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*A U.S. Perspective on Cross-Border "Informal" workouts:
Mr. Morgan Kelly, Deloitte Touche Tohmatsu, Australia*

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“There are some who would argue that the role of the bank supervisor is to minimise or even eliminate bank failure; but this view is mistaken in my judgement. The willingness to take risk is essential to the growth of a free market economy.... [I]f all savers and their financial intermediaries invested only in risk-free assets, the potential for business growth would never be realised.”

Alan Greenspan, Chairman of the Federal Reserve Board
November 1994



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1. HISTORY OF BULK SALES IN ASIA

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, such as:

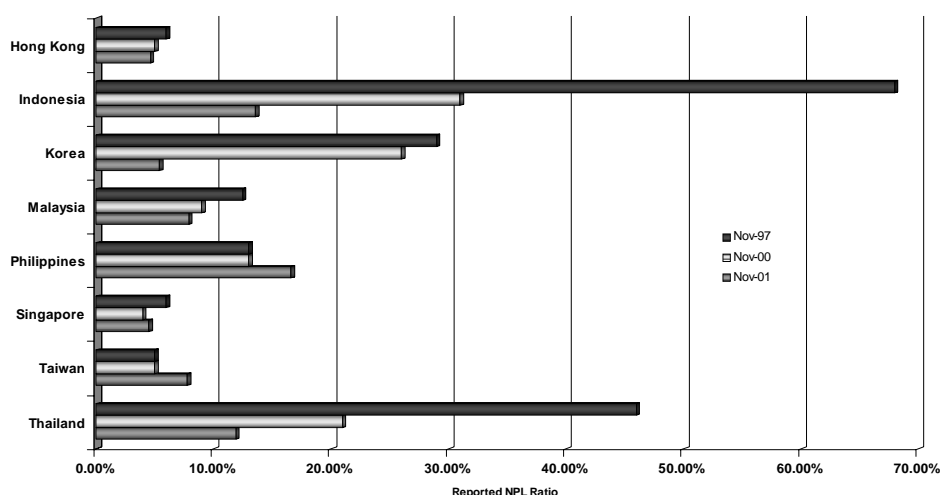
- Thailand (FRA, TAMC),
- Korea (KAMCO),
- Indonesia (IBRA),
- Vietnam (VAMC)
- Malaysia (Danaharta)
- Taiwan.

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 Thailand. Traditionally, most Thai 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. Throughout years of solid growth, in the wake of competitive pressure and a lack of relevant and reliable data, many foreign banks also practiced forms of relationship-based lending.

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, 2000 and 2001.



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.

More on the difference between debt restructuring and rehabilitation will be discussed at section 4 below. I will now provide some broad and general comments on specific countries in Asia and their experiences with and responses to the NPL crisis in Asia:

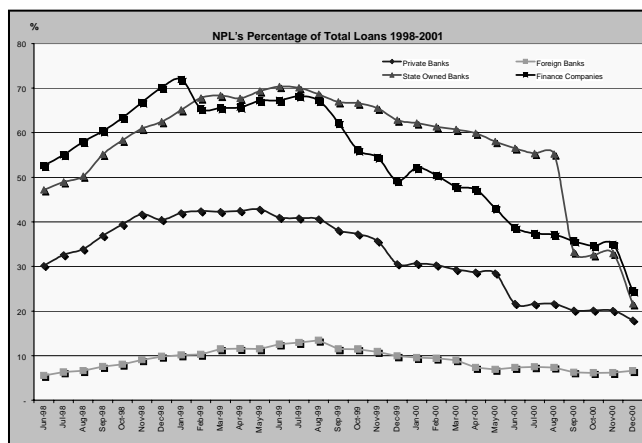
Indonesia:

The government formed the Indonesian Bank Reconstruction Agency (IBRA) with over \$US 60 billion in assets in its care. Sales of NPL portfolios have been slow, partially due to an overdeveloped bureaucracy and a cumbersome internal approval process. Ministry of Finance (MOF) transaction approval is not always forthcoming, which slows the process still further.

There is also a general refusal to discount principle, which reduces the saleability of risky assets. Holding companies have been established to facilitate sales, but these retain incumbent management. Foreign investment restrictions are also limiting sales.

Thailand

In August 1997 Thailand committed to a \$US 17.2 Billion rescue package managed by the IMF, and by the end of 1998 Thailand was in economic recession, worsened by a significant outflow of capital. Bankers and credit officers in Thailand lacked the skills and experience at that time to manage the complexity of many of the issues which arose (many through syndicated lending issues and different approaches, agendas and mandates of different banks) and the sheer volume of NPL's that had to be examined and restructured.



The chart (source: the Bank of Thailand) illustrates the movement in NPL's in Thailand over the period 1998-2001.

Note that the definition of a non-performing loan for the purposes of the Bank of Thailand is any loan which has remained outstanding for greater than three months.

The original AMC in Thailand (1997-1999) was established to act as the bidder of last resort at FRA auctions. Legal and regulatory issues facing

credit officers in government banks included potential criminal liability for loss of public funds (which could have included writing off bad debts). This created significant concerns regarding the workability of the original AMC.

