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**BRIDGING CREDIT RISK AND CREDIT ACCESS:
INSOLVENCY SYSTEMS AND CREDIT RISK MANAGEMENT:
Risk Management Systems: The Framework and Practice in Asia**

by

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Bridging Credit Risk And Credit Access: Insolvency Systems And Credit Risk Management : Risk Management Systems: The Framework And Practice In Asia

Definitions

NPL	Non-performing loan
AMC	Asset management company
CMU	Credit management unit
LMU	Loans management unit

Introduction - Credit access: the lifeblood of the economy

Any discussion of insolvency and risk management can be very dry, and it is a topic that can be hard to get excited about, even though it is one of the most important facets of our economic model and wealth generation in the modern world.

What is a loan? A loan is more than a debit on a banks balance sheet. It represents the hopes and dreams of a group of people, it represents someone's livelihood, someone's idea brought to life, someone's family business continuing to grow and trade. It represents a persons life, their job, their families welfare. It represents economic growth and development and improvement of a nations economy.

And sometimes it's pretending to be one of these things, and in fact is a rich businessman's Porsche or helicopter, or funding of an extravagant lifestyle, and is backed by non-existent collateral. And sometimes, a loan is a struggling or irrelevant business that should be out of business, and is being kept afloat by its bankers long after it's usefulness or relevance has passed.

A loan ideally is cash advanced to a business that needs it to grow and develop. A bad loan or a non-performing loan (NPL) is cash that is tied up unproductively. These loans present an opportunity cost to the bank, the bank's depositors and shareholders, and also to society as a whole: the wheels of commerce become rusty and credit access is threatened.

This paper aims to discuss how credit access and credit risk are protected and mitigated by insolvency and credit risk management systems within banks. What business are we in when we are talking about insolvency and credit risk management? We're in the business of keeping the wheels of commerce turning over and ensuring credit access. The focus of this paper is mitigating insolvency risk in a downstream context: looking at ways that banks manage their insolvency risk internally, and what shape those risks take. The paper also looks at the use of secondary debt markets in Asia, and their impact and relevance on insolvency risk management in the banking context.

In a free market economy there are always going to be fraudsters and there are always going to be businesses that fail for an enormous variety of reasons. I like to compare an economy to a human body: cash is the blood, and the banks are the delivery system getting the cash to where it is needed in the economy to generate healthy growth. Fraud, theft, bad loans or NPL's are clots in the blood of the banking network, and it's our business to stop these clots from occurring, and when they do, finding them and unblocking them so cash gets to where it's meant to go: supporting viable and real businesses to create jobs, to grow the economy and improve the standard of living of a nation overall. By protecting credit access we're helping generate wealth and improving lives, making sure that every business idea has a chance for success and sustainable economic growth is realised.

1. The Nature of Credit Risk and Credit Risk Management

The business of banking is risky business-it is the risk taken on by a bank that allows them to make money. Banks are in the business of lending money and charging interest for it. By lending money a bank shares the business risks faced by the borrower, and their risks of becoming insolvent. Banks mitigate this risk through *upstream* processes and procedures, including due diligence, pre-lending investigation, an interview and application process and the taking of security in the form of collateral or personal guarantees, and *downstream* processes and procedures which are discussed in this paper. These downstream processes and procedures refer to the controls in place to minimise the loss after insolvency happens.

All banks are seeking new business, and have to compete for lending opportunities. It is a fundamental feature of banking that due to expense, the fear of driving new customers away and the different outlook of a sales officer to a credit recovery officer that upstream processes and procedures are inevitably less thorough and sophisticated as the downstream processes and procedures.

Some definitions

Risk is the possibility that decisions made will lead to financial losses or other problems, due to changing market conditions, errors of judgment or gaps in operational process. Losses can be:

“**Expected,**” i.e., forecastable and within the range of tolerable loss, or

“**Unexpected,**” i.e., not predicted and beyond the boundaries of risk tolerance.

The normal method of risk measurement is an appropriate index of volatility of asset/liability values. Tolerable losses fall within the range of the pre-defined acceptable volatility.

Risk-taking is the active conduct of business, which involves risk of some kind. Results can involve expected or unexpected levels of losses; and the objective is to produce an adequate return on capital, within an acceptable level of volatility.

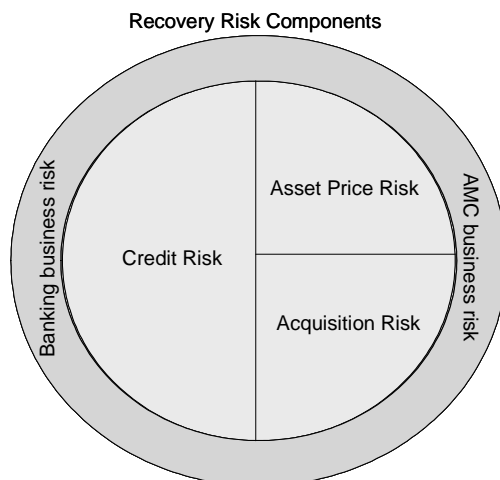
Risk Management is the supervision of risk-taking to ensure that it is conducted within set volatility limits and in accordance with the processes and procedures of the financial institution. This pre-empts losses within an expected and tolerable range, and avoids unexpected losses.

What is **recovery risk**? Recovery Risk has two components: Credit Risk, and Asset Price Risk.

- **Credit Risk** is the risk that a borrower will fail to honour its obligations to a financial institution that has advanced credit to that borrower. Such a default may result in a loss to the financial institution advancing the credit of principle, interest or other fee revenue with respect to the borrower’s obligations to the lending financial institution. Default can be a result of fraud or insolvency. These are the risks a bank faces from normal operations and trading.
- **Asset Price Risk** refers to the risk that the prices of traded credit exposures (purchased NPL’s), purchased or acquired collateral and / or equities will move downward. Such a downward movement in price would mean the holding institution would be unable to recover their acquisition cost from subsequent sale. **Acquisition Risk** refers to the risk that arises from the potential that an acquirer fails or is unable to perform a proper assessment of asset values, and therefore pays a higher price than the sales proceeds subsequently realised. Proper due diligence and valuation skills and a clearly defined portfolio strategy minimise this risk. These risks apply mainly to Asset Management Companies (AMC’s).

Everything to lose: Different risks are faced by banks and AMC's

So, credit risk management refers to how we manage the risks of the business of banking, while asset price and acquisition risk relates to the risks experienced by an AMC. Consider the following diagram:



In many areas and circumstances of course the different risks overlap: some banks operate like AMC's, and some AMC's operate like banks. The lines can become blurry.

Asset Price Risk in the case of an AMC relates closely to foreclosed collateral, equities and other assets held for realisation. The risk is that the market may not provide a favourable return to the seller for these items when they are realised. These assets are generally realised at some form of public auction.

The difference between asset price risk and credit risk is that credit risk does not apply where the asset is being held for re-sale.

Where an asset is purchased by an AMC, and the intention is to sell that asset again in the near future for a profit utilising the secondary debt market, then it is asset price and acquisition risk that is the concern: will the AMC recover what they paid for the asset? Credit risk, however, is the risk that a borrower will fail to meet its obligation in relation to an outstanding loan (the normal business risk of any lender). In the case of an AMC, this is somewhat different as the borrower already has defaulted-the new performance criteria depend on a restructuring arrangement either already agreed to or established.

For an AMC "credit" is measured as a function of the outstanding principle and accrued interest, and the date of collection. "Credit" is what a bank or an AMC must "recover", although the loss recognized in relation to credit differs. For a bank, there is everything to lose, while an AMC can choose how it will calculate it's loss, for example:

- The amount recovered against acquisition cost
- The amount recovered against acquisition cost plus interest accrued after acquisition
- The amount recovered against target recovery estimates

The use of acquisition cost is generally required according to internationally accepted and standard banking and accounting practices, however the point is that due to the different kinds of risks faced by AMC's and banks, the losses that are borne by each are also different.

In contrast, a bank or originating lending institution has at risk the entire amount loaned to the defaulting borrower, outstanding interest and penalties and the opportunity cost of lending these amounts to a performing borrower.

Where a bank has recurring or regular credit related problems¹ it is necessary for the bank to separate the workout function from the credit origination area. A credit workout area of a bank (in this paper referred to as a loans management unit or LMU) requires highly specialized skills which improve returns from recovery and / or rehabilitation. Concentrating and focusing these skill sets and experience within a specialized team in a bank greatly enhances recoveries to financial institutions. An LMU is a division within a bank that exists only to deal with NPL's for that bank. It is not an independent agency and in the first instance deals solely with the NPL's for the bank it is a part of (although in some cases LMU's do purchase new NPL's from other institutions).

