Credit Risk and Credit Access in Asia



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Foreword

Insolvency systems play a major role in a modern market economy. Strong insolvency systems contribute to the efficient use of resources and hence economic growth. They also help underpin investor confidence and financial stability. But closing down or restructuring failing companies, be they public or privately owned, while managing bad and doubtful debts on bank balance sheets - or preventing new debts accumulating, inevitably raises sensitive policy issues and practical challenges for national governments and practitioners.

Although Asia's economic fortunes have dramatically improved in recent years, insolvency related issues remain a major concern for Asian countries. The sheer volume of company debt overhang and the gap between insolvency rules and their practical implementation suggest that insolvency reform must remain at the top of the policy agenda. Indeed, there are increasing indications that hidden losses in Asian financial systems may be much higher than estimated. There is also concern that the resumption of economic growth has weakened the political resolve to continue on the path of reform.

Action is needed on several fronts, by governments, regulators and other actors to strengthen the insolvency and risk management systems.

First the existing procedures, techniques and information systems used in the risk-management process need to be improved. Second, the competencies of the legal and financial professionals involved in risk management need to be reviewed and training offered where needed. Third, Asian economies should strive for effective implementation and enforcement of the legal framework for company restructuring, liquidation and recovery to support better risk-management practices.

These were among the main conclusions of the fourth meeting of the Forum for Asian Insolvency Reform (FAIR), held in New Delhi, India, on 3-5 November 2004, which was co-hosted by the Ministry of Finance Banking Division, the Ministry of Company Affairs of India and the International Association of Restructuring, Insolvency and Bankruptcy Professionals (INSOL) India. This publication, which is the fourth in the OECD series on insolvency, contains the proceedings of the 2004 meeting, as well as comparative reports and country papers on risk management and insolvency issues in China, Chinese Taipei, Hong Kong China, India, Indonesia, Nepal, Pakistan, Philippines, Sri Lanka, Thailand and Vietnam. Participants included government experts, regulators, lawyers, bankers and other practictioners with extensive experience in dealing with insolvency issues.

The FAIR was launched in 2001 by the OECD, the Asia-Pacific Economic Co-operation, the World Bank, the Asian Development Bank and the Australian Government, with the support of public and private sector experts from the region. The Japanese government has extended sustained financial assistance to ensure the FAIR's continuity. Public sector bodies from Indonesia, Korea and Thailand have provided support by hosting previous FAIR meetings in their respective capitals.

The opinions expressed in this publication are those of the individual authors and do not necessarily represent those of the OECD, or the governments of OECD members or non-OECD countries. Elena Miteva of the OECD Corporate Affairs Division in the Financial and Enterprise Affairs Directorate and Richard Frederick, OECD Consultant, edited this publication.

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Executive Summary

The OECD, the World Bank (WB) and the Asian Development Bank (ADB) organised a meeting on *Insolvency Systems and Risk Management* in Asia, which took place on 3-5 November 2004 in New Delhi, India. It was co-hosted by the Ministry of Finance Banking Division, the Ministry of Company Affairs of India and INSOL[1] India. Approximately 120 policy makers, members of the judiciary, private sector practitioners, insolvency experts and academics from 12 Asian countries, 5 OECD member countries, and international organisations attended.

This was the fourth in a series of meetings on insolvency held in the framework of the Forum for Asian Insolvency Reform[2] (FAIR). The FAIR has become an established regional forum for promoting insolvency regimes conducive to good corporate governance, and has contributed to keeping insolvency at the heart of the reform agenda in Asia. The primary objective of this meeting was to discuss the interrelation between risk management and insolvency systems and to identify priority areas for reforms. In addition the meeting provided an opportunity for participants to report on recent developments and initiatives in the region, to examine concrete insolvency cases and to focus on progress with insolvency reforms in the host country, India.

Participants welcomed the high-level support and participation of the Indian co-hosts in the meeting. While commending such support, they pointed to the need for insolvency policy makers in Asia to play an even greater role in FAIR. In the concluding session, participants recognised that the meeting had elicited an interesting and fruitful discussion. They also voiced their strong desire for a continuing dialogue within FAIR, and their commitment to participate actively in future annual meetings. They urged the sponsoring organisations to remain active in this area.

