


APPENDICES

APPENDIX A

Prudential regulations and requirements set by the Basle Committee are as follows (Basle 1997):

(a) Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

(b) An essential part of any supervisory system is the evaluation of a bank’s policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

(c) Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices, and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

(d) Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposure to single borrowers or groups of related borrowers.

(e) In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm’s length basis, that such extensions of credit are effectively
monitored, and that other appropriate steps are taken to control or mitigate the risks.

(f) Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

(g) Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

(h) Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

(i) Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
(j) Banking supervisors must determine that banks have adequate policies, practices, and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.
APPENDIX B

The following are some of the guidelines on public disclosures, given by the Basle Committee on Banking Supervision (Basle 1998):

(a) Users of a bank’s financial reports need information on the institution’s credit risk exposure and risk management practices, the quality of the loan portfolio, its profitability and the impact of losses on the financial position and performance of the bank. Disclosure in a bank’s annual financial report should include clear and concise information on the matters discussed below.

(b) Institutions should be encouraged to provide as much of the information listed below as possible in audited financial statements, i.e., primary financial statements and supporting notes. In particular, disclosure of accounting policies should be in the audited part of the financial report.

(c) A bank should give information about all significant accounting policies for the accounting for loans, loan impairment and related allowances (including the accounting for the effect of changes in those policies), and the methods employed to apply those policies. It should disclose information about its policies for:

- Basis of measurement for unimpaired loans at their initial recognition and subsequently;
- Income recognition on unimpaired loans (e.g., effective interest rate method);
- Determining how and when to recognize impairment in a loan and the basis of measurement for impaired loans;
- Determining allowances (specific and general)
• Determining when loans are considered past-due for accounting and disclosure purposes (number of days in arrears);
• Charging off loans;
• Accounting for recoveries;
• Determining when the cease accruing interest on a loan;
• How it recognizes income from impaired loans, including interest recognition and the treatment of fees and expenses.

(d) A bank should disclose information on the risk management and control policies and practices adopted by the bank relating to credit risk of the loan portfolio.

(e) A bank should disclose geographical information about loans, impaired loans and past due loans including the related amount of specific and general allowances.

(f) A bank should disclose balances of loans, impaired loans and past due loans by major categories of borrowers and the amounts of specific general allowances established against each category. A bank should disclose information about the composition of the loan portfolio based on a meaningful categorization of borrowers (e.g., commercial loans, consumer loans, and related parties). For each major category of borrowers and for the overall loan portfolio, there should be separate disclosure of:

• Total loans, before and after allowances;
• Total impaired loans, showing separately those that are past-due (e.g., 90 days or more);
• Unimpaired past-due loans (e.g., 90 days or more)
• General allowances (General allowances include allowances against impairment that has been determined to be present in a group of loans that share common identifiable characteristics).

• Specific allowances;

  (g) If there is a portion of the general allowance that is not allocated to a major category of borrowers, the amount of the unallocated allowance should be disclosed separately. Institutions are encouraged to disclose other meaningful measures of deterioration of credit quality in the loan portfolio.

  (h) A bank should disclose commercial loans by significant industry sector (e.g., real estate, mining).

  (i) It can be also appropriate to give summary information about the composition of the loan portfolio categorized by type of loan (e.g., mortgage loans, credit card loans, finance leases), type of collateral (e.g., residential property, commercial property, government guaranteed, unsecured) and/or creditworthiness (e.g., based on internal or external ratings).
APPENDIX C

(1) Centralized Asset Management Companies

Centralized asset management companies are typically state-owned. A key objective of a state-owned centralized asset management company is to buy NPLs from banks and thus help banks clean up their balance sheets as fast as possible. Centralized asset management companies have been used in Korea, Malaysia, and more recently in Indonesia.

The advantages and disadvantages of a centralized public asset management company are as follows (Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo 1999: 39):

- **Advantages**

  1. Serves as a vehicle for getting NPLs out of troubled banks based on uniform valuation criteria.

  2. Allows government to attach conditions to purchases of NPLs in terms of bank restructuring.

  3. Centralizes scarce human resources (domestic and foreign).

  4. Centralizes ownership of collateral, thus providing more leverage over debtors and more effective management.

  5. Serves as a third party for insider loans (Indonesia).

  6. Can better force operational restructuring of troubled banks.

  7. Can be given special legal powers to expedite loan recovery and bank restructuring.
• Disadvantages

1. Management is often weaker than in private structure, reducing the efficiency and effectiveness of its operations.

2. Such agencies are often subject to political pressure.

3. Values of acquired assets erode faster when they are outside a banking structure.

4. NPLs and collaterals are often “parked” long-term in an asset management company, not liquidated.

5. If not actively managed, the existence of a public asset management company could lead to a general deterioration of credit discipline in financial system.

6. Cost involved in operating an asset management company may be higher than a private arrangement company.

7. If dealing with private banks, determining transfer prices is difficult.

(2) Decentralized Asset Management Companies

A decentralized approach that encourages each bank to set up its own asset management company allows arrangements to suit each bank’s conditions. Thailand followed such a route, encouraging banks to set up their own asset management companies to which they can transfer assets at market value. The advantages and disadvantages of decentralized asset management companies are exhibited below:

a. Within banks

• Advantages

1. Knowledge of the borrower may facilitate debt restructuring.

2. Access to borrower through branch network.
• Disadvantages

1. Lack of skills for restructuring of NPLs, operations of companies, debt entity swaps, etc.

2. Hampers "normal" banking functions (lending activities), particularly if the NPL portfolio is large.

3. Less loss recognition up front. Does not clean up the bank's books.

b. In private asset management companies

• Advantages

1. Specialized skill mix. Focus on restructuring function.

2. Creation of an asset management industry and secondary market for distressed assets.

3. Loss recognition up-front.

4. Cleans up the bank's books.

• Disadvantages

1. Lack of knowledge of the borrower.

2. Bank may not have sufficient capital to recognize losses up front.