2. Need for Improved Risk Management Practices in Asia: General Trends and Traditional Risk Factors

Some Asia specific developments

Oil prices edging towards \$US 50 a barrel have caused concern for some Asian business groups, and some analysts are concerned that this could adversely affect the regions recovery and growth potential.² Higher oil prices could change the Asian landscape and require expected growth rates to be revised downwards. Asia depends heavily on imported oil, so economic growth is vulnerable when prices rise. The International Energy Agency (IEA) calculates that a \$US 10 prolonged spike would reduce by 0.8% Asian GDP. The IMF estimates that the Philippines would lose growth of 1.6% and Japan would slip by 0.4%. India faces different issues, with inflation nearing 8% (a three year high), taxes and duties on oil related products have been cut. India's oil imports have also increased by 11% from last year to 102 million tonnes in 2004-05. China is the biggest oil consumer behind the US and last year oil demand rose by 24.6% to 6.48 million barrels per day.³

The EIU country risk rating report for Asia⁴ however indicates that the large number of exporting countries in the Asian region have been benefiting from robust demand from China, leading to higher trade and current account surpluses and rising international reserves, boosting real GDP growth for the region. This report indicates that the strength of export growth and prices is offsetting the rise in oil import costs and having a positive effect on liquidity.

Political risk and the threat of terrorism and associated activities remains a stumbling block to effective bank and insolvency risk reform. Anti money laundering and counter terrorist funding (AML/CTF) activities and programs have been initiated by many banks in the region, focussed on know your client (KYC) policies, and several banks have also already suffered penalties through correspondent bank relationships under the U.S. PATRIOT Act.

With year on year rates of inflation rising, there is still speculation that the Chinese government will have to do more in coming months to slow the economy, however with the overall economy now slowing it seems unlikely that inflation will rise out of control. Consumer prices fell in May and the rise in inflation has been driven by structural factors (the end of a multi-year grain glut in the countryside and a subsequent sharp rise in prices). Officials are now encouraging grain production to stabilise prices. However, with the government seeking to reduce the most important driver of GDP growth, investment spending, the economy

¹ Unless a bank only lends to risk free borrowers, this will always be the case. An inevitable side effect of banking is a certain percentage of NPL's, and if this is not the case the bank is likely being too conservative in its lending and is not maximising profit opportunities by taking sufficient risks.

² Charter Magazine, October 2004, Vol 75 No.9, "Over a barrel" article by Peter Switzer

³ Charter Magazine, ibid.

⁴ Economist Intelligence Unit Country Risk Service: Risk ratings Review July 2004

needs a new engine. Private consumption is a likely candidate yet it is possible that consumption will not pick-up sharply in 2005, slowing overall GDP growth.⁵

2.1 Insolvency risk management factors in Asia

To try to capture the risk factors as they face insolvency and business risk is a large task, and it is almost impossible to definitively achieve a summary of these. The profiles and nature of countries across Asia are so diverse the challenges in each are wildly different. However to draw out some broad factors throughout Asia, the following key areas are important factors facing business, effective insolvency regimes and risk management practices and procedures for banks:

- Fraud and corruption
- Insolvency and recovery frameworks and regimes
- Banking sector sophistication and development.

2.1.1 High levels of fraud and corruption

The impact of fraud and corruption on insolvency and work-out procedures is well known. The Transparency International Corruption Perceptions Index⁶ charts levels of corruption in 133 countries, as seen by business people, academics and risk analysts and ranges between 10 (highly clean) to 0 (highly corrupt). Some of the relevant findings are detailed below:

Country	Country rank (out of 133 surveyed countries)	Corruption perception index 2003 score (10=highly clean, 0=highly corrupt)
Singapore	3	9.4
Hong Kong	14	8.0
Japan	21	7.0
Taiwan	30	5.7
South Korea	50	4.3
China	66	3.4
Sri Lanka	66	3.4
Thailand	70	3.3
India	83	2.8
Pakistan	92	2.5
Philippines	92	2.5
Vietnam	100	2.4
Indonesia	122	1.9
Myanmar	129	1.6

Source: Transparency International Corruption Perception Index 2003

One of the key conclusions of the 2003 corruption perceptions index report was that nine out of ten developing countries urgently need practical support to fight corruption. Issues facing bankers when dealing with NPL's relating to corruption include:

- Personal physical risk and danger
- Non-existent or ghost loans
- Fraudulently altered loan documentation
- Bribes to employees of the bank facilitating preferential treatment
- Enforcement officials (judges, etc) susceptible to bribery

⁵ EIU Country Risk Service, *ibid.*

⁶ The TI Corruption Perceptions Index is a composite index drawing on 17 different polls and surveys from 13 independent institutions carried out amongst business people and country analysts, including surveys of residents, both local and expatriate.

These are a very few examples. Coupled with these are poor, ineffective or simply non-existent anti-corruption frameworks within many countries. For example, Cambodia presently is considering for the first time the systematic declaration of all assets and liabilities of High Court judges. Although a small step on its own, in conjunction with other steps can move to fight corruption. Fraud and corruption remains a crucial area to deal with in creating an environment where an effective insolvency and work-out regime can develop.

2.1.2 Weak insolvency frameworks and recovery regimes

Although not the subject of this paper, it is a critical component of a working insolvency regime to have effective laws and regulations, courts, judges and legal frameworks in place to enable insolvency systems to be effective. A common theme across some countries in Asia is difficulty in enforcing repayment of debts due to ineffective or non-existent insolvency regimes. In some cases, for example Thailand, this is partially due to the relatively recent introduction of insolvency laws and business practice has not accepted them.

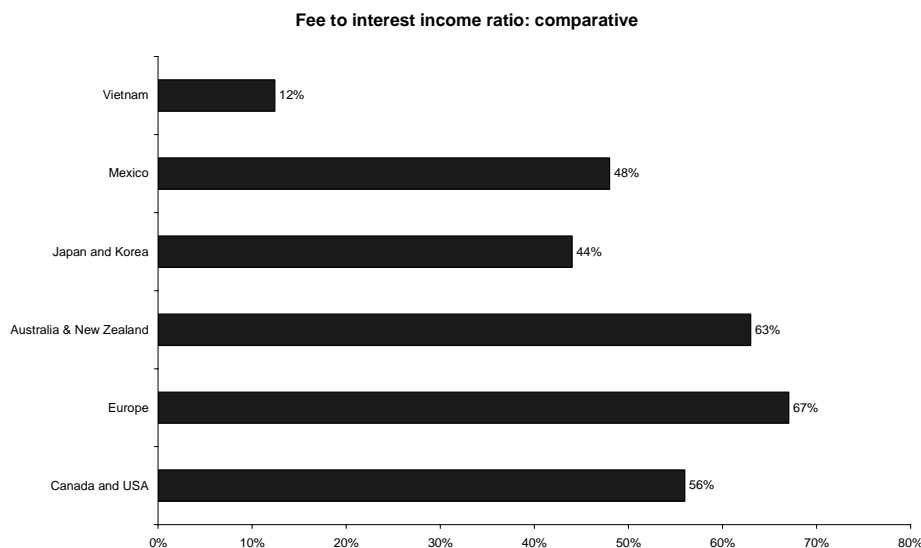
Due to poor enforcement regimes, lenders need to be prudent, and in extreme cases (e.g. Vietnam and Cambodia) seek 100% or greater security for credit advanced. This greatly reduces credit access to borrowers. A flow on effect of the lack of an effective legal insolvency system is often the lack of will to enforce recovery and restructuring. The lack of will to drive recovery can be a result of:

- Not normal business practice
- Personal physical risk
- Perception that legal rights are ineffective
- Risk of personal liability for losses for some state bank employees

Coupled with these problems is commonly a failure of the judiciary: either in terms of the knowledge and experience of the court systems or their overall effectiveness.

