit is a component of IBRA. Its objectives include recovery, restructuring, and sale of loans—transfer, restructure, and liquidate core and non-core assets of closed banks, and the NPLs of state banks and banks related to IBRA. It is in the process of selling the Rp 158 trillion of financial assets it has acquired so far. The Asset Management Credit Unit plans to contract out recovery of loans below Rp 25 billion.

b. Resolution, restructuring and sale of banks

IBRA's Asset Management Investment Unit carried out resolution, restructuring and sale of banks, which includes the restructuring and merger or sale of banks taken over or related to IBRA. In September 1998, the authorities in Indonesia announced that four state-owned banks would be merged into the new Bank Mandari. Their NPLs would be transferred to IBRA's Asset Management Credit Unit (Hawkins 1999: 209). By March 1999, the closures and takeovers were handled effectively by BI and IBRA (Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 64).

IBRA has recapitalized seven banks, merged four state banks, took over 14 banks and closed 66 banks. The cost of its operations is to be fully borne by the government, estimated to be around Rp 351.6 trillion (USD 47 billion) as at 6 March 2000, to be met by the issuance of government bonds (Danaharta 1999).

4.2.5.3 Bankruptcy Procedures

An amended code adopted in August 1998 was patterned on United State Chapter 11 provisions and established a new commercial court to facilitate realization of collateral and bankruptcy procedures (Hawkins 1999: 217).

4.2.6 Vulnerabilities of the Indonesian Model in Resolving the NPL Problem

4.2.6.1 Lack of Bank Exit Regulation

No effective bank closure and exit regulation was in place. Instead, failed private banks were generally absorbed by BI. In late 1996, a bankruptcy law for banks was passed, but it was deficient because it granted important rights to shareholders in the liquidation process and foresaw a liquidation process lasting several years (Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 55).

4.6.2.2 Slow Progress of Restructuring

Beyond the emergency measures, though, little has actually happened by way of restructuring. The number of banks put under supervision in Indonesian seems large, but this simply reflects the fact that their liquidity support from the central bank exceeds more than five times their capital. Nothing has happened in terms of actual restructuring. The progress of consolidation has been slow (Eschweiler 1998). By September 1998, there were only four state-banks announced to be merged.

4.2.6.3 Insolvent Banks Remained in the System

Given the problems with bank closure, several known insolvent banks remained open. While the combined overall negative net-worth of insolvent banks remained relatively small (about 0.5% of GDP in 1996), the situation created moral hazard problems (Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 58). Thus, the NPL ratio remained high in the banking and financial system.

4.2.7 Conclusion

Indonesia needs to draw on the international community to provide technical and financial assistance in the resolution of its financial sector problems, which includes the NPL problem. The challenge for the international community is to engage the Indonesians in a policy dialogue, to assist in providing some of the necessary financial and human resources for resolving the financial sector problem. This will require simultaneous and coordinated action and political will.

4.3 SOUTH KOREA

4.3.1 Overview

Given its economic success, South Korea provided a surprising example of high level of NPLs in its banking system in late 1970s and during 1980s. In 1984, NPLs of the five major nationwide South Korean banks constituted 11% of total loans and represented 2.8 times their reported net worth (Park and Kim 1994: 213). Some troubled firms were in declining industries like textiles and plywood, others were in heavy and chemical manufacturing, and others in shipping and overseas construction (Park and Kim 1994: 209-13).

This bad loan syndrome continued to hinder the full liberalization of the South Korean financial system despite the successful monetary stabilization (McKinnon 1991: 389). The recent financial crisis has been the most severe to hit South Korea in its thirty-five year history of rapid economic development. It was triggered by the loss of the credibility of the South Korean economy among international investors following the earlier crises in South-East Asia (Kim 1999).

By the fall of 1997, the balance sheets of South Korean financial institutions had deteriorated severely. The share of NPLs in the total assets of commercial banks had increased by about 70% between December 1996 and September 1997 and amounted to about 80% of the banks' capital (Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 71).

4.3.2 Factors Contributing to the NPL Problem: 1979-1994

4.3.2.1 Heavy Government Intervention

In many cases, the South Korean government constituted the reason for the financial difficulties in the corporate sector (Park and Kim 1994: 209-13) For example, the government embarked upon a policy of developing heavy and chemical industries in the late 1970s, coercing the banks to make risky loans, many of which became nonperforming (McKinnon 1991:389).

The South Korean government used the banking system as a treasury to finance development projects and to manage risk sharing in the economy. Commercial banks in South Korea were involved so heavily in directed credit programs that they almost functioned as development banks. In the process, they incurred large NPLs (Cho and Kim 1995: 67) (See Table 4.7).