A number of important issues pertaining to insolvency and related areas were discussed. The following conclusions were drawn based on the discussions and the recommendations provided by the experts, and, in particular, the session chairs:

1) The framework and practice of risk management in Asia

The first session focused on how credit risk and credit access are mitigated by insolvency and credit risk management in the banking sector. In their lending practices, banks share the risks faced by borrowers, including the risk of insolvency. Prudential practices include upstream processes and procedures, along the lines of the Basel II[3] framework on the capital requirements of banking organisations, which revolve around risk rating and capital adequacy needs. Downstream risk management systems and practices are also important as they allow banks to minimise the loss after insolvency occurs. Participants examined both aspects of risk management in Asia.

Risk management in Asia as a tool for bridging credit cost and credit access

The region is not homogeneous and the profile and nature of risk management factors varies widely. However, in most countries, risk management depends strongly on the following key areas that need to be addressed by policy makers: 1) fraud and corruption; 2) insolvency and recovery

frameworks and regimes; and 3) banking sector sophistication and development. **Participants agreed that there is an urgent need to improve risk management frameworks and practices in Asia. They stressed that sound legal systems for restructuring, liquidation and recovery constitute an important basis for mitigating credit risk and that legal systems require increased attention by Asian countries.**

At the macro level, the discussions focused on the correlation between sound risk management, insolvency systems and recovery levels. A common theme for some Asian economies is the difficulty in enforcing the repayment of debts due to ineffective insolvency regimes. Poor enforcement is often mitigated by requirements for greater security that can significantly reduce access to credit. It was further noted that a lack of transparency and information frustrate risk management efforts by banks throughout Asia. On occasions, short institutional memories lead to reckless lending and poor risk management practices similar to those witnessed before the 1997 crisis. Moreover, there is a widespread perception that the development of international credit risk management processes are inadequate in many Asian banks.

At the micro level, participants looked into the frameworks for downstream insolvency risk management in banks and asset management companies. In general, banking sector development in most Asian economies is characterised by a relatively limited range of services offered by banks, less diversified income and, hence, generally higher risk exposure, which leads to reduced lending opportunities and higher credit costs.

Participants further examined the various elements of an effective risk management system and emphasised that proactive risk management practices that rely on frequent reviews of non-performing loans (NPLs) are of critical importance. They agreed that **a well-designed risk management system needs procedures, techniques and tools to mitigate and quantify recovery risks, and ensure compliance with benchmarks and risk ratings**. **A special capacity building effort is required in order to develop technical skills and experience in restructuring and workout**.

Communication among the concerned departments and performance tracking systems are additional elements of a well-functioning risk management system. Participants agreed on the importance of greater transparency, speed and accountability to improve the returns on non-performing loans and stressed that the development of standardised procedures for risk management, restructuring and resolution can be instrumental in this respect. Some Asian regulators have started exploring the possibility of issuing standards on credit risk management in which it will be important to include the workout and recovery process. The Monetary Authority of Singapore (MAS), for example, has done this in a draft paper on credit risk management.

The development of secondary debt markets was seen as an alternative to sound insolvency systems in mitigating risk since they effectively deliver liquidity to troubled banks over time. However, liquidity has come at the expense of reduced profit opportunities for originating banks. It was noted that secondary debt markets have evolved the most in environments in which the insolvency and creditor rights systems were most advanced. **Participants also stressed that in relying on secondary debt markets, regulators need to ensure that adequate incentives for encouraging workout are in place in order to maximise the value of non-performing loans.**

Some implications for risk measurement, regulatory action and the participation of banks in insolvency reforms

Banks are the ultimate holders of credit losses and a primary constituency for insolvency reform. There was widespread agreement that **FAIR action in favour of sound insolvency systems could be reinforced by the greater involvement and participation of banks and bank regulators.**

Asian banks drew lessons from the 1997-1998 economic crisis, including the need for greater attention to risk management. However, banks tend to lag rather than lead their regulators, and there is a strong need for regulatory action. **Participants felt that reform efforts need to start by ensuring a better legal environment. Asian banks, bankers associations and regulators are likely to benefit from joining forces in this endeavour.** As part of this effort, Asian regulators can also work on regulations for property and other collateral used to support commercial credit, and, more specifically, on the development and improvement of the registration of both fixed and floating collateral.