2.1.3 Lack of sophistication in the banking sector

How does one measure the sophistication of a banking sector? One measure that can be applied is the *fee to interest income ratio*, which is often used as a measure of the degree to which banks have adjusted to a financially deregulated market. The higher the ratio, the more advanced the range of services offered by that bank. A comparative chart of fee to interest income ratios is set out below:



Source: *Profitability and Competition in Banking Markets: An aggregate Cross Country Approach*, Horst Gischer and D. Johannes Juttner, Division of Economic and Financial Studies, Macquarie University, Sydney, Australia (Vietnam statistics: Deloitte survey)

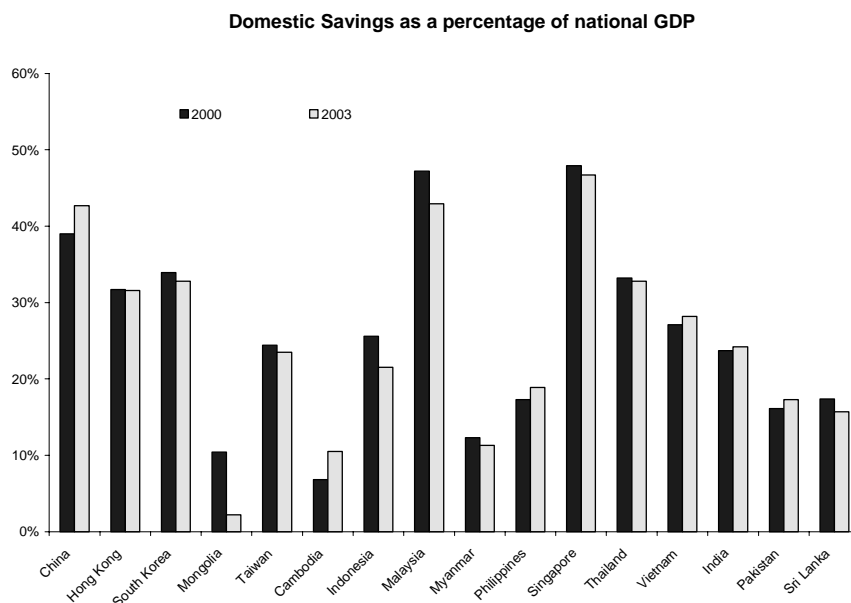
There is presently an international trend to increasing the proportion of non-credit income as a component of overall income and is a key indicator of profitability and competitiveness in the international banking market.⁷ A well developed non-credit services market indicates diversification of income for banks in that market, and diversified banks are less risky. Although statistics provided in this paper are not comprehensive and more research is required, it is clear that the Asian banking sectors for which this data was available lag behind other regions, indicating less sophistication.

What do non-credit services have to do with credit access? A small range of services indicates a lack of sophistication and skills in the banking sector generally. These overlap into credit access and customer service generally: less people are using the banking system and don't know what services are available, or potentially available. This is often the case in countries which have traditionally cash economies. Development of services such as:

- Deposit services
- ATM's
- Trade finance
- Drafts and remittances
- Cheques
- Advisory services

All contribute to increasing the usage of and access to the banking system, which also facilitates the growth and spread of banking services into regional areas.

Another indicator of the development of the banking sector is the *participation rate*.



Source: *World Development Report 2003: The World Bank*

⁷ *Profitability and Competition in Banking Markets: An aggregate Cross Country Approach*, Horst Gischer and D. Johannes Juttner, Division of Economic and Financial Studies, Macquarie University, Sydney, Australia

What does a low participation rate indicate?

- Lack of confidence in the banking sector
- Lack of development or sophistication / penetration of the banking sector
- Lack of available capital to banks to be on-lent

Low participation in the banking sector also increases the seriousness of the risk of a run on the banks, as generally cash economies are slow to adopt a credit culture and often have an inherent distrust of the banking system. This indicates a lack of lending opportunities and an underdeveloped credit culture.

3. The Evolution of the LMU and the AMC- Importance of Work-out Procedures for Risk Management and Resolution of Distressed Assets

A good way to illustrate the importance of work out and work out skills within a loans management unit (LMU) or an AMC is to discuss the relative merits of selling NPL's through the secondary debt market against working them out internally (merits to the bank, the debtor and to the overall economy). The same principles apply to an AMC or a LMU within a bank.

Before exploring this area, it is worthwhile to revisit the concept of risk management. What is modern risk management?

- Recognition that risks do exist and must be managed
- Clear concept of direction and the risks to be managed in reaching targets, focused on
 - "Where could we lose, how much and why?"
 - How likely is the loss?
 - What can we do about it in advance?
- Disaggregating and quantification of risks to understand root causes
- Clear responsibilities for risk decisions and monitoring
- Clear measurement of actual performance vs. targets and benchmarks
- High integrity
- Rigorous, systematic processes to accomplish objectives.

3.1 Workout vs. Sale

All AMC assets are in some way "distressed" from the start, and all carry varying degrees of recovery risk. Returns from repayment of principle and interest, or from sale could be greater or less than acquisition cost.

An accurate method of measuring and quantifying this recovery risk is the use of a pro-active and regular review risk assessment and risk grading system. An AMC's experience with NPL's is thorough and extensive. AMC staff have significant experience in dealing with NPL's, and an AMC's database or experience skill set contains substantial data which can be extremely useful.

The risk measurement approach based on asset categorisations only is broad, simple and indicative only. It does not help either a bank or an AMC make decisions, prioritise loans or prepare for losses (turning unexpected losses into expected losses). Turning an AMC's "data" into "information" helps AMC's create a vastly more accurate risk-rating system and assists in more accurately quantifying recovery risk, or alternatively, assist in determining a revised asset acquisition pricing model for benchmarking or negotiation.

A bank or an AMC's objective is recovery maximisation, which must include consideration of timing (inclusion of interest element) and the time value of money (NPV considerations) and recovery performance, which is subject to changing economic conditions as well as being variable against book values, depending on the assets/claims involved.

Multiple quantifications and risk measures are appropriate. The most useful data for risk measurement, however, is the data gathered by a bank or an AMC over time, and applying this experience to loan specific characteristics within each loan to identify risk issues. This system would create asset classes, and asset-by-asset targets and benchmarks to measure risk and to judge accomplishments / performance.

A very important consideration in this area is the concept of “cost of capital”, “funding drag” and ongoing funding costs, or holding costs. This needs to be factored in to calculations to ensure that the asset realisation value (over the term of the workout or recovery process) exceeds the bank or AMC’s cost of capital.

Information-based Risk Management improves business performance, and reduce volatility as a bank or AMC moves to a new, “recovery” stage of activity, and allows for:

- More effective bidding for acquisitions
- More effective realization of NPL values
- Identification of potential problem areas for special action

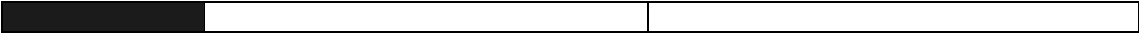
Quick disposals vs. restructuring: If you don’t work out the loan, someone else will

There are two main approaches or philosophies to dealing with NPL’s:

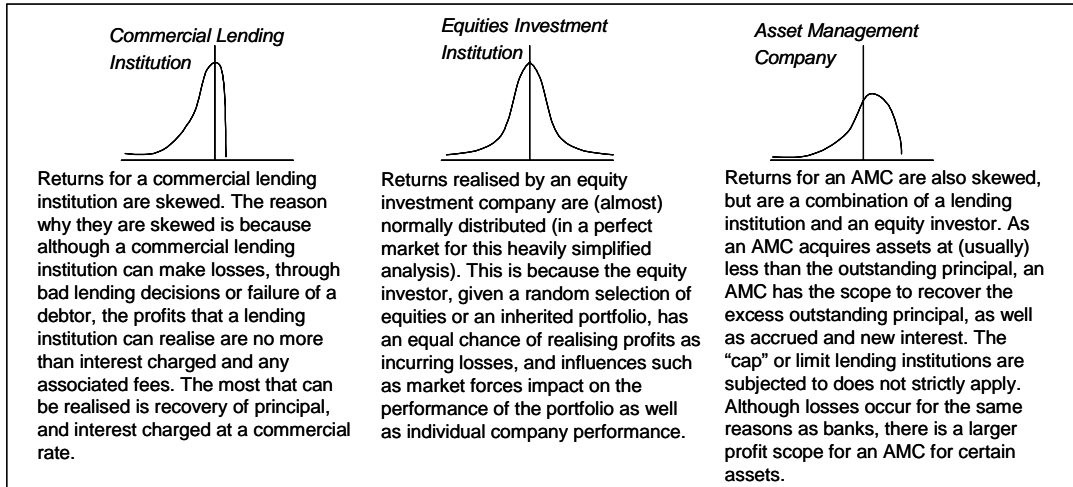
- Rapid resolution by sale of NPL’s, and
- Internal workout and restructure.