The Thai Asset Management Corporation (TAMC) was expected to manage over US \$31 billion in NPLs represented by 6,000-7,000 borrowers. TAMC's establishment was delayed by constitutional issues on superpowers and appeal limitations which led to considerable parliamentary debate. There were also initially some concerns regarding influence and transparency, which were addressed.

The stated main strategy of TAMC to be employed in restructuring is debt-for-equity swaps and “haircuts”, or reductions in accrued interest and loan principle. Both strategies were designed to help targeted borrowers reduce their debt-to-equity ratios and better match up loan payments with

cashflow, with the ultimate goal being making companies independent of new long-term borrowing altogether.

Assets transferred must involve debt of over THB 5 million owed by at least two creditors. The TAMC will have a lifespan of approximately 12 years. After two years, the finance minister will establish an assessment committee to oversee the agency's performance. After seven years, the agency will begin preparations for closure and formal dissolution will occur after 10 years and full payment of accounts after 12 years.

Transfers were made at book value, with 10-year bond finance guaranteed by the Financial Institutions Development Fund (FIDF), and methods for sharing gains and losses were also established. Superpowers were granted for reorganisation, and immunity for officers conducting workouts was achieved.

Korea

The Korean Asset Management Corporation (KAMCO) was restructured and given a new mandate as an AMC in 1997. KAMCO Manages US \$76.4 billion of NPLs.

KAMCO structures NPL sales using asset-backed securities (ABS), by transferring assets to special purpose vehicles allowing securitisation. These vehicles (Corporate Restructuring Companies or CRC's and Special Purpose Vehicles or SPV's) operate as joint ventures, and permit foreign ownership in reality, as well as skills transfers and cash injection.

KAMCO has also formed a large number of joint ventures with foreign firms, and has signed MOU's with seven countries to share experiences and know-how. More recently, KAMCO has begun to move its focus from NPL sale to managed work-out.

Malaysia

Malaysia's Danaharta was established in June 1998, and only managed 2,000-3,000 accounts. A willing buyer / willing seller approach to transfers was used. Superpowers were also granted to credit officers. Danaharta assisted restructurings by using special administrators, or by acting as lead bank in syndicated credit restructurings. 80% of assets under Danaharta's care have been sold.

Japan

NPLs in the Japanese banking sector are more than four times those of the US Savings and Loans crisis. The Resolution and Collection Corp, a debt collection agency funded by Deposit Insurance Corp has taken assets of 90 institutions purchased at considerable discounts from failed institutions only – these NPL's are not attractive to operational banks and difficult to sell.

There are substantial Issues surrounding organized crime links for NPL's, which also make restructuring and resolution difficult, and adversely impact on the will and impetus to conduct workouts.

Taiwan

The Taiwan Asset Management Company (TAMC) was established in May 2001. NPL levels in Taiwan remain high, and resolution problems are exacerbated by difficulties with level of confidence in government and regulators and financial reform packages proposed by the government.

Recent efforts by private banks have started the NPL sale process and market. The reported ratio of NPL's to good loans fell to 7.48% in the June quarter from 8.04% in the previous quarter, and the

Government Financial Restructuring fund requires another NT \$910 billion to reduce the overall ratio to 5% within two years.

The total NPL market in Taiwan is valued at NT \$1.43 Trillion (US \$42 Billion).

2. WHY ARE BULK SALES PERFORMED?

A nation's economy is very like a human body. Cash is like blood, and the banking sector like the circulatory system. The banking sector is the system that delivers cash to the places it is required, such as financing of a new business venture, which creates employment and productivity, and ultimately economic growth.

NPL's are places in the system where cash is paralysed. Extending the analogy, NPL's are like blood clots or arterial blockages. NPL's prevent cash from being delivered to where it is required, and also create additional costs for the institutions holding them.

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 can be converted to cash, removing the blockage.

This also 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.

The usual vehicle for facilitating a bulk sale is an Asset Management Company (AMC). AMC's are either developed as a separate division of an existing financial institution, a joint venture with some third party, a separate private organisation, or a centralised government authority. Using AMC's improves banks capital structure, and frees up cash for allocation to more profitable areas.

Why do we use the AMC structure? 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.

2.1 AMC Mandates and conflicts

The objective of an AMC structure is to ultimately improve the overall quality of certain assets, which are under-performing or distressed through either one or a combination of two alternative approaches.

The improvement in quality of an NPL is measured by reference to the percentage of the NPL's book value which is ultimately recovered in cash. For the purposes of fair comparisons, the calculation is normally performed as net present value (NPV) of the income stream or sale proceeds of the NPL. AMC's are reporting entities too, and are accountable for achieving results. There are two main ways in which an AMC can manage assets in its care:

- Sale of loans, or outsourcing management, and
- Internal management and internal workout.

Each of these approaches has major ramifications for the management style, approach and techniques that will be employed by the AMC in recovering from these assets, and in managing recovery risk. In many cases a combination of these approaches is used. The primary objectives driving an AMC are speed of recovery and results, and maximising the recovered value. These objectives are sometimes mutually exclusive. In some cases the faster an NPL is resolved, the smaller the recovered value. Where more time is allowed recovered value can increase (although holding costs increase over time).