Meanwhile, the issue of achieving a working-level understanding and implementation of sound risk management practices remains important. Absolute losses, as well as losses stemming from collection delays and related expenses are too high. This is often due to the lack of credit information. **Participants felt that there is a pressing need to improve credit information systems throughout the region.**

The discussion of the New Basel Accord[4] emphasised its impact on bank investment and portfolio management policies. **The New Basel Accord implies that banks need to control the quality of their lending book constantly, which in turn, influences credit risk management and recovery procedures.** The creation of asset management companies (AMCs) to deal with non-performing loans in bank portfolios might, in many cases, have provided a one-off solution to a particular problem at a particular time. However, to protect the quality of their books, banks now need to deal with the prevention and handling of difficult loans as an ongoing, day-to-day issue.

What is more, in order to improve risk management, Asian banks need to focus on the meaningful measurement of risk and risk weight. Under the Basel Capital Accord, the credit process is related to risk weight, which is embodied in the "expected loss" equation. The latter is a function of the probability of default (PD); the exposure at default (EAD); and loss, given default[5] (LGD) where the coefficients for PD are much lower than those of EAD and LGD.

In many Asian countries, banks tend to simplify risk management by using risk ratings and facility ratings instead of a comprehensive analysis of their expected losses. LGD is a critical element of credit risk measurement that can lead to better risk management and higher levels of recovery**. It was felt that Asian banks will benefit greatly from focusing on the development of LGD statistics on an ongoing basis.** Where feasible, this could be done based on a national consortium with a neutral data collector. Data collection[6] can be based on existing models, such as those of the Risk Management Association[7] or the credit rating agencies, supplemented by additional work to reflect local factors. The Joint Credit Information Centre of the Taipei Bankers Association is an example of initial steps undertaken in the Asian context.

Further work by international standard setters, such as the Basel Committee, may be useful in linking the issue of LGD to the insolvency and credit recovery process with a greater level of detail than is currently provided in the Basel documentation. This could have a positive effect on Asian central banks and regulators, and could elicit greater attention to LGD matters and, more broadly, to collateral management.

2) Trends and developments in risk management and insolvency reforms in South-East Asia

Participants engaged in a lively discussion of country developments since the third FAIR meeting in Seoul. Perceptions of progress with insolvency reform and risk management varied significantly. The fundamental driver for change in insolvency systems has been the imperative of crisis management. As most Asian countries are showing signs of recovery, insolvency reform has moved lower on national agendas. Moreover, trends show that countries that have been more successful in reforming their insolvency systems tend to benefit from cheaper credit. In contrast, slow insolvency reforms can be expected to hamper access to finance and, more generally, to slow economic development. Participants noted that, in spite of effective measures supporting the development of insolvency systems, some fundamental problems have not been resolved. **Asian insolvency systems are still perceived as vulnerable, and participants agreed on the urgency of stepping up reforms while macroeconomic conditions are favourable.**

Speakers felt that more effective policies need to be implemented with respect to non-performing loans in South-East Asia. The situation has improved, though NPLs still remain high in some countries. Economies with clear and predictable policies have benefited from maximising the value of NPLs quickly and refocusing themselves on growth. Active resolution schemes, including through the establishment of asset management (AMCs) and/or asset resolution companies (ARCs), have encouraged positive trends. However, some resolution schemes are not working properly and banks continue to create new NPLs. Thus, the delay in addressing NPLs and distressed businesses has lead to significant losses from idle or poorly managed assets. Moreover, hidden or fictitiously rescheduled NPLs are still an important issue along with the extension of soft credits to state-owned enterprises.

At the policy level, the need for a long-term focus cannot be overemphasised. Instead, there is a focus on balancing short-term interests. There should be greater recognition that sustained strategies for building effective and efficient insolvency systems will counterbalance some of the short-term problems resulting from reforms since they will more adequately address the long-term growth prospects of the economy.

Participants felt that FAIR should provide more opportunity for structured dialogue on the development and implementation of the legal framework for insolvency. Furthermore, it was repeated that highly developed AMC and ARC regulations, rehabilitation laws and rescue procedures have been enacted without paying sufficient attention to the design of an effective liquidation backbone. **The development and enforcement of effective liquidation proceedings remain important priorities** as tools for imposing discipline and facilitating lending.