As AMC’s are driven largely by rapid results, the first approach is often the most popular. The following table summarises the key differences between the two approaches:

	Sale and outsource approach	Internal management and workout approach
Description of approach:	This involves the strategic “quick fix” approach involving the sale and packaging of NPL’s to external parties. Usually this includes packaging loans into tranches grouped with like characteristics to make the tranches more attractive to potential buyers. Value is realised from the receipt of sale proceeds.	This involves working with the borrowers being administered, with particular attention being given to larger loans with better viability restoration prospects. Some loans with greater potential are granted “intensive care” status, and all loans are progressively graded in terms of recovery potential. Value is recovered from repayment and progressive recovery, although liquidation is resorted to in some cases.
Skills required:	Sale skills, asset due diligence and packaging for targeted bidders is the key skill required. The main constraint or driver of the process is timing: sale of loans usually equates to an expectation of rapid results.	Restructuring, workout and reorganisation skills are required, as well as an in-depth understanding of business and commercial issues and cashflow analysis. This is because decisions need to be made quickly regarding loan classification, and they need to be correct so the right attention is focussed in the right areas. All loans are assessed in the same way, but loans with better recovery prospects get more attention.
Performance indicators: how are they assessed?	<ul style="list-style-type: none"> •Speed of recovery and asset turnover, •Quantum of return vs. OPB or acquisition cost, •Holding costs incurred, •Discounts or prices achieved, •Distribution of recoveries (returns to originating banks). 	<ul style="list-style-type: none"> •Speed of recovery and asset turnover, •Levels of returns on NPV basis vs. acquisition cost, •Opportunity costs or funding drag (over time) and operating costs, •Proportion of negotiated workouts vs. litigated ones.

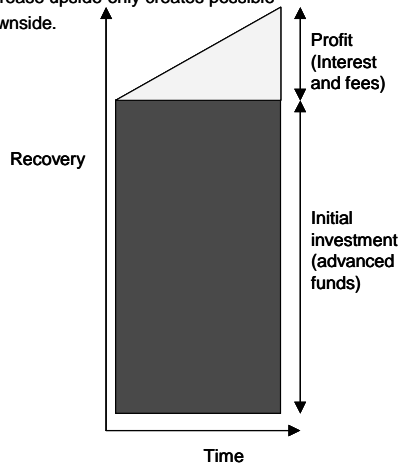


Dealing with NPL's by an AMC is comparable to a normal bank, or an equity investment institution. Assets being managed involve varying risk, and returns achieved are controlled and measured using similar techniques and approaches.

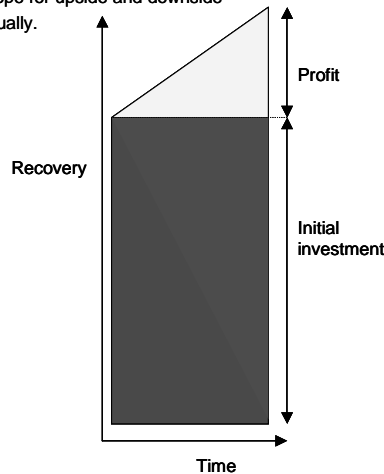


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Commercial Lending Institution:
Profit pre-determined: risk does not increase upside-only creates possible downside.

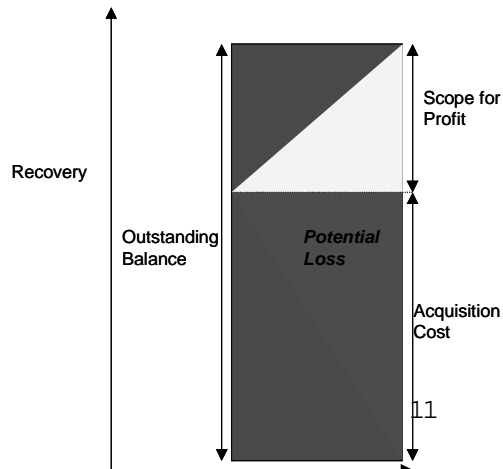


Equity Investment Institution:
Profit variable: risk provides scope for upside and downside equally.



more simplified illustration of this is asset basis:

The combination of invested funds losses is much lending the AMC is the



recovery potential for an AMC, however, is a these. As acquisition cost is less than (advanced funds), the scope for profits and greater for an AMC than for a commercial institution: The amount that is at risk for acquisition cost.

The worst result that could be achieved by the AMC would be to lose the entire amount paid for the loan, and realise nothing. This risk is balanced by the potential upside, or scope for profit, which exceeds acquisition cost and accrued interest on an NPV basis. Loans with greater profit potential must be identified early, to ensure that these loans are focussed on and nurtured, to ensure that wherever possible, this upside is realised.

Where NPL's are sold on to third party investors outright, This upside or profit scope cannot be realised. Only by adopting the "incubator" approach can this be realised. The risk of the downside, however, is also then present.

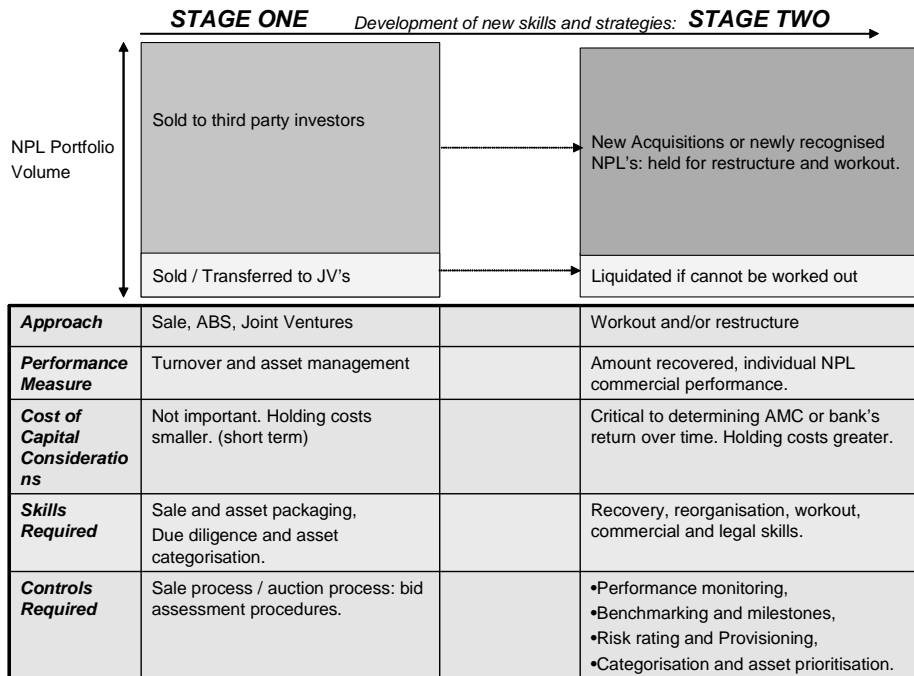
Adopting the internal management approach affords new opportunities for profit making, but also new risks. Risks of the downside, loss of acquisition cost, are passed on to an investor in an outright sale, but when the asset is retained for workout and restructure the risk of this loss is retained by the AMC or the LMU.

It is important for an AMC to ensure the profits that can be realised (NPL's with high potential for recovery and work-out) are given every opportunity to perform, and focussed efforts are made to restore the debtor to financial health and viability as quickly as possible. Realised profits must exceed losses. In order to determine the position of the AMC, the risk of losing acquisition cost must be quantified. The Recovery Risk Management and Mitigation system in place must:

- Measure and quantify recovery risk, and changes in recovery risk
- Assist in identifying those loans that have scope for profit, and
- Once potential losses are identified and quantified, guide account officers in deciding which course of action will minimise the loss

The most important decision that must be made quickly is which loans to liquidate, and which to incubate. This process can be described as moving from being "liquidator" to "incubator", or from Stage One to Stage Two competency.

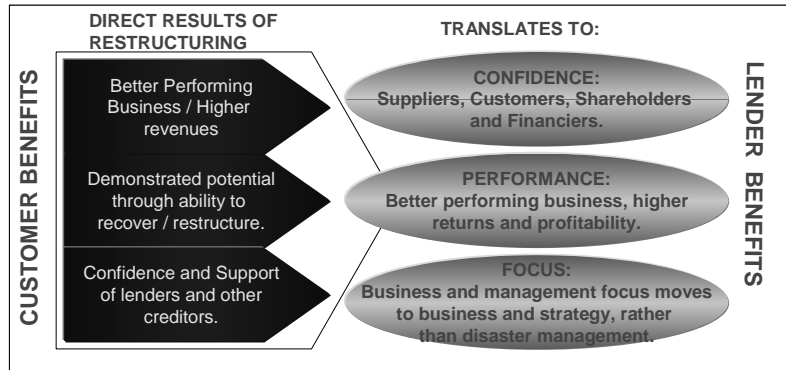
The diagram illustrates the differences in skill sets between the two, and the transition that can occur.



As discussed earlier, the mandate of an AMC is ultimately to either release as much cash as possible from non-viable debtors so that it can be loaned to viable ones, to restore viable businesses to performing status, and to recognise losses when and where they have occurred.

