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Developing the Asian Markets for Non-Performing Assets

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Developing NPL Markets

The Asian Currency Crisis severely crippled the financial system in most Asian countries and brought to light the magnitude of Non Performing Loans (NPLs) at Asian financial institutions. Driven by the need to proactively tackle the soaring NPL levels the respective Governments embarked upon a program of substantial reform. This process involved establishment of asset management companies (AMCs) for resolving the impaired assets held by the banks and financial institutions. AMCs in countries such as Indonesia, Malaysia, Korea and Thailand were initially structured as centralized government-owned entities, though banks in countries like Thailand subsequently set up their own individual entities to resolve distressed assets. Taiwan has gone a step further with large-scale portfolio sales and a number of foreign investor owned AMCs dominating the NPL market. This process of establishment of AMCs was often supplemented with establishment of "Out of Court" Debt restructuring mechanisms in these countries. A number of factors influenced the successful resolution of NPLs in these countries and some of these key factors, experiences in relation to which hold significant lessons for emerging NPL markets, are discussed below.

Willingness to Transfer

Lenders are often reluctant to sell or transfer assets at values lower than their book value to prevent a hit to their financials as well as to avoid risk of criticism for having undersold. Banks in Malaysia were encouraged to transfer their assets to Danaharta by providing them with upside sharing arrangements and the facility to defer the write-off of financial loss on transfer for 5 years. These incentives coupled with the directive of the Central bank to make adjustments in the book values of the assets not transferred to Danaharta (after Danaharta identifies them) were sufficient to ensure effective acquisition. In Taiwan, the increasing number of NPL auctions by the banks were facilitated by the regulatory requirement to reduce their NPLs to 5% by the end of 2003 and the flexibility to amortize their financial losses over a five year timeframe.

Ease of Implementation of Recovery Strategies

Enforcement of Creditor rights

A significant dimension influencing NPL resolution and investor participation is the ease of implementation of recovery strategies. Certainty and timing of ability to enforce creditors' rights is key to success in resolution. AMCs like Danaharta have been provided with a strong platform to effect the resolution of NPLs with clearly laid down creditors' rights. Danaharta has been allowed to foreclose property without reference to the Court and thus has been able to dispose collateral swiftly by using the tender route. Special resolution mechanisms that have involved minimal intervention of the Court have also served to entice investor interest in the NPL market in certain countries like Taiwan. On the other hand the operations of Thailand Asset Management Corporation, the Government owned AMC, have been hindered by deficiencies in the Bankruptcy Law provisions.

Effective Restructuring Implementation

Most Asian countries adopted "Out of Court" restructuring mechanisms to minimize court intervention and speed up restructuring of potentially viable entities. However, this process has yielded mixed results. In Korea for example, while most Chaebols and Corporate entities entered into workout arrangements this often did not lead to far reaching restructuring of these entities. While debt

restructuring was generally implemented quickly, delays were witnessed in asset reduction programs and improvement in operating performance was slower and lower than expected. In Thailand similarly, majority of restructuring arrangements have typically involved extension of grace periods or concessional arrangements and it is widely held that adequate financial and operational restructurings have generally not been effected.

In Malaysia, however, Danaharta has been able to exercise considerable influence over the restructuring process through the appointment of special administrators that have prepared workout plans and have exercised management control over the assets of the borrower during plan preparation and implementation stages. The restructuring process effected by the special administrators has been facilitated by the automatic moratorium that comes into place at the time of the administrator's appointment.

Foreign Direct Investment (FDI) Policy

Domestic and foreign institutional investors require a conducive regulatory and tax environment for entering the NPL market. Flexibility in ownership, collaborations, transaction structures, remittances and issue of financial instruments are key parameters of this framework apart from the tax incidence. For instance, Taiwan's willingness to allow foreign ownership of AMCs has helped attract investor interest. While the profit that the AMC generates from the disposal of the NPLs is subject to the current 2% business tax rate as applicable to banking institutions, foreign shareholders are accorded certain tax benefits in the form of a lower withholding tax rate of 20% (as opposed to the 35% rate generally applicable) on the dividend remitted by an AMC that has secured the " Foreign Investment Approval" status from the Ministry of Economic Affairs. The bank-based AMCs in Thailand have been subject to a payment of 30% corporate income tax charged on the net profit generated but only after the cash on the NPLs is collected.