	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 level of 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 an NPV basis vs. acquisition cost, • Opportunity costs or funding drag (over time) and operating costs, • Proportion of negotiated workouts vs. litigated ones.

An AMC can either recover / convert to cash *quickly* – improving returns by maximising cash in hand and therefore NPV, or nurture and incubate the loan through a work-out or resolution framework, to improve the quality of the loan and potentially return the loan (or part of the loan) to performing status. Performing status loans perform on normal commercial terms.

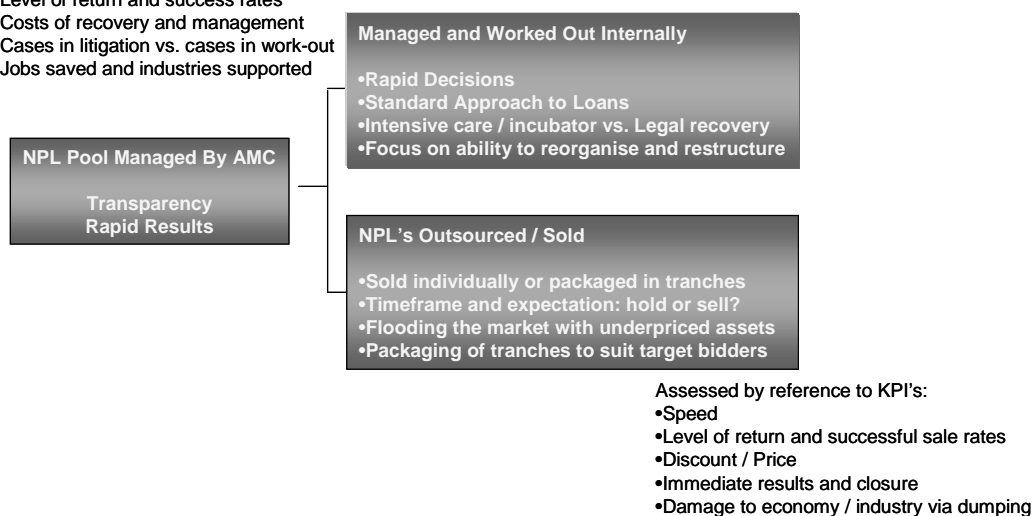
Unfortunately, an AMC has conflicting mandates:

- Produce results QUICKLY, and
- MAXIMISE returns from NPL's.

The two objectives are not compatible. In fact, they are mutually exclusive.

Assessed by reference to KPI's:

- Speed
- Level of return and success rates
- Costs of recovery and management
- Cases in litigation vs. cases in work-out
- Jobs saved and industries supported



To explain further: under the internal management approach, the AMC puts a top percentile of loans with good recovery prospects under “intensive care”. At the same time, “portfolio fishing” helps identify other good loans to place in intensive care.

This means helping the debtor repair or reorganise their business to become profitable.

The ultimate aim is to increase cashflows over the life of the loan.

Where reorganisation and restructuring is managed internally, the credit officer remains mindful of:

- The ratio of new write-offs against reorganised loans,
- Returns achieved from recovered / saved loans,
- The ratio of work-out loans to litigation / recovery action loans,
- Movements in asset levels (provisions vs. write backs),
- Operating costs vs. operating income,
- Individual credit officer time spent on individual loans (i.e.: the ratio of officer time spent to the value of the loan).

In contrast, the outsourcing or sale approach is focused purely on handing the NPL's on to someone else: the AMC is a warehouse for the loans until they are sold to a new owner.

Concerns are mainly:

- Asset reduction against NPL turnover,
- Prices and returns achieved vs. book value,
- Costs incurred relative to portfolio value,
- Timing of sales and number of sales held, and
- Immediate and tangible results, perception of the public, regulators and investors.

2.2 Benefits and dangers associated with conducting bulk sales

The benefits of conducting bulk sales of NPL's are many and varied. 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 associated with using AMC's:

- 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.

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.

Bank pricing thinking always considers the NPL is worth more, and are usually suspicious of the purchasers 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 must resolve the NPL and eliminate the funding drag, or potentially face closure.

3. HOW IS IT DONE?

3.1 Options for AMC structuring

There are a broad range of legal structures that may be used to structure an AMC, and a variety of issues to be considered when determining which is the most appropriate structure. Some alternatives are:

- A separate department within an existing bank
- A joint venture with an organisation with the right skills sets or funds
- A separate government agency
- A separate corporate entity, owned by the owner of the NPL's
- An independent third party (foreign investor) buying in
- A consortium of independent third parties.