Participants noted the **implementation gap** between the design and enforcement of laws in most economies. Moreover, governmental interference has been unpredictable in some countries. As a consequence, the fears of investors and bankers have been priced into the cost of credit. **Institutional capacity building and regulation need to receive greater attention since they are critical to the emergence of an effective and predictable insolvency system.** Improvements in the competence, independence, accountability and efficiency of the judiciary remain an urgent necessity. In addition, the role of insolvency professionals requires further attention. One expert remarked that practitioners with questionable ethics have prospered in the absence of a sound regulatory framework. In addition, fee structures are not used as a mechanism to develop the profession, while the potential for knowledge transfer which can occur in working with renowned international experts has been underestimated.

Notwithstanding the importance of an effective formal insolvency regime, it is essential to reserve a central role for out-of-court arrangements. Asian governments should encourage and assist in the development of informal insolvency systems. In the short term, in the absence of an efficient insolvency system, the government and the banking sector could explore the development of policies encouraging parties to undertake informal workouts. The World Bank is developing unified standards in this respect to provide international benchmarks and recommendations for informal workout practices and, in particular, structured workout practices. It is, nevertheless, important to emphasise that the development of informal mechanisms should not come at the expense of the development of strong formal mechanisms of insolvency.

Regional co-operation of insolvency systems might constitute an important next step in Asian insolvency reform. National concerns have lead to a focus on developing individual systems and there is a scope for greater consultation at the regional and global level.

3) Trends and developments in insolvency in South Asia

FAIR participants discussed insolvency systems in South Asia for the first time. They expressed concern regarding the level of development of insolvency systems in the sub-region. Indeed, they noted that the legal framework is not complete (*e.g.* restructuring legislation is missing in Bangladesh, Nepal and Sri Lanka). Implementation is generally weak, as is institutional capacity. **There was widespread agreement that insolvency frameworks in South Asia need to be strengthened and brought into compliance with international standards. With regard to capacity building, a structured effort is required to improve the function of the judiciary through adequate training, transparent systems for the appointment of judges and the institutionalisation of insolvency courts. Supporting the development of insolvency practitioners is another important priority.**

The discussions of risk management, revealed the absence of sophisticated methods for tracking and monitoring exposure at default and default levels. With minor exceptions, most banks do not monitor client businesses, use effective tools, or implement established techniques of risk management. As in South Asia, reliance on collateral is used to remedy inadequate credit risk management. Credit recovery departments do not possess the knowledge and skills required for balancing the need to keep businesses alive while ensuring timely and adequate recovery. While India has made some progress in this area, experts noted that accelerating reforms is of the essence. **Therefore, participants agreed that there is a pressing need for South Asian countries to build their capacity and improve the legal framework for risk management.**

Furthermore, it appeared that credit information systems in all the countries need urgent attention. Traditionally, banks and financial institutions are reluctant to share credit related data. **It was felt that reformers should focus on credit information availability, referencing and rating.** More concretely, the following steps need to be explored: 1) the establishment of credit information bureaus with statutory backing, which is missing in all countries with the exception of Sri Lanka; 2) improving the availability of information among bank branches; and 3) improving the banking legislation that regulates the exchange of information.

Informal workout practices are inadequate or are not applied, except in India where the Corporate Debt Restructuring scheme sponsored by the Reserve Bank of India produced some successful multi-creditor restructurings. **This is an important area for future reform.**

With regard to asset reconstruction and non-performing loans, particular attention was paid to the discussion of the recent Indian experience in establishing asset reconstruction companies. One expert pointed out that **in designing ARCs, it should be remembered that they are a short-term**

emergency solution. Therefore, it is important to provide incentives and allow investors to make adequate profits in exchange for the risk in investing in distressed assets. Moreover, greater consideration may need to be given to foreign investment in bridging the funding gap in the context of NPLs and ARCs.

Comprehensive insolvency reforms in South Asia must also encompass reforms in related areas. Some of the measures recommended by participants include improvements in corporate governance and the strengthening of investor rights. More generally, it was felt that the ability of the region to provide greater certainty and efficiency in insolvency systems will depend on the enabling environment determined by its laws and markets.