	<u>Stage One</u> Asset Acquisition and Disposition	<u>Stage Two</u> Managing Ongoing Assets
Principal Activities	Pricing acquisitions. Packaging assets attractively for auction or negotiated sale. Legal actions to realize available collateral.	Working with distressed companies to improve operations and cash flow, restructure liabilities, etc to improve economic viability and enhance returns.
Risks	Acquisition prices too high, too few potential and actual bidders, failures in legal actions. Documentation deficiencies.	Companies do not or will not improve basic operations so they can service (restructured) debt. Companies or assets are unattractive to buyers and book values cannot be realized. Debtor company management resistant to change or other creditors prevent action.
Risk measurements and accounting	Asset turnover; realized prices vs. book values. Assets often not held for very long so auction experience probably more important than a detailed fair valuation analysis.	Realization value at risk in a probability context, but with an eye to future developments and not just historical experience. Alternative gross returns on an NPV basis over the period of the loan, compared to the cost of capital.
Skill sets needed	Negotiation skills, due diligence skills, asset packaging and sale.	Reorganisation, restructuring, commercial knowledge, legal skills, financial analysis skills.
Process and policy requirements	Generally covered in the "auction process" – must demonstrate all actions taken to achieve best price.	Detailed and thorough review, demonstrate consistent application, and all actions possible taken for the maximisation of value. Transparent, documented and arms length decision processes.

The benefits of restructuring and workout are equally beneficial to a an LMU or financial institution based AMC as they are to a government agency or central AMC:



When acting as an “incubator” an LMU or AMC needs to take ownership of their NPLs, and to be proactive in the NPL management process. AMC’s and LMU’s need to educate debtors to work with them in achieving essentially the same goal: improvement of the cash flows of the assets and businesses underlying NPLs.

The most important advantage to work-out over restructure is that with proper communication and stakeholder management during the workout process the bank or AMC and the debtor are pulling in the same direction: they both want the same thing. The interests of the stakeholders are aligned, and where this is effectively communicated and understood by all stakeholders, the possibility of a successful work-out improves dramatically. Unfortunately, work-out is not always a viable option however and sometimes liquidation is inevitable.

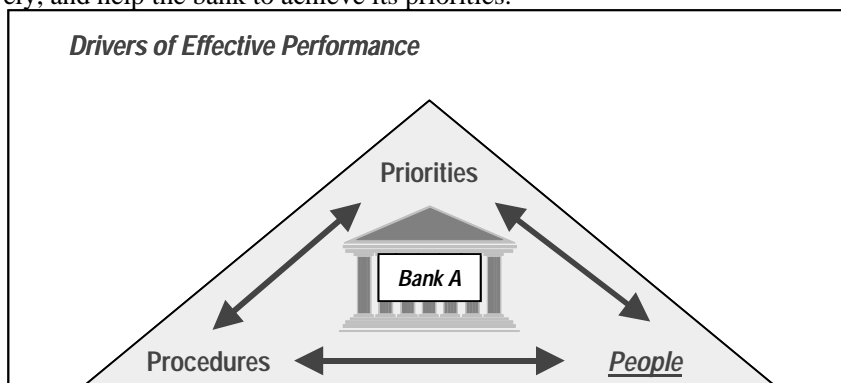
Restructuring of NPLs needs to be conducted quickly. Too often the NPL deteriorates in value through lack of action or time wasting during the sale or holding process. Before the NPL deteriorates in value too greatly, the exercise of determining the maximum principal the debtor can manage needs to be determined, so the remaining debt can be dealt with and the loan returned to performing status as a genuine performing loan.

AMC culture is changing, and needs to continue evolving. AMC’s need to take a more holistic and hands on approach to solving NPL problems. How do we capture these into practice? This is considered in the next section.

4. Bank Prudential Regulations and Practices: Frameworks, Internal Procedures and Capacity for Proper Insolvency Risk Management and Resolution

The performance of any bank is determined by three factors: *priorities, procedures and people*. The bank’s owners establish priorities and reward or punish management according to those priorities.

Management develops procedures (and support systems) as required to achieve the priorities, and the bank’s people carry out the procedures, based on their understanding of the priorities. All three factors must be aligned for the bank to function properly. The best procedures will not be effective if people do not possess the skills to follow them, or if they are not required or encouraged to do so. By developing an effective credit policy and adopting effective systems, a bank is addressing *procedures* as they relate to risk management. The remaining challenge is to ensure that the bank’s *people* are well equipped to carry out the procedures effectively, and help the bank to achieve its priorities.



To help a bank properly carry out the procedures effectively, they must exhibit:

- Consistency,
- Clarity,
- Be widely known and understood, and
- Applied consistently and application of the procedures monitored.

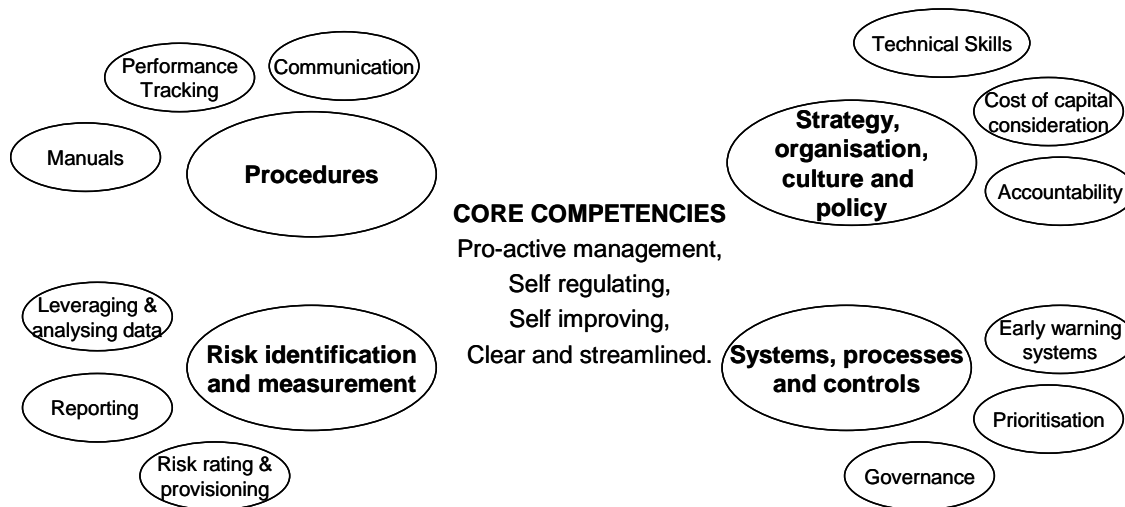
We discussed earlier the concept of Recovery Risk and its components. Asset Price Risk and Credit Risk clearly overlap in some areas in the case of an LMU or an AMC. Although a bank is exposed to credit risk while loans are being held, as borrowers may fail or be unable to meet their obligations, in some cases the intention remains to sell the loan to an investor, and so the risk again is that acquisition cost will not be recovered from the sale proceeds realised.

Where a bank or AMC moves to Stage Two Competency, credit risk becomes increasingly important. NPL's will be retained for longer periods, and recoveries will be spread over time, linked to the reorganisation and restructuring skills that are applied to particular loans. Rather than considering the liquidation value of collateral (for sale or disposal), a stage two organisation needs to focus on business viability, longevity and cash flow potential to decide whether to incubate or liquidate.

4.1 Effective procedures for proper insolvency risk management and resolution

How do we implement or capture these needs in a system? Outlined below is a roadmap providing some of the broad and essential characteristics and requirements for a downstream insolvency risk management system. The system needs to quickly (a) flag those loans with recovery potential for work out and (b) remove the bad loans from the equation.

Naturally, competencies interrelate and support each other.



Core competencies

Core competencies refer to the overriding factors that permeate the entire risk management system. These can be described as ideals, objectives or approaches that determine the structures and procedures that form the framework of the specific competencies. Core competencies are not procedures in themselves, but are directives for formulating procedures.

Pro-active management

The concept of pro-active management is critical for managing NPL's. A passive approach to NPL management will not maximise returns. In order to identify loans with potential for realising profits, account officers must be working the portfolio all the time, analysing data, assessing industry conditions and contacting the debtor company.

All NPL's carry recovery risk. We also mentioned that circumstances are always changing. For this reason, management of the portfolio must be pro-active and aggressive. Conversely, recovery risk relating to a particular loan may improve. In this case, the account officer must dedicate additional attention and resources to attempting to further enhance the value of that NPL, and attempting to restore the business to financial health.