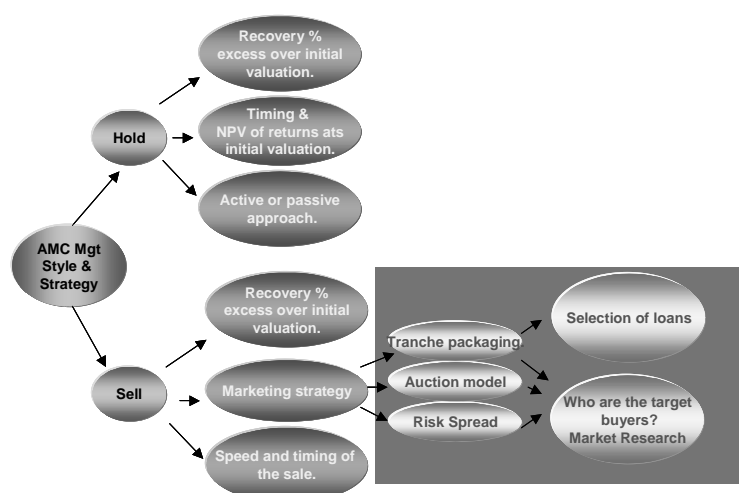
Considerations when structuring an AMC include:

- Who will manage the portfolio?
- How will the manager be held accountable?
- How will the internal governance framework be established? To whom will the AMC be answerable?
- How will costs of establishment, operations and recovery be shared?
- How will management be remunerated? How will fees be structured?
- How will gains and losses be allocated between the institutions?

Where the strategic planning and conduct of NPL management or sale will significantly impact on the economy or a business sector, government level guidance and intervention is often required. Similarly, where special powers will be required for the AMC, regulatory intervention and assistance is prudent.

There is usually a desire for the original NPL owner to distance themselves from an AMC to avoid adverse publicity and brand damage. Tax considerations are also crucial in determining the structure (particularly JV's).

3.2 Tranche packaging and valuation



This flowchart summarises the decision chain discussed earlier.

Presuming a bulk sale is to be performed, we will now focus on the highlighted section of the NPL sale process.

Some of the key considerations here are:

- What are the types of loans available for packaging? This will provide guidance on the composition of the tranches, and assist in structuring the sale focus

- What is the quality (value) of the loans in the portfolio? This will assist in determining the risk spread, also a critical consideration when composing tranches
- Who are the likely targets / likely purchasers of these loans? Finally, this will determine the sales strategy. Who will the characteristics identified appeal to, and how can they be combined in such a way as to make them more appealing, and maximise price?

Packaging and saleability will obviously be affected by the types of loans included in the tranche:

- Size and term of the debt
- Nature of credit (motor vehicle, credit card, working capital)
- Whether the debt is cashflow or collateral dependent, and
- If the loan is a special purpose project loans

Property loans require particular attention to market characteristics, e.g.:

- Commercial
- Residential
- City
- Provincial
- Development

When pooling loans into tranches, the following considerations should apply:

- Transfer of loans grouped with similar characteristics,
- Transfer of larger loans first,
- Identification of immediate disposal opportunities and strategies for loans tagged for immediate recovery action (i.e. loans for which workout is impossible),
- Terms and method of payment: is there a process for a new purchaser to rely upon or adapt after purchase?
- Accounting treatment for the original bank debt, loss adjustment or write-off where appropriate, post sale.

Broader considerations, which will affect the marketing strategy and the tranche appeal, also need to be thought about:

- Quality of the loans being transferred to tranches
- Composition of the tranches, mixed or specific, loan dynamics (characteristics and underlying industries)
- Requirements and objectives of the target purchasers, and the tranche composition that will be most attractive to them
- What trends can be expected for the tranche in the future: how will they perform?

Valuation

Why do we perform a valuation and examine the risk spread of the NPL's we are selling?

- To assist with tranche packaging: we need to know what sort of loans we are offering to a potential buyer. The most important characteristic is risk, and we must understand it to present a more attractive package
- To set price parameters and criteria for accepting or rejecting bids made

- To assess bids made for our NPL's from an informed perspective: we need to form our own view of what the NPL's are worth, and ensure we maximise our return for them rather than sell them at undervalue, particularly if there is negotiation involved
- To assist with the AMC's own budgeting and planning: especially where it is expected a sale program is going to take a long time

There are many different approaches to valuing NPL's, each with their own strengths and weaknesses. The "real" value of a portfolio of NPL's is of course whatever someone is willing to pay for them. Astute analysts utilise several techniques or combinations of techniques to calculate a range of values. The following tables provide a summary of some of the more common methods used for valuing NPLs, and their relative strengths and weaknesses:

Approach	Advantages	Disadvantages	Key Requirements
Discounted cash flow	Provides free cash flow to assess capacity to service obligations. Allows quick sensitivity testing. Expresses value in today's currency. Rigorous and widely accepted.	Difficult to quantify cash flows. Difficult to find right discount rate, and difficult to estimate terminal value.	Estimates of the assets terminal value, appropriate discount rate. Identify and value assets not contributing to cash flow.
Asset valuation-going concern	Provides a quick assessment of value.	Difficult to obtain reliable asset values. Does not allow for time value of money, nor costs and taxes.	Difference between FMV and BV. Allow for prior charges and undisclosed liabilities, allow for realisation costs and time delay.
Asset valuation-liquidation	Facilitates a quick sale process.	Represents a minimum value only.	Consider appointment of external administrator.
Portfolio valuation	Provides a cost effective method for valuing smaller loans.	Valuation is not as accurate as more detailed techniques for each loan.	Sample test portfolio to set benchmarks (by size, loan type, industry etc)
Comparable values	Provides a general benchmark and a "reality check" against other valuation methods.	Subjective and simplistic. Requires ready access to appropriate comparables.	Identify many comparable cases.