The Emerging Indian Market

The process of resolution of NPLs has only just been initiated in countries like India. Banks and financial institutions in India are faced with the task of dealing with NPLs which are reportedly of the value of around US $ 20 Billion as on March 31, 2002. While the NPL situation in India may not be as grim as some other Asian countries at the height of the Asian crisis (ratio of reported net NPLs to net advances is 5.5% for banks and 8.8% for the financial institutions in India), it is significant enough to warrant urgent attention. The total stressed assets are considerably higher than the reported NPL numbers and it is widely believed that NPLs could be double the reported figure if more stringent international classification norms are applied in India.

Creditor rights have historically been difficult to enforce in India, often involving long winded court procedures. Furthermore, in India defaulting borrower companies have often misused the shelter provided by the mechanism of the Board for Industrial and Financial Reconstruction (BIFR) (the Indian equivalent of Chapter 11 proceedings). A company entering the purview of BIFR was protected through a moratorium on lender actions during the course of its proceedings, which often took very long to get completed on account of systemic deficiencies in the working of BIFR.

A consortium lending approach has typically been followed in India. While development financial institutions (e.g. IDBI, IFCI) have typically provided term loans to borrowers, the commercial banks have typically been working capital lenders. The resulting inter- creditor issues and lack of an effective platform for resolution of the same often caused delays by lenders in responding to borrower issues.

Steps taken by the Government of India

The Government of India has over the past year or so, taken several steps to help create an enabling environment for NPL resolution. Notable among these are:

- The enactment of "The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act" (SRFAESI) in December 2002 which lays down the legal basis for the formation of asset reconstruction companies (ARCs) and provides lenders and ARCs with the powers to enforce security interest (if 75% by value of the secured creditors agree) and sell the assets of the borrower without court intervention. Furthermore SRFAESI empowers lenders to remove a company from the purview of the BIFR. ARCs are also allowed various measures for asset reconstruction, including change of management of the borrower's business though guidelines for implementing this are still awaited.

- An out of Court restructuring mechanism called "Corporate Debt restructuring (CDR)" mechanism has been set up which provides a platform for resolution of inter creditor and debtor-creditor issues.

- A National Company Law Tribunal (NCLT) is being set up to replace the Board for Industrial Finance and Reconstruction (BIFR). NCLT is, inter alia, envisaged to perform BIFR's functions more effectively.

Development of the Indian NPL market

Pursuant to the SRFAESI Act a number of Asset Reconstruction Companies (ARCs) have applied to the Reserve Bank of India (India's central bank) for setting up operations. Asset Reconstruction Company (India) Limited (ARCIL) and Asset Care Enterprises Ltd. have been promoted by groups of Indian lenders and are among the first ARCs in India. The process of acquisition by ARCIL of the first lot of assets is currently underway.

A number of issues could however hamper effective development of the Indian NPL market:

- Legal Challenges

Tremendous outcry has been raised by the borrowers against the provisions of SRFAESI Act who have termed this as being against the principles of Natural Justice. A number of petitions are currently pending before the Supreme Court that challenge the right of lenders to take over and sell the borrower assets with limited opportunity to borrowers to challenge the action in a court of law. The Supreme Court judgment on this issue could profoundly impact the efficacy of this Act.

- Valuation issues

Provisioning requirements against NPLs allow Indian banks an extended time frame and banks can carry NPLs in their books almost indefinitely. Different Indian lenders typically have differing provisioning levels for the same asset and often these levels are low, even more so in view of resolution timeframes and costs under the prevailing Indian framework. Given that no amortization of financial losses upon transfer of NPLs is permitted (RBI guidelines suggest transfer of assets to ARCs at market values) and no regulatory fiat that forces the lenders to compulsorily transfer their NPLs has been issued, success in overcoming the reluctance of lenders to transfer their NPLs at market prices is key to the development of the Indian NPL market. Apart from the ability to absorb the loss arising from a sale or transfer of NPLs, there are strong concerns about possible criticism for having undersold, particularly among public sector lenders who form well over 70% of the banking system, which would dissuade NPL transfers.

- Tax and regulatory issues

The high level of transaction costs in the form of the stamp duty (varying from 3- 14% in the various states of the country) payable on the transfer of financial assets by way of assignment is a significant deterrent to the acquisition process except in case of some progressive states.

While the government appears keen to encourage both foreign and domestic investors, the need for specific policy, regulations and tax provisions responsive to their requirements has still to be addressed.

- Restructuring Implementation

The CDR process has dealt with and approved a large number of restructuring cases in the past few months in a time bound manner. Inevitably, concerns have been raised regarding the quality of restructuring packages in certain cases, where it is felt that more stringent or innovative operational and financial restructuring was needed to facilitate early recovery. The CDR cell is increasingly seeking to involve professionals in coordination, implementation and monitoring in restructuring cases.