Another issue that was brought up during the discussions concerned attitudes towards the mangers of failed companies. Management is usually held accountable if businesses fail and the discussion focused on "wilful default". Managers guilty of fraud or recklessness deserve sanction. However, where competent directors exercise due diligence and make decisions in good faith, there is an argument for allowing them to be rehabilitated. Arguably, directors who have experienced a business failure might be more aware of potential problems and inclined to take earlier remedial action.

4) The importance of insolvency frameworks and cross-border legislation for investment in distressed assets and risk management in Asia

In an increasingly global economy, there is a wealth of capital seeking investment opportunities. However, investment life cycles are now shorter. Investors need to be able to move their money out as well as in, without undue delay or difficulty. Collective investment vehicles and mutual funds are concentrating into fewer hands, and investors are cautious of their money going into countries with inadequate safeguards. Countries willing to attract investment need to have modern and effective insolvency laws with developed frameworks for cross-border proceedings.

In a special session, participants discussed the importance of national issues that have domestic and cross-border implications. Case studies were examined in which the debtor was part of a corporate group operating in a number of jurisdictions. Cross-border issues become more pressing with globalisation and multi-national enterprises with assets and liabilities in different countries. Globalisation affects the way companies are structured, where assets are located and, as a consequence, influences valuations and realisations. The way in which such issues are addressed will be of increasing importance in the future.

In the absence of cross-border insolvency arrangements, or where they are sub-optimal, one can expect that each member of a corporate group will be dealt with separately within each jurisdiction as shown in a discussion of the Parmalat case. The Asian Pulp and Paper debacle shows that dealing with a group of companies without an international insolvency framework may lead to a standstill, while the debtor remains in possession of the group's assets. Such situations generate uncertainty and undermine insolvency proceedings. Moreover, the financial consequences for stakeholders, debtors, shareholders, creditors, employees, suppliers and others are significant, and may signal increased credit risk and deter investors from the region.

There is a range of incentives for adopting cross-border insolvency legislation. They include cost of capital considerations stemming from the higher price borrowers would pay in the absence of international insolvency frameworks. In such a context, the pricing of risk by lenders and the cost of provisioning would be transferred to borrowers. More broadly, better access to trade and investment opportunities are additional reasons to consider the adoption of cross-border insolvency provisions.

Regional co-operation and support, for example, through bodies such as the Association of South-East Asian Nations (ASEAN), Asia-Pacific Economic Co-operation (APEC), or other international organisations could play an important role.

Participants discussed the following options for reform and recommended that they be given serious attention by Asian policy makers: 1) a cross-border insolvency convention or treaty, involving as many countries in the region as possible, and providing an inclusive framework that facilitates and encourages adherence; 2) bi-lateral arrangements; and 3) unilateral cross-border legislation enacted by as many countries as possible.

The option of a regional treaty needs to be explored as long as it does not preclude outsiders from becoming a part of the treaty. In addition, special attention needs to be paid in the way it is designed and operated. A discussion of the European Union (EU) insolvency regulation and its interpretation illustrated certain problems that can result from the establishment of international proceedings. In adopting international insolvency regulations, it is, therefore, important to ensure that the laws that are passed are effective, efficient, and fully thought through in order to avoid disputes between national courts and other unexpected results. EU member states are bound by the European Parliament, European directives and other common instruments. In the event of a dispute between the courts of member states, the European Court is able to make a binding decision. It would be difficult to replicate this in a region where an overall governing body with ultimate sanction is lacking.

Notwithstanding the above considerations in favour of cross-border insolvency reforms, inadequate domestic law and practices are harmful for the development of such initiatives. **Ideally, shortcomings in the national insolvency framework should be addressed before adding the overlay of cross-border arrangements.** However, experience in Japan suggests that establishing international insolvency proceedings takes time and, therefore, there is a case to be made in favour of immediate action.