Typically, loans are allocated to one of two categories, high value loans, a small number of loans representing high credit concentration, and large volume, low value loans. Often the 80/20 rule can be used as a guide for making this classification.

Key loan criteria are identified, stratifying the NPL portfolio characteristics, such as:

- Loan Size,
- Industry Group,
- Nature of collateral security,
- Ageing and arrears, and
- Loan terms

Specific Reference is given to variables based on the RISK impact and their VALUE impact. For example:

RISK IMPACT	VALUE IMPACT
<ul style="list-style-type: none"> • Collateral Existence and Value • Location • Industry • Arrears 	<ul style="list-style-type: none"> • Repayment Frequency • Term to Maturity • Instalment • Interest Rate

Three main approaches for applying these variables will be discussed:

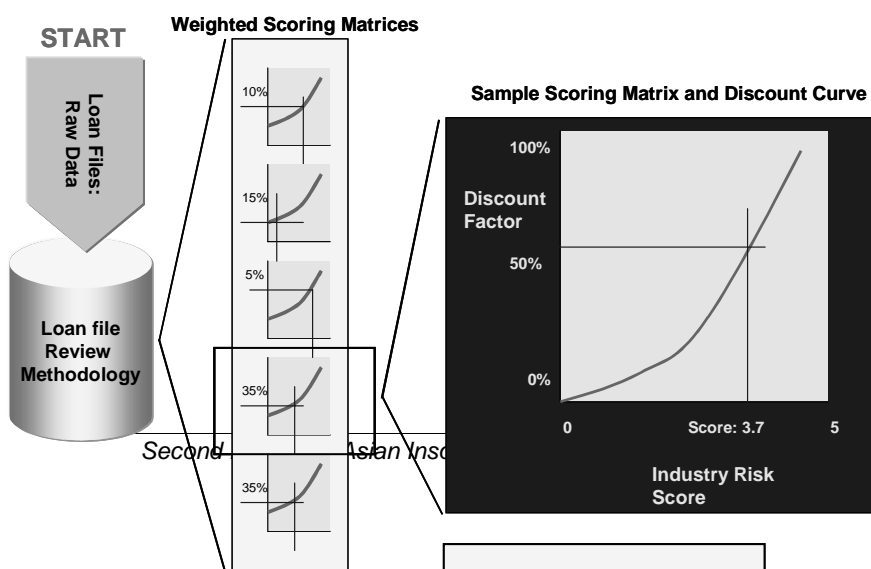
- Sampling / statistical analysis,
- Collateral based / asset based valuation, and
- Net present value / cash flow based valuation.

3.2.1 Statistical sampling method

By analysing the local industry dynamics in conjunction with the loan portfolios historical performance, we are able to allocate to the risk factors a discount percentage. This is the input for our *Loan Portfolio Discount Matrix*. These discounts are weighted to provide an overall discount coefficient for the individual loan.

The advantage of using local industry source data for this exercise is its relevance to the marketplace, however often requires a significant amount of research to ensure the discount percentages for the risk factors are right. Once we have the indicative impaired value of the loan, using the value impact variables allows us to determine the net present value of the impaired loan, and determine an overall indicative value of the loan portfolio as a whole for benchmarking purposes.

This is a very subjective approach, and provides a rough indication only. However, it looks at the entire portfolio, and provides a broad range of indications. A diagrammatic representation of the process appears below:



The various risk factors and their coefficients are weighted to ensure that all relevant data is captured in the overall discount, yet reflected accurately in terms of its importance:

The various risk factors and their coefficients are weighted to ensure that all relevant data is captured in the overall discount, yet reflected accurately in terms of importance.

3.2.2 Collateral / asset based approach

Generally, this approach is used where the subject loans are collateral dependent, i.e. completely reliant on the value of underlying assets (cashflow from the loan only accrues at the end of the life of the loan).

The approach is also useful for special purpose / special project loans (e.g. ships, oil rigs). Often specialised assets, and independent experts are required for the valuation.

This approach is rigorous, but it is difficult to cover the entire portfolio. Generally the analyst will use credit concentration rules for sampling the population.

3.2.3 NPV / Cash flow approach

Again, a more rigorous approach: credit concentration rules must be applied to select loans for analysis. Involves detailed study of cash flow dynamics and sensitivity analysis: useful for estimating anticipated time of default. Discounted cash flows over the life of the loan provide loan valuation (P&I repayments).

This approach usually provides a range of values, however it can be difficult to conduct due to selecting discount rate, and the cost / benefit analysis of spending large amounts of time reviewing data of dubious accuracy

3.2.4 Tranche valuation and risk spread

Once we have the indicative values of the NPLs and the portfolio it is necessary to allocate to each loan a simple risk grading system to “tag” NPL’s. This assists in allocating those loans to tranches in the desired risk spreads.