In either case, recovery risk levels change all the time. Changes to recovery risk can be caused by:

- Debtor specific events (legal actions, new products, failure of machinery)
- Industry events (trade union actions, changes in consumer demand, competitive pressures)
- Regulatory issues (taxation issues, tariffs and other protection mechanisms)

Frequent, aggressive and pro-active review and action relating to the NPL portfolio is essential. It is essential for preventing unexpected losses, and for identifying unexpected gains or profits. It is also imperative to "work" the portfolio (continual individual contact, frequent visits) to prevent loans from going "stale". Too long a period of time without contact from creditors provides little incentive for struggling debtors to continue repayments, particularly if it appears they are not noticed when they fail to remit on time.

Self regulating and improving

The recovery risk management system includes procedures, techniques and tools to mitigate or quantify recovery risk, but their usefulness is greatly reduced if they are not followed consistently or thoroughly. To ensure compliance with all procedures and tools within the recovery risk management framework, the system must have built in safeguards and systems to ensure that:

- All procedures and techniques are followed,
- They are applied consistently (every debtor is assessed in the same manner, and no unreasonably favourable treatment is afforded to particular debtors), and
- They are applied thoroughly and in the manner they were designed to be used.

A well designed recovery risk management system must include checks and balances to ensure compliance. A good recovery risk management system must also be self improving, and continually refine, upgrade and improve itself. Generally this is achieved through data gathering and analysis. As a recovery risk management system progressively sets benchmarks, milestones and risk ratings to NPL's of specific categories, variances are almost certain to arise due to unforeseen vagaries in the analysis and factors not yet been attributed risk status. As analysis of newly gathered data proceeds, the system generates "lessons learned" analyses, which allow recovery risk quantification to be progressively refined and accuracy is progressively improved.

Clear and streamlined

The recovery risk management system must be clear and streamlined. This means that the system must be non-intrusive, yet pervasive. The system should enable users to interact with it constantly, entering and accessing data, receiving support and following through procedures.

However, the system cannot be difficult or cumbersome to apply, as it would detract from account officers time spent on doing their actual job: managing and restructuring distressed loans.

Strategy, Organisation, Culture and Policy

Technical Skills

In order to be able to carry out their task effectively, account officers must have sufficient technical skill to recover loans effectively. Skills, knowledge, practical experience and overall competency for each account officer must coincide with a level of complexity or difficulty of the various NPLs being managed within that account officer's portfolio. "Matching" of skills to tasks at hand is an important aspect of technical skills development: as every account officer will have varying degrees of skills and specialisations, it is critical that these skills are applied where best suited.

Skill enhancement and ongoing training is critical given the skill sets required for the restructuring and workout approach. As illustrated earlier, the skills for Stage One and Stage Two are distinct and separate, and in addition to on the job training, specifically focussed training and staff education is needed to bring technical skills into Stage Two.

Finally, there are a large number of specific skill sets that an account officer cannot have more than a basic knowledge of. A good example is legal knowledge and expertise. The areas of specific skill requiring additional support must be identified, and where required must either be recruited, or outsourced. Some examples of technical training and support include:

- Training of staff in NPL performance assessment and reappraisal,
- Training of staff in specific financial skills and workout skills,
- Training staff in identifying recovery risk, and techniques for mitigating recovery risk,
- Providing legal support to staff. Where very specific and technical skills are required must either retain appropriately skilled lawyers as part of its own staff, or outsource these requirements,
- Education of staff in commercial aspects of NPL recovery, with particular emphasis on continual identification of profit making opportunities.

Accountability

Accountability refers to the linking of performance and reward or penalty of employees. Where, for example, benchmarks or milestones are set for recovery levels of certain categories of NPLs or NPAs, and these are exceeded by account officers managing particular individual loan files, then a reward system should exist to encourage greater effort by employees, for example:

- Encouragement of staff in continually identifying profit-making opportunities,
- Linking staff performance bonuses to specific recoveries against set targets or benchmarks.

Communication and Cost of Capital Considerations

Communication simply refers to the development of employee "buy in" or enthusiasm for conducting aggressive loan recovery, for example:

- Conducting internal staff seminars / training sessions to educate staff in objectives and techniques,
- Training of staff in NPL valuation and performance measurement using NPV and funding drag techniques,
- Educating staff in recovery maximising techniques, procedures and approaches. For example, a market driven approach to asset realisation, pooling assets where possible, or seeking enhancement opportunities, to increase overall recoveries.
- Encouragement of skill and knowledge sharing amongst different divisions,
- Conducting training courses where possible with attendees from different groups,
- Formalising an intra-departmental communication channels for support and assistance.

Procedures

Procedures refers to the overall approach and philosophy utilised in conducting day to day business. The approach or philosophy must incorporate the core competencies, and capture these as part of every aspect of NPL management and debt recovery methodology, approach and procedure. These core competencies as discussed above include:

- Proactive management,
- Self regulation,
- Self improvement, and
- Clear and streamlined systems and procedures.

Performance Tracking

Performance tracking must be timely. In order to reduce unexpected losses, an AMC or LMU needs to know whether performance is slipping, and if this can be addressed. In the event that external factors have resulted in a drop in performance, the risk rating system may need to be revisited.

Unexpected losses arise due to changes in the external environment. Where the recovery risk profile of an NPL has changed because of some internal or external event, the change in recovery risk can be managed (seeking additional collateral, negotiation with the borrower, debt rescheduling). However this can only be achieved when the credit officer is aware of the change in the recovery risk. By building on the advantages and benefits of other specific competencies, a more deep and thorough understanding of the loan portfolio and changes in circumstances surrounding specific categories of NPLs can be monitored pro-actively, for example:

- Establishing formalised regular performance measurement reports (against benchmarks and targets rather than acquisition cost),
- Formalising follow up and reassessment procedures for NPL's failing to meet targets,
- Development of a risk-rating systems,
- The risk rating system must become a pervasive part of the thinking of all staff in conducting day to day work. Encouraging a more aggressive, active and hands-on approach to managing the loan portfolio is critical part. *Manuals*

Process manuals are a critical component of the overall recovery risk management framework, yet it is extremely important to remember that these are not a stand alone tool. As with the IT specific competency, process manuals are linked to, and depend heavily on, other specific competencies, namely human resources, policies and procedures and the IT framework. Process Manuals provide support to employees and assist with the core competency of self regulation. They achieve this in the following ways:

- By using checklists and having completed checklists signed off by superior account officers, credit officers are able to demonstrate all actions taken in relation to a particular loan file.
- Well documented and structured process manuals enable loan files to be well structured and easily reviewed.
- The use of checklists enables issues to be highlighted as and when they occur and these are easily reviewed when explanations for decisions having been made are sought.

Risk identification and measurement

The Risk Identification and Measurement competency forms the platform upon which effective recovery risk management control is achieved, and the system employed is usually an IT based system. It is important to realise, however, that no matter how sophisticated the management information system (MIS) employed is, it is simply a part of the entire recovery risk management system and thinking culture. A good MIS will not prevent recovery risk on its own: it will help quantify and control recovery risk within the overall framework.

Risk identification and measurement is critical in assisting in recovery action and in the establishment of early warning systems, performance tracking, prioritisation and identification of specific issue NPL's or industry trends.

As information gathered over time grows in volume, the progression or evolution of raw data to useful and valuable information becomes more and more an effective and meaningful recovery risk management tool from both a portfolio specific and individual NPL specific perspective.

The organisation of data and the ability to present this data in meaningful formats (information) requires a sophisticated MIS to track all the information pertaining to an asset or portfolio of assets.

Leveraging and Analysing Data

Leveraging and analysis of data refers to the evolution of raw data to information. That is, taking data normally included in relation to any non performing asset file, and interpreting this data to identify industry trends, loan category performance and employee performance.

In order to be effective, the IT system must facilitate this data analysis and make best use of the available data historically, and also as it is received (updated data representing ongoing experience). Progressive analysis conducted through lessons learned in relation to specific recovery actions and proceedings over time can give valuable information regarding expected recoveries and quantification of risk, such as:

- Using existing data and historical recovery records to establish benchmarks,
- Establishing a progressive system of information refinement as new data is added,
- Converting recovery data held into industry / loan type specific information for due diligence / acquisition strategy use. (Using experience and data gathered to indicate "good buys" will significantly mitigate acquisition risks).

Reporting

The IT system must include sufficient flexibility to allow a number of reports to be extracted from the available data. Communication of results must be progressive, ongoing and timely. The reports generated must address:

- *Access and usage* of the loan files, being the timing, frequency and type of intervention users are making to individual files,
- *Loan Specific Data* being fundamental changing characteristics of the loan, and
- *Risk factor data* being changes to factors that affect the overall riskiness of the loan.