Most cases of cross-border insolvency in Asia can be expected to involve corporate group issues and problems. Therefore, group companies presenting an additional layer of difficulty require further attention, both on the domestic and international front along the lines of the Parmalat example. **The UNCITRAL Model Law on Cross-Border Insolvency presented at FAIR III in Seoul, as well as the INSOL Cross-Border Insolvency Guide to Recognition and Enforcement need to be explored by Asian policy makers to help find solutions to insolvency in groups of companies.**

Notes

1 International Association of Restructuring, Insolvency and Bankruptcy Professionals (INSOL).

2 The FAIR was launched in 2001 by the OECD, the Asia-Pacific Co-operation Forum (APEC), the ADB and the Australian Government's overseas aid programme (AusAID) with the support of public and private sector experts from the region. The Japanese government has extended sustained financial assistance to ensure the continuity of FAIR. Various public sector bodies from Indonesia, Korea and Thailand have provided the forum with significant support by hosting it in their respective capitals.

3 The so-called revised international capital framework sets out the details for adopting more risk-sensitive minimum capital requirements for banking organisations. See www.bis.org.

4 The New Accord, so called "Basel II" Accord, has three Pillars for calculation of capital adequacy, supervision and risk disclosure by banks. Basel determines capital requirements through a process of "risk weighting" of assets. "Risk Weight" is a percentage of the asset that must be added into a total of "Risk Weighted Assets", which determines the total amount of capital needed (adequacy), i.e. 8 per cent of the risk weighted total.

5 Loss given default can be defined on the basis of the Basel definitions of « default » (unlikely payment of debt in full, 90 days delay on credit obligation, etc.) and "loss" (discount effects, funding costs and direct and indirect costs)

6 It is far from easy to collect LGD data and it would appear impossible to produce appropriate historical LGD data because the needed components have simply not been collected.

7 RMA Journal, 1 May 2004, Nadeem A. Siddiqi and Meiqinq Zhang, *A General Methodology for Modeling Loss Given Default*

Part I

REGIONAL OVERVIEWS

INSTITUTIONAL LESSONS FROM INSOLVENCY REFORMS IN EAST ASIA*

by
Terence C. Halliday and Bruce G. Carruthers**

Introduction

Changes in Asian insolvency systems since 1997 vary widely in their success. Our research indicates that effective implementation of an insolvency system relies on three sets of institutional factors:

Formal design

Knowledge is well advanced about the core features of an insolvency system. International organisations[1] have worked together with nations through UNCITRAL (UN Commission on International Trade Law) to produce a legislative guide of 197 recommendations and consensually developed norms for substantive corporate insolvency law.[2] The World Bank has articulated a set of principles for insolvency institutions.[3] Moreover, there are now many models of institutions that play a supporting role to insolvency regimes–informal restructuring mechanisms (*e.g.* INSOL's workout principles), formal out-of-court workout processes, asset reconstruction companies and asset management corporations among others. Yet, formal design accounts for probably no more than 30% of what needs to be done to manage risk through a solid insolvency system.

Lawmaking in a national context

The experiences of countries in Asia and in the former Soviet Union and Soviet bloc since 1997, demonstrate that the politics of lawmaking are both critical yet poorly understood. This is not surprising since neither the lawyers nor economists who characteristically build insolvency systems are specialists in policy making or what it takes to get a formal design implanted into the governance structure of a nation-state. As a result, no codified protocols or lawmaking guides exist that systematically present the political processes and contingencies that will produce legitimate and effective insolvency systems. Perhaps another 30% of risk management resides in lawmaking.

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* Revised version of a paper presented at the Fourth Forum on Asian Insolvency Law Reform (FAIR) 2004, *Insolvency and Risk Management in Asia*, jointly organised by the OECD, World Bank and Asian Development Bank, New Delhi, India, 2-5 November 2004.

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Implementation in a national context

Since the law-in-action effectively is law for those it regulates, implementation is concomitantly the most important and the least understood aspect of institutionalising an effective and fair insolvency system. Again, the professionals and, sometimes, civil servants who dominate this process are not specialists in institution building, nor have international institutions gone very far in systematising tacit knowledge about the conditions under which formal design and lawmaking will facilitate implementation. Indeed, lawmaking frequently incorporates within its recursive cycles a number of problems that make implementation unpredictable and lawmaking unstable.[4] Arguably, another 30-40% of what makes an insolvency system successful resides in the implementation process.

Just as formal design of a system requires looking ahead to lawmaking and implementation, so difficulties in implementation require looking back to problems in design and lawmaking with a view towards prospective reforms that will correct earlier flaws.