As these risk tags are the result of earlier work, they incorporate:

- Industry factors and the debtor’s position within that industry
- Gearing comparatives (Industry specifics)
- Performance trends v. cashflow assumptions / projections (industry specifics)
- Collateral support v. unsecured
- The local industry, economy and market dynamics

The end result of the risk spread tagging exercise is a loan grading reflecting comparable numerics across an entire portfolio, allowing us to mix and match riskier assets with less risky assets to alter tranche composition:

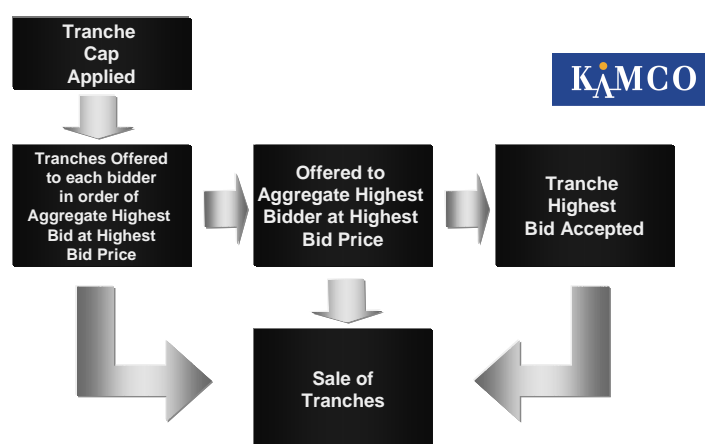
- Normal loans graded A to D
- Watch loans graded E
- Substandard loans graded F
- Recovery loans graded G
- Bad / loss loans graded H

Loans such as a G or H are higher risk and therefore cheaper, but the potential upside for the buyer is also higher (risk / return).

3.3 Tranche packaging and sales strategy

Generally, the due diligence process conducted by the seller forms the basis of the IM. It is normal to provide a data room, or electronic format portfolio data to qualified bidders for analysis on payment of deposit. More recently, web based IM's and NPL data have provided easier access for bidders.

Bids can be open or closed. The nature of the bid varies in jurisdictions and is often driven by the nature and quality of NPLs, and the range of competing bidders. The selection process for successful bidders also varies.

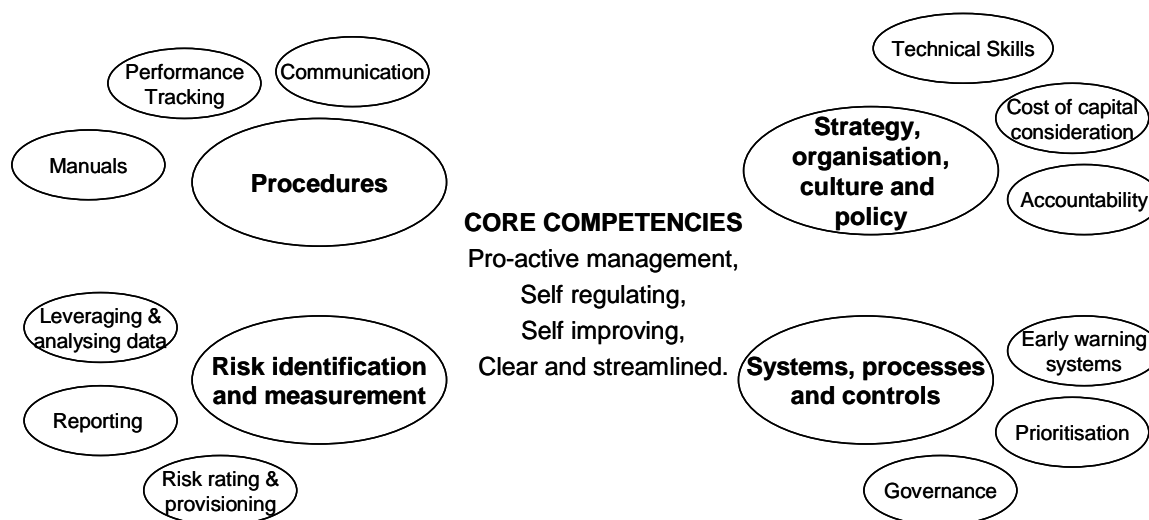


Auction models such as direct bid, spectrum auctions and linked bids (successful bids for one tranche commit to purchasing another, lower quality tranche) have also been used effectively.

Example: one of the contemplated KAMCO selection processes for tranche sale by auction.

3.4 What makes a good AMC?

Naturally, AMC competencies interrelate and support each other. Some of these relationships are diagrammatically represented below:



Technical Skills

- 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

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

Communication

- 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.

Leveraging and Analysing Data

- 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

- Extending reporting to cover efficiencies staff are achieving / failing to achieve against benchmarks,
- Regular reporting of performance against benchmarks to encourage aggressive and active portfolio management.

Risk Rating and Provisioning

- Using benchmarking approaches and data to link specific loan characteristics to risk factors,
- Using risk factors to rate loans and categorise these appropriately,
- Automated conduct of risk rating regularly for reassessment purposes (daily, weekly) and to encourage active portfolio management by staff,
- Development of good early warning systems,
- Prioritisation of NPLs with better recovery opportunities.

Internal governance

- All loans treated in a uniform manner
- Procedures for loan files exhaustive
- File maintenance disciplined and accurate
- Decision making processes documented
- Adequate paper trail created, from OPB to sale / realisation value

Communication and Cost of Capital Considerations

- 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.

Performance Tracking

- 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.