Some examples of reports that the IT system should generate are detailed below:

- *Employee performance assessment:*
- *Performance Assessment:* Aggregation of recoveries achieved vs. expected returns provides a recovery risk adjusted estimate of returns for the individual loan and for the portfolio.

- *Efficiency Assessment:* An indication of the time spent recovering the loan provides an estimate of the difficulty in collecting the recovered amount. This data is useful for forming estimates at a later stage of the difficulties and likely timing of turnover for a portfolio of loans with like characteristics.
- *Employee Rewards:* Returns of a certain percentage above expected returns linked to employee bonuses.
- *Profitability Assessment:* A detailed analysis of returns achieved will provide an indication of overall profitability. Where cash flows and / or realisations are analysed using the maximum cost of capital to KAMCO (CD + 1.5%) in relation to the return achieved from a particular NPL, the actual contribution to profitability / loss for that loan can be assessed and used as a guide for future acquisition policy.
- *Historical Results / Risk Assessment Refinement:* By assessing returns on an ongoing basis, and continually providing new data to the system, the system can correlate loan values and risk levels to loan characteristics in order to identify key risk drivers, and help make ongoing improvements in the recovery risk management function.

Risk Rating and Provisioning

Although the risk rating and provisioning functions are separate and independent issues, the risk rating system will have a significant influence on level of provisioning.

As discussed above, using an AMC or LMU's own data, correlation analysis can be conducted to convert this data into useful information. This data can provide:

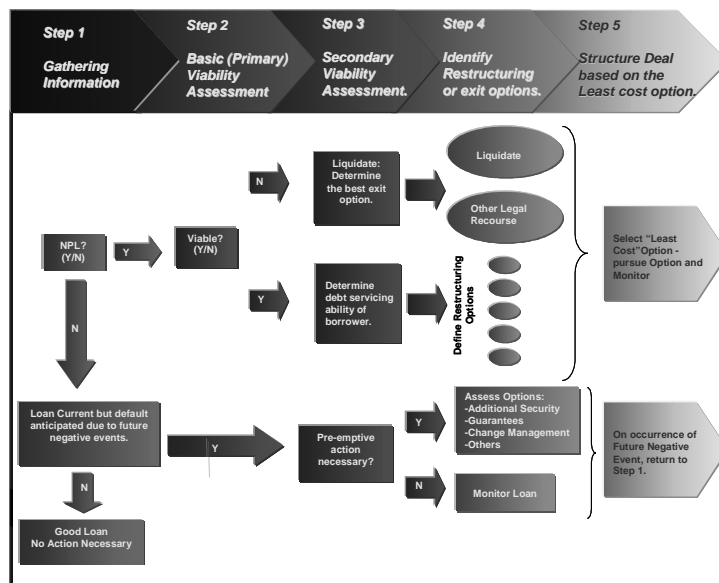
- Early warning of loan default,
- Quantify expected recoveries (using experience linked with loan data),
- Assist in planning of resource allocation (staffing and staff time commitments to loan files) and
- Cashflow forecasting and business planning.

4.2 Example of a functioning downstream insolvency risk management system

The flowchart detailed in this section represents an actual downstream insolvency risk management system developed in the form of a manual for the Bank of Thailand.

The flowchart is self explanatory. The manual was developed with the guidelines outlined above in mind in a simple to use manual, complete with checklists and flowcharts, and detailed explanatory memorandum at each step of the process.

The key features of this system which made it an improvement on existing practices include:



Transparency: By providing a standardised checklist driven approach, the guidelines ensure that all debt restructurings and NPL resolutions are conducted in the same way and that no debtors are treated differently from another. The paper trail and structured file approach means that auditors and regulators can easily ensure that minimum requirements have been dealt with. However, while the guidelines are structured, they still permit flexibility to deal with the individual characteristics of each loan.

Speed: The guidelines provide a structure that allows credit officers to follow a standardised process, which accelerates the process by providing step by step guidance in different situations. Alternative checklists for smaller loans ensure that the level of effort expended in resolving an NPL is commensurate with the size of that loan. Any NPL's which are not worth restructuring, either due to financial non-viability or lack of cooperation, are ejected from the process and resolved through other means.

Decision Support: The guidelines provide support for decisions made by credit officers when conducting their work, by allowing them to present their work flow and findings in a structured manner. This allows the officer to justify decisions made regarding resolution of an NPL (such as the write off amount) at a later date, demonstrating that all items that needed to be considered and / or performed were done, and that a comparative cost and benefit assessment was made for each available solution for dealing with the loan.

Improved Returns from NPL's: The guidelines provide an international best practice approach to NPL resolution, covering all aspects of the process. At the same time, the guidelines retain sufficient flexibility and scope to allow individual credit officers to exercise their own professional judgement and skill in structuring the deal which provides the best possible return on any NPL. Combined with the accelerated process and the decision support framework which introduces a catalyst for action, returns on NPL's are enhanced.

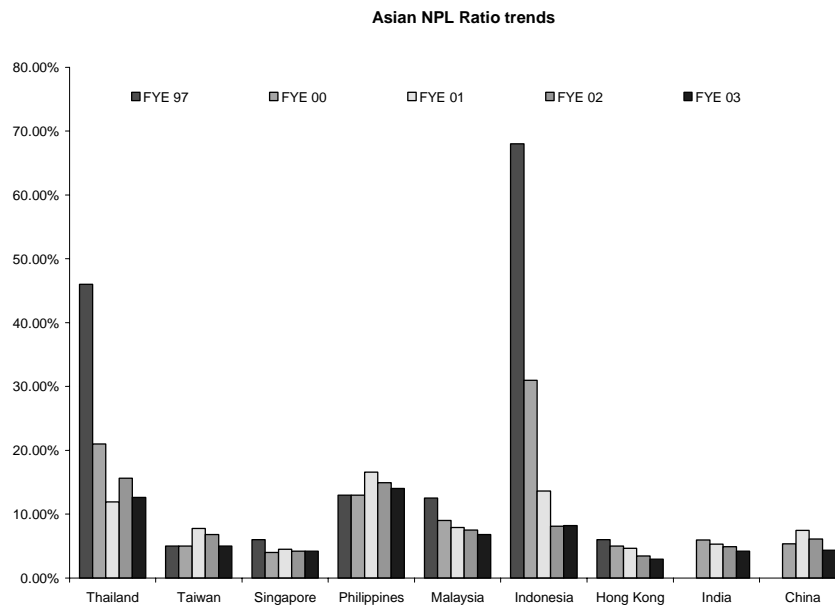
5. Development of the Secondary Debt Markets in Asia and their Importance for Insolvency Risk Management

Bulk sales of NPL's have been effectively used in a number of jurisdictions throughout Asia, and AMC's have traditionally played key coordinating roles.

Debt trading has become a thriving business in Asia, and financial institutions seeking to remove NPL's from their books are often able to find investors to purchase these debts by taking advantage of the secondary debt trading market. The lack of adequate credit analysis and risk management practices in both local and foreign banks served to accentuate the effects of the recent financial crisis in Asia. Traditionally, most banks had made loan decisions based almost exclusively on two criteria: the borrower's reputation or social stature and the book value of underlying collateral. The borrower's ability to repay the loan, measured through projected cash flow, was typically overlooked.

When, as a result of the crisis, borrowers began to cease repaying their loans on time, banks were slow to react forcefully, not wanting to endanger relationships with key clients. The use of bulk NPL sales is to a degree a reaction to this, as drastic steps need to be taken to address a large and entrenched problem. The NPL situation in Asia is gradually improving, and each country has utilised unique and specific resolution frameworks and mechanisms to deal with NPL problems, with varying degrees of success.

The following chart indicates the NPL ratio trend in a number of countries throughout Asia from 1997 to 2003.



Source:
central banks

various

Although improvements generally are clear, and in some cases dramatic, it is important to note that the NPL ratios are *reported* ratios. They are driven by the classification criteria used in the relevant jurisdiction, and are particularly affected by the criteria used to determine when a loan returns to performing status.

The same NPL's, although the reported ratios are improving, still exist. They are either:

- Being worked out by a new investor
- In a "holding pattern" in an AMC
- Subject to negotiations with creditors and being restructured, or
- Have been restructured and returned to performing status.

Secondary debt markets and insolvency risk management

It is important to note that in the absence of a viable insolvency legal framework, often the use of the secondary debt market is the only real alternative available to banks in dealing with NPL's. Secondary debt markets can act as a catalyst for work-out and restructuring (the new buyer of an NPL is usually eager to realise a profit by improving returns from a loan) but can also hinder the process where there is no impetus or motivation for work-out.