This paper draws on two bodies of research to identify the fundamental challenges of building and implementing effective insolvency risk management systems. We have been directing an international research programme on the globalisation of insolvency regimes, with special attention to reforms from the mid-1990s to the present in China, Indonesia and Korea.[5] We are also informed by the findings of extensive research in economics, political science, finance and sociology that have accumulated over the past 15 years on institution building in all sectors of the economy and polity.[6] These provide a framework for interpreting current developments and for lawmakers who intend to embark on more ambitious reform programmes.

We make four arguments. First, establishment of an effective IRM system depends on the successful interplay of three processes: design, lawmaking, and implementation. The system will not succeed, no matter how sophisticated the design, without as much attention to the processes by which laws are made and the impediments to implementation. We illustrate from several recent experiments in Asian insolvency systems how risk management depends on getting the balance of effort right among design, lawmaking, and implementation. Second, comparative international research shows that insolvency risk management (IRM) systems comprise a large number of elements in common. Relationships among the elements also vary. No part of an insolvency system can be implemented successfully without an adequate understanding of how it relies upon and contributes to the functioning of other elements in the system. Third, the attributes, importance and location of each element inside the state or market vary widely because they must be adapted to each country's distinctive history, policies, and current domestic and international situation. Indiscriminate transplants of foreign models will almost certainly fail. This adaptation ultimately relies upon the government, because governments everywhere are the ultimate risk managers. Fourth, just as there is wide variation in the structure of insolvency systems in advanced countries, we should expect as much or more variation in developing countries. In part, this variation occurs because countries vary in their paths of development and, correspondingly, because each country will configure differently the elements of its insolvency risk management system in order to be effective in its particular context.

In this paper, we draw lessons from innovations in: 1) courts; 2) professions; 3) state mediation agencies; and 4) monitoring and market workout mechanisms. However, the so-called private or market-based elements of an insolvency system depend not only on public institutions (most notably courts and often government agencies) but must be understood as options governments employ and often design for allocating risk in a society.

Elements of an Insolvency Risk Management System

Conventionally, an insolvency system has five elements: 1) substantive and procedural law; 2) courts; 3) government agencies to administer some types of bankruptcy and to regulate implementation; 4) out-of-court mechanisms for liquidation or re-organisation (but which exist in the shadow of the court); and 5) professions, usually lawyers, accountants and insolvency practitioners.[7] In practice, a total insolvency risk management system embraces much more than these five elements for it must encompass risk to creditors, risk to the financial system, and the risk-taking of debtor corporations. For our purposes, elements of an insolvency risk management system include state institutions, market institutions and those that overlap both, either because they may be independent state institutions or because they are private organisations but are heavily regulated by the state (Figure 1).

IRM elements inside the state

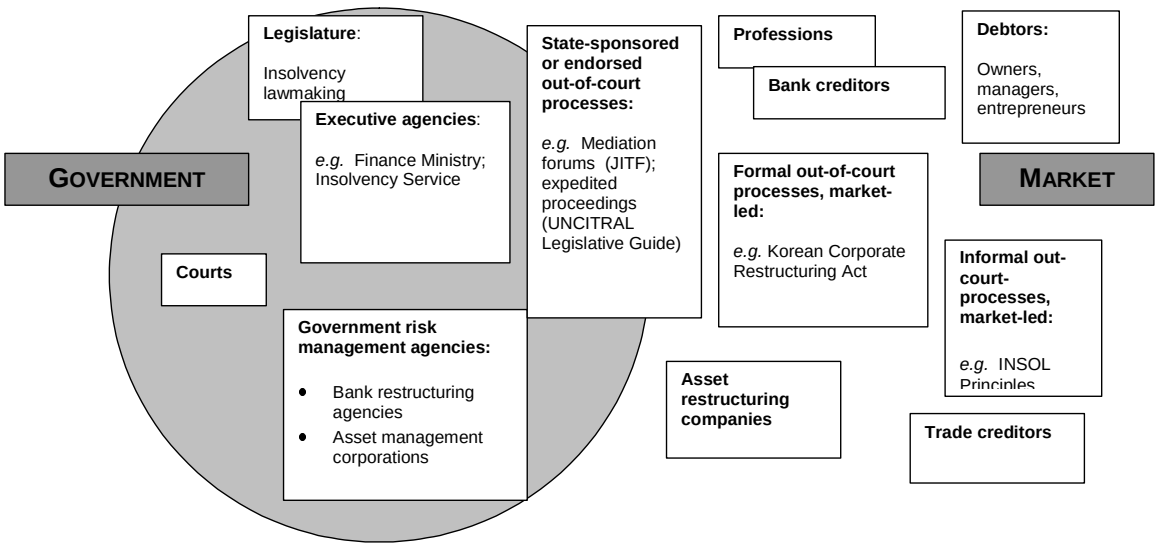
All IRM systems are centred on the state.[8] In Asia, as elsewhere, state initiatives are advanced through various configurations of legislatures, executives and courts, although these are not well differentiated from each other in many countries. The legislature usually passes insolvency statutes and endows them with whatever legitimacy it derives from the quality and representativeness of the deliberative process. The executive manifests itself in two ways: through government ministries (usually Justice, Finance, Commerce or Trade) which have primary responsibility for designing, making, and administering insolvency law; and through special agencies which may be set up by the government permanently or temporarily to restructure companies or financial institutions.[9] The courts variously authorise actions by debtors, creditors, or insolvency representatives, adjudicate disputes and often appoint or monitor trustees to oversee liquidation or restructuring.