Table 4.7: South Korea: Share of NPLs and Bank Profitability of Seven National Commercial Banks

	1971-75	1976-80	1981-83	1984-86	1988	1989	1989
Net profit/total assets (%)	0.44	0.80	0.34	0.20	0.19	0.36	0.66
Share of NPLs(%)*	1.3	2.4	7.6	10.5	8.4	7.4	5.9

Note: NPLs are those against which actions of collateral or other measures are necessary, regardless of whether they are secured by collateral (classified as fixed) or not (questionable), or are judged to be uncollectible (estimate loss)

*The figures are the ratio of NPLs to total credit outstanding including acceptances and guarantees. For 1971-75, the share represents the ratio of narrowly defined NPLs (classified as questionable and estimated loss) to total loans.

Source: Bank of Korea, quoted from Cho and Kim (1995)

4.3.2.2 Lack of Autonomy in Loan-making Decision and Other Weaknesses of Financial Institutions

The root of the troubles besetting the South Korean banks lies in the fact that they have not been operating on financial principles but on non-financial, administrative expedience. South Korean financial institutions have not been good resource allocators, as they were not allowed to play an active role in loan-making decisions. They have been poor saving mobilizers because most of the deposit rates have been held artificially low. Many bad loan decisions were made, especially in the 1970s, thus a number of NPLs were created (Soon 1994: 133).

4.3.2.3 "Strategic Interdependence" between the Government and Big Business and their Impact on Banks

The "Strategic Interdependence" has fostered, rather than sanctioned, the weak corporate financial structure of big business. When the highly-leveraged investments he corporations faced financial difficulties for whatever reasons (economic ssion, structural depression, etc.), it has never been their problem alone. The ted banks have been forced to accumulate bad loans—In this situation, the failure revent their bankruptcy would mean the bankruptcy of banks (Choi 1991: 67-8).

.3 Resolution of the NPL Problem: 1979-1994

.3.1 Measures Undertaken by the South Korean Government

e South Korean government decided to support the troubled firms and persuaded banks to carry the NPLs on their book as long as they could. Banks had to *pump more credit* into troubled firms, so squeezing credit to healthy firms. After plementing industrial restructuring by providing subsidies so that solvent firms uld *take over* troubled firms, the government *rescheduled the NPLs* at lower terest rates and additional credit. To avert bank insolvency, the Bank of Korea mpensated banks for some of their losses through *subsidized rediscounts* (Park and im 1994: 212).

.3.3.2 Limit the on Loans to Single Borrowers

1991 revision of the General Banking Act set the limit for single borrowers at 20% f a bank's capital for loans and 40% for guarantees. Limits on lending to big onglomerates were set bank-by-bank under the "basket control system" under which the shares of loans to the top 5 and 30 business groups relative to total loans of he banks should not exceed the ratios set by the Office of Banking Supervision Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 70).

4.3.4 Factors Contributing to the NPL Problem: Mid-1997 Financial Crisis

4.3.4.1 Financial Problems of Bank Borrowers

In South Korea, the financial system was in a severe crisis because of excessive lending to large conglomerates, a number of which went bankrupt before the currency crisis hit in late 1997 (Corsetti, Pesenti and Roubini 1998). It should be noted that, in several cases, private banks in South Korea were effectively controlled by *chaebols* (interlined business groups), given those conglomerates privileged access to credit and exacerbating the moral hazard problem.

The banking system exhibited increasing signs of stress during the first half of 1997 as a number of major conglomerates went bankrupt. In the first quarter of 1997, two rating agencies downgraded the three major creditor banks of two bankrupt conglomerates. The banks' low profitability and large losses on their securities holding had left them badly positioned to handle a substantial rise in problem loans. By the first week of September 1997, six highly leveraged *chaebols* had failed or have been placed under bankruptcy protection, raising concerns about the banks' asset quality (World Bank 1997).

4.3.4.2 Weaknesses in Prudential Regulations and Supervision: Lack of Transparency and Regulatory Forbearance

The regulatory system's lack of transparency and regulatory forbearance significantly underestimated asset quality problems. The authorities had traditionally published as bad loans only the two most seriously delinquent categories of loans, amounting to only about 1% of total loans at end-1996, while other reported categories including a larger amount of impaired loans were not disclosed (World Bank 1997).

4.3.5 Resolution of the NPL Problem: Mid-1997 Financial Crisis

4.3.5.1 Purchase of NPLs

The Korean Asset Management Corporation (KAMCO) was established in 1962 to collect NPLs for banks. In November 1997, legislation was passed to create a new fund (Nonperforming Asset Management Fund) under KAMCO, supported by contributions from financial institutions and government guaranteed bond issues. This KAMCO-administered fund was given the mandate to purchase impaired loans from all financial institutions covered by a deposit guarantee.

On August 10, 1998, a major reorganization of KAMCO as a "bad bank" was completed with a view to strengthening its asset management and disposition capabilities. KAMCO adopted a structure similar to the United States Resolution Trust Company, providing additional business functions such as workout programs for NPLs and more efficient asset disposal. To enhance the transparency and the efficiency of its operations, KAMCO has its accounts audited semiannually and publishes the results.