Desire to Work-out f (Inverse proportion to) (expected return – purchase price)

The desire to work-out the loan is inversely proportionate to the difference between the expected return and purchase price. The expected return is driven by accountability and expectations of stakeholders. The purchase price is determined within the sale process. If either factor do not function, then the motivation to conduct a work-out fails.

Motivation to work out can be reduced where there is insufficient accountability to the purchaser (i.e. there is no one the purchaser is answerable to for results) or there the purchase price is too low.

NPL's reduce bank profitability as well as available reserves, and create "funding drag", a combination of opportunity cost and real cost. Elimination or transferral of NPL's from the books removes this funding drag.

Market Lending Rate	=	Σ	(Average Funding Cost) (Risk Margin) (Profit Margin)
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By eliminating, selling or transferring NPL's away from a bank, the NPL's are converted to cash, eliminating the funding drag, a quick fix substitute for conducting a work-out or recovery internally.

In the absence of a functioning insolvency legal regime, this is effective for banks (although there is a loss in the discount on purchase price). The difficult task of recovering the funds from the NPL falls to the purchaser, who is normally skilled in this area. However as the reduction in value of the loan has already been factored into the purchase price, the new buyer has at least the possibility of making a profit.

For the selling bank, this exercise reduces the funding cost, being the cost of raising funds from capital and deposits, which is incurred as NPL's generate little or no revenue, so the financial institution makes ongoing losses funding these assets. It also reduces the opportunity costs to the bank, because the funds tied up in the NPL cannot be applied to a good, income-generating loan, with obvious flow-on effects for society as a whole.

Why are AMC structures popular? AMC's:

- Protect the franchise and image of the originating bank, prevent adverse publicity and potentially more damage,
- Directly improve the banks profitability and balance sheet,
- Centralise debts under one creditor (particularly in syndicated loans) which vastly simplifies negotiations and recovery,
- Eliminate possible confusion or doubt in the mind of the borrower as to who should be paid, and allows a systematic repayment structure to one creditor to be established,
- With the establishment of special powers, improve chances of recovery,
- Dedicate and centralise resources for work-out or sale, and concentration of skills,
- Allow for many NPL's to be combined and dealt with simultaneously (tranche sales), and
- Convert NPL's from "blockages" to cash.

However there are dangers as well as benefits associated with conducting sales of NPL's through the secondary market

The benefits of conducting bulk sales of NPL's are many and varied and substituting workout procedures and systems with the secondary debt market can work well. Some of the key benefits are:

- Protection of individual banks image and franchise, allowing them to continue to operate as viable banks without a marketplace adverse perception,
- Removal of funding drag and opportunity costs from banks balance sheets, allowing them to operate more profitably,
- Allows banks to focus on core business rather than disaster management,
- Economies of scale: concentrating problem loans into one pool and focusing management,
- Uniform approach to restructuring is adopted through AMC policy: all parties know where they stand,
- Multi-creditor restructurings become single creditor restructurings, eliminating conflicting policies, procedures and objectives, Enhancement of bargaining position with debtors, particularly where AMC's have special powers,
- Potential for securitisation of asset pools,
- Centralised ownership of collateral: enhances enforcement, and also disposal of grouped assets,

- Breakage of links with connected debtors, and
- In some cases, where confusion or doubt exists with debtors as to who should be paid, centralised identified collection authority.

There are also dangers and drawbacks associated with selling NPL's through the secondary debt market:

- Expectations of more favourable treatment by debtors
 - Breakage of relationships and information links which can facilitate or accelerate debt restructuring and recovery
 - A lack of "ownership" or responsibility of the AMC and AMC staff for recovering the funds: reduced motivation
 - Where delays occur in communicating with borrowers, payment discipline can collapse
 - Complexity of transfers can create significant lengthy delays
 - AMC's can on occasion be used to "hide" or "warehouse" bad loans and conceal problems
 - Loss of skills in the banks in recovering debts and managing bad loans
 - Moral hazard: banks do not take responsibility for their mistakes.
 - Loss of revenue to the originating bank from the potential upside of loans through the workout process
- Loans where there is a chance of a return to rehabilitation may not get that chance. One of the greatest risks and dangers of an AMC is the unnatural dumping or flooding of a market with assets which can significantly worsen a national economic problem. For example, depressed real estate or motor vehicle markets can be significantly adversely impacted by flooding the market with underpriced non-performing assets attached to NPL's, and care must be taken when determining a strategy for NPL disposal to address this.

Another obvious risk of course is the loss to the originating bank. Specialist NPL purchasing organisations throughout Asia have made profits over the last eight years by buying loans from banks at a discount and realising more than the purchase price. These profits were made at the expense of the originating bank which lost that margin, the relationship with the borrower, the future lending opportunities and also the recoverable loan value. The situation is even worse when the NPL is not really an NPL, for example where the borrower has failed to make payments due to a lack of communication or confusion. This situation has arisen several times in NPL sales transactions and results in the purchase price being too low.

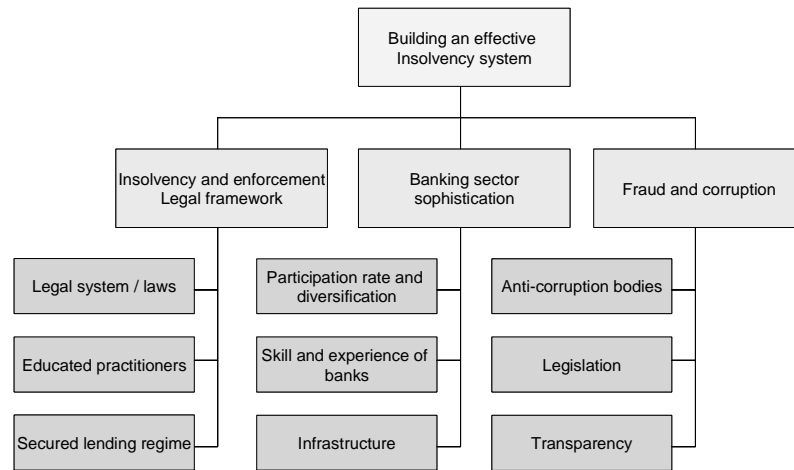
Bank pricing thinking always considers the NPL is worth more, and are usually suspicious of a purchaser's pricing model. The real value of an NPL is what a willing buyer and a willing seller can negotiate. The buyer has other investment options, whilst the lender is usually under pressure to resolve the NPL and eliminate the funding drag, and in the absence of downstream insolvency processes and procedures or work out skills, has no other option.

6. Some Conclusions

Although facing a positive future, insolvency in Asia is not going to go away or vanish solely due to regional growth. Growth in Asia itself faces some challenges and is not guaranteed, and as discussed earlier insolvency is a function of lending: it will always be there and we will always need to address it.

Section 4.1 of this paper details a suggested micro-level theoretical framework for individual banks to apply to assist in developing effective downstream insolvency risk management systems or for assessing the systems in place and determining which areas require attention. All are very important, but should be prioritised depending on the individual bank and its existing systems, risks and challenges. A useful approach is to use this map as a discussion or workshop focus point: what do we have in each of these areas? Which are strong and which are weak? Which are more important to us? What are we doing about strengthening these areas? Capturing answers to these questions is a very useful exercise, and in an organised framework assists banks to focus and prioritise their efforts.

Section 2 of this paper takes a much higher level approach, looking at some macro level issues facing insolvency risk management generally. These can be considered the “drivers” of an effective insolvency risk management system. Consider the following diagram:



As with the micro-level map, this representation suggests some areas for reform and development on a higher level under the three “drivers”. These are the primary obstacles to an effective insolvency risk management system, and behind each driver would be a number of projects and reforms in progress to strengthen these drivers.

History indicates that catastrophic or sudden reform is often less successful than “creeping” or “insidious” reform: reforms in progress need to be holistic and interwoven, to attack each problem or obstacle slowly from a number of directions.

Finally, the role of secondary debt markets in Asia has been an effective support for the lack of insolvency risk management, and has effectively delivered liquidity to troubled banks in the region over time. However this has come at a cost. Reliance on the secondary debt market reduces profit making opportunities for originating banks, however given the need to improve liquidity when faced with NPL’s and the lack of skills in dealing with them, and in the absence of a strong and effective insolvency regime, banks have no alternative but to utilise it.

Where the secondary debt market is being used, regulators need to be mindful of the need to ensure that the motivation to work-out is present. For a private institution accountability to investors and shareholders is often sufficient to ensure high levels of commitment to maximising returns through work-out, however where this degree of accountability is not present this is not always the case. Where there is no accountability, expected return is low, and the desire to work-out is also low. Regulators can influence the expected returns function of the equation by ensuring strict accountability for state AMC’s, and in this environment the potential profits from work-out will not be lost.