4. Lessons learned: Disposals vs. restructuring

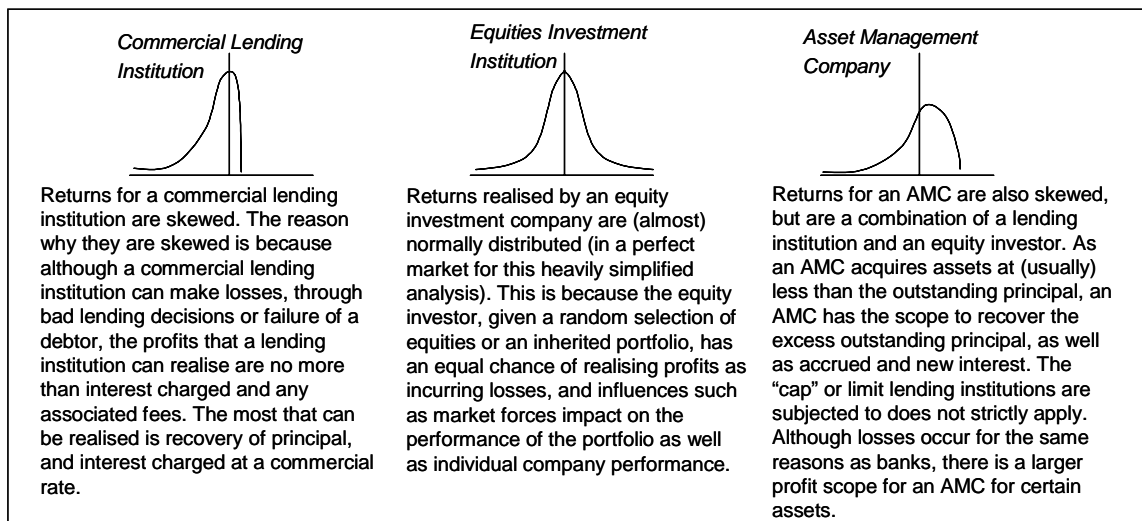
As discussed earlier, there are two main approaches or philosophies to managing an AMC:

- Sale of NPL's and outsourcing management, and
- Internal workout

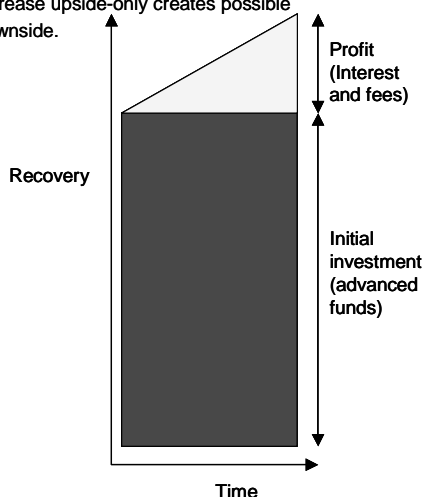
As AMC's are driven largely by rapid results, the first approach is often the most popular. The following table summarises the key differences between the two approaches:

	<i>Sale and outsource approach</i>	<i>Internal management and workout approach</i>
<i>Description of approach:</i>	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.
<i>Skills required:</i>	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.
<i>Performance indicators: how are they assessed?</i>	<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.

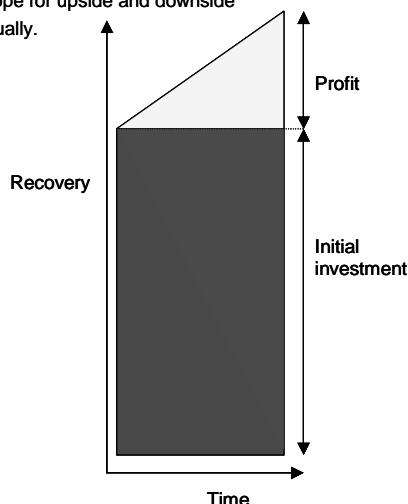
Dealing with NPL's by an AMC is comparable to a normal bank, or an equity investment institution. Assets being managed involve varying risk, and returns achieved are controlled and measured using similar techniques and approaches.



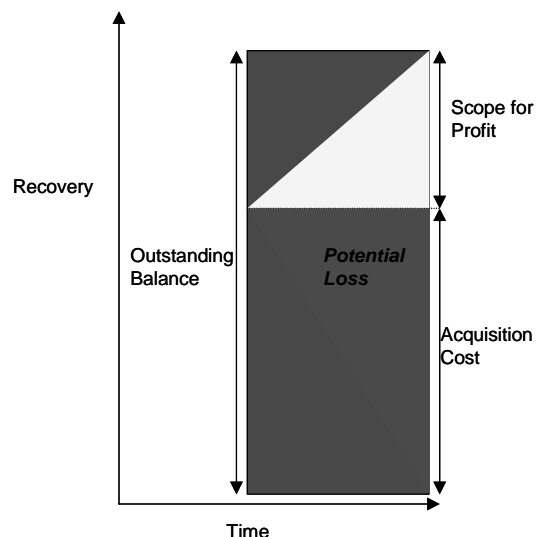
Commercial Lending Institution:
Profit pre-determined: risk does not increase upside-only creates possible downside.