As of mid-June 1999, KAMCO has purchased assets with a face value of 46 trillion won (11% of GDP). Its purchases comprise two categories of assets:

(i) "general" NPLs which are loans in default for 3 months and longer

(iii) "Special" NPLs which are corporate loans which have future cash flows and have obtained court approval for financial restructuring.

For the purchase of NPLs, KAMCO paid 45% of the book value of the underlying collateral. This is the average price obtained in auctions of similar collateral in the market.

KAMCO's sale strategy is to dispose of NPLs in the fastest way possible, but in a manner that would maximize recovery value. KAMCO has four methods in collecting on its assets: (a) it has sold NPLs to international investors; (b) foreclosed and sold underlying collateral; (c) sold NPLs in a public auction; (d) collected on loans. (Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 72)

As of June 1999, KAMCO had recovered (through sales and collections) about 9 trillion won from loans with a face value of 17 trillion won. Details on these operations are provided in Table 4.8 below. Schedule for KAMCO's purchase of NPLs is shown in Table 4.9.

Table 4.8: South Korea: Disposition and Sale of KAMCO's Assets
(In trillion of won, as of June 1999)

Disposition/sale	Face amount	Price paid by KAMCO	Amount Recovered by KAMCO
International sale	2.9	1.1	1.2
Foreclose sale	2.1	1.0	1.0
Public sale	0.2	0.1	0.1
Collection	11.3	5.9	6.5
Total	**16.5**	**8.1**	**8.8**

Source: KAMCO

Table 4.9: South Korea: Schedule for KAMCO's purchase of NPLs (In trillion won)

	Nov 97-Sept 98 [1]	Oct 98- Mar 99 [2]	From April 99 [3]	Total
NPLs	39	5	32 – 42	76 – 86
Purchase price	17.8	2.2	12.5	32.5

[1] 30 Commercial banks and special banks, 30 merchant banking corporations, and two fidelity/surety insurance companies
[2] Specialized banks, some sound banks, merchant banking corporations, securities companies, and mutual savings companies.
[3] Newly arising NPLs.

Source: Kim 1999: 158.

4.3.5.2 Restructuring of Financial Institutions in South Korea

In close consultation with the IMF, the government is pressing ahead with the exit of nonviable banks. It is also helping the viable banks to recapitalize and dispose of their NPLs by injecting public funds on the condition that they make every effort themselves to rehabilitate by mergers, induction of foreign capital and improvement of management. In a further move to improve banking soundness and to remove NPLs, a systemic policy framework is being prepared. It will include the adoption of prudential regulations in line with internationally accepted standards and tightening of internal control systems (Kim 1999: 147).

a. **Improving Related Systems, such as Prudential Regulatory Standards**

From July 1998, prudential regulation has been tightened by classifying loans in arrears for three months or more as "substandard" instead of "precautionary", and those in arrears for from one month to three months as "precautionary" instead of "normal" loans. Also the required provisioning rate for precautionary credits was raised from 1% to 2%.

The revised General Banking Act (effective April 1, 1998) reduced the single borrower credit ceiling from 45% to 20% of a bank's equity, and lowered the single group credit ceiling from 45% to 25% (Bank of Korea Annual Report 1998).

From 1999, banks are required to set aside provisions for losses from guarantees at the end of each fiscal year. Asset quality classification standards are to be introduced based on the assessed future ability of borrowers to honour their obligations (Kim 1999: 154).

b. Mergers

The government has been encouraging mergers between banks that are both sound and of substantial size. Its objectives are to give a competitive edge to the South Korean banking industry through economies of scale, removal of the inefficiency caused by the presence of many relatively small banks and to resolution of the NPL problem (Kim 1999: 153). The South Korean government acted to improve the merging banks' capital adequacy ratio through the injection of public funds.

c. Improving the Efficiency of Bank Management

Much of the discretionary authority concerning loan decision-making formally given to presidents and branch managers has been removed, and banks have now generally established credit appraisal committees whose main function is to assess the status of potential borrowers before providing any large-scale loans (Kim 1999: 156).

4.3.6 Vulnerabilities of the South Korean Model in Resolving the NPL Problem

In South Korea where problems are more widespread, potential buyers of NPLs may be harder to attract. In such cases, the authority has often to first "clean-up" the weaker banks' balance sheets by moving their NPLs into a separate bank or asset management corporation. While this can improve the long-run viability of the banks, it is likely to make the exercise considerably more expensive for the government.

In the case of bank mergers, forcing a healthy bank to assume a heavy burden of bad loans—admitted or concealed—may be counterproductive in restoring a willingness to lend, particularly if such actions are taken when the banking system as a whole faces difficulties. In addition, the search for a healthy bank prepared to accept a weak bank under such conditions may prove fruitless and delay bank restructuring (Hawkins and Turner 1999: 76).

4.3.7 Conclusions

Provided that the financial restructuring and resolution of NPL problem are completely successful, normal operation of the financial system can be expected to be resumed. Along with this, domestic business and customer confidence will pick up, moving the South Korean economy back onto a sustained growth track.