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



A more simplified illustration of this is on an asset basis:



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

It is clear that adopting the internal management approach affords new opportunities for profit making, but also new risks. Whereas the risks of the downside-loss of acquisition cost, are passed on

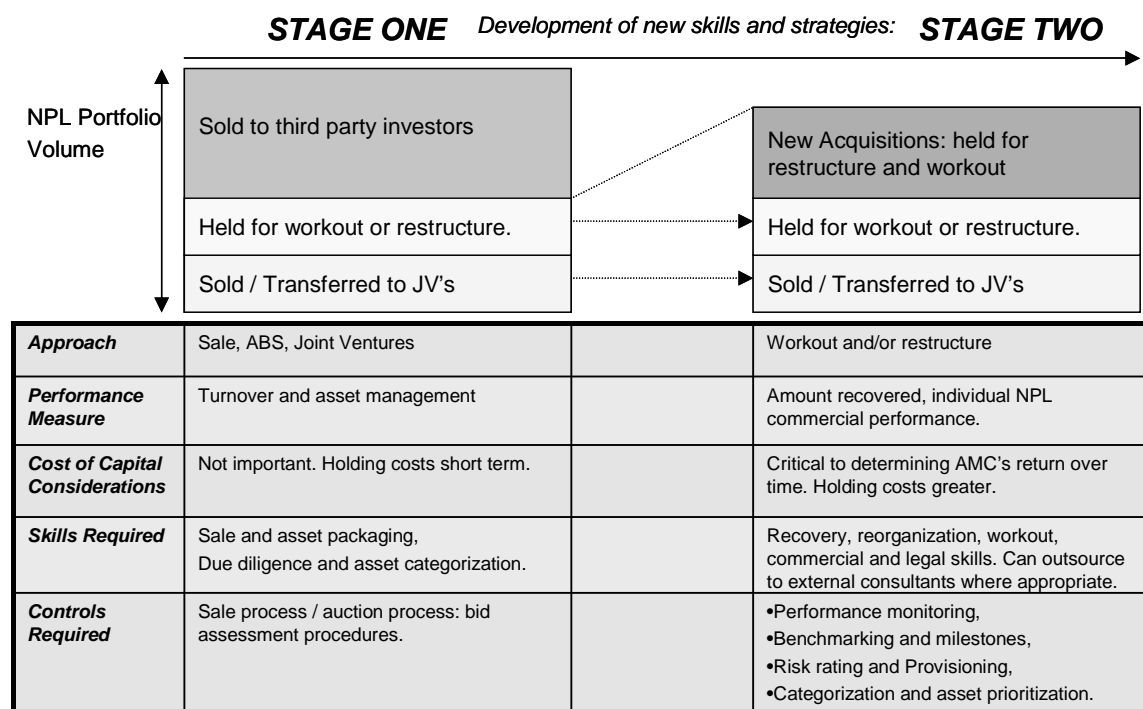
to an investor in an outright sale, but when the asset is retained for workout and restructure the risk of this loss is retained by the AMC.

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 must:

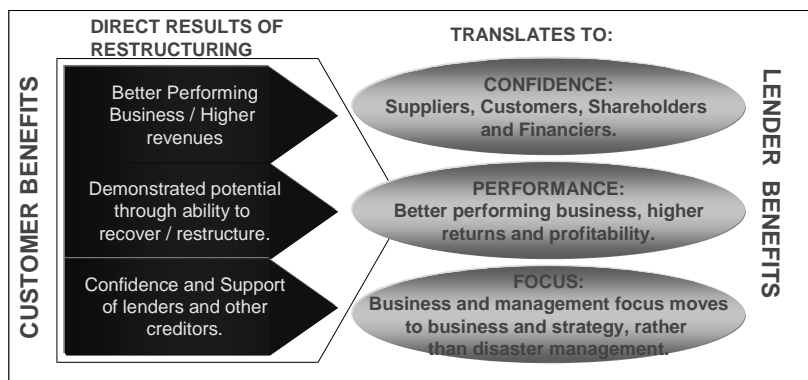
- Measure and quantify recovery risk, and changes in recovery risk
- Assist in identifying those loans that have scope for profit, and
- Once potential losses are identified and quantified, guide account officers in deciding which course of action will minimise the loss

This process can be described as moving from being “liquidator” to “incubator”, or from Stage One to Stage Two competency. The following 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. Until losses on non-viable debtors are recognised, NPL problems do not go away. Shareholders, depositors and employees and regulators cannot be confident that accounts reflect accurate asset values and are not “inflated”.

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



A good AMC needs to take ownership of their NPLs, and to be proactive in the NPL management process.

AMC's must educate debtors to work with them in achieving essentially the same goal, which is improvement of the cashflows of the assets and businesses underlying NPLs.

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's are uniquely placed to lead industry reform at the "grass roots" level. To achieve this, they need better awareness of:

- Successful turnaround and business improvement strategies
- Quick wins and "business triage" skills
- Assessment and evaluation skills
- The ability and the will to recognise losses and deal with them
- Regulator support and encouragement

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.

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Assignments Morgan has conducted have spanned a number of industries and disciplines, involving debt restructuring, AMC establishment, structuring and general consulting, regulatory reform consulting and assistance as well as commercial entity level reorganisation, change management and business improvement.