Since the relative centrality of these institutions varies greatly in the power structure of a country, and their powers relative to each other vary similarly, we can expect that much of the negotiation over construction of an effective IRM system effectively turns into a problem of changing the balance of power within the state. It is for this reason that many insolvency reforms stall or collapse—they presuppose a shift in which part of the state wields power not only in the economy but also in society more generally. In practice this means that reforms premised on major changes in powers of courts must be based on careful appraisals about the feasibility and political will necessary for executive agencies, legislatures and market institutions to yield power to courts.

IRM organisations at the intersection of the state and market

In recent years, organisations have been created that sit astride the state-market frontier. Situated more on the state side are independent short-term agencies such as the Jakarta Initiative Task Force that was set up by the Indonesian government as a short-term corporate restructuring forum. Situated more on the market side are mechanisms for expedited proceedings, which have recently been adopted by UNCITRAL. In UNCITRAL's Legislative Guide, secured creditors can negotiate a debt restructuring amongst themselves and the debtor that would subsequently be confirmed by a court in order to make it binding.[10] Overlapping both state and market are varieties of the London Approach to informal workouts that rely on state structures or sanctions. A workout mechanism co-ordinated by a central bank is a case in point.

Figure 1. Selected elements of insolvency risk management systems



IRM organisations in the market

These fall into two categories: those directly regulated by the state and those indirectly regulated by the state.

Directly regulated: The two most important market-based IRM elements are banks and professions. While the banking industry is generally regulated to varying degrees by the central banks or bank regulatory commissions, occasionally governments may mandate that banks follow particular procedures that are designed to mitigate corporate failures and protect bank viability. As we shall see below in more detail, in 2001, the Korean government enacted the Corporate Restructuring Promotion Act with the explicit purpose of compelling banks to monitor their corporate debtors more closely and take collective action when corporate debtors begin to slide into financial difficulty, thereby resolving in the market what might otherwise overburden the courts. A London Approach that relies more on the leadership of private banks than guidance by a central bank offers another mechanism in this category.

Arguably, professional regulation is the most important element in the regulation of insolvency-related risk in the market. This is true, in a very general sense, in that the expectations of professional performance that government maintains of accountants helps establish a threshold of corporate governance that enables risk to be monitored and controlled by professionals, particularly in their capacity as auditors. It is true in a quite specific sense that corporate restructuring in the market may be successful in direct proportion to the adequate supply and skill of the financial and restructuring experts available to the creditors and debtors. Yet, many governments go a step further and obligate professionals to appraise the actions of company directors that may have led to insolvency and report lapses in competence or honesty to government regulators (*cf.* England and obligations of insolvency practitioners). By this method, government multiplies its monitoring capacity and inserts its regulatory precepts directly into firm management on a case-by-case basis.

Indirectly regulated: There are several other elements in a complete insolvency risk management system, which are easily neglected or overlooked. Most visible are market-led out-of-court processes

such as those conducted by workout departments of banks. They are influenced indirectly by banking regulations, such as those governing non-performing loans, and by the shadow cast by potential court involvement if the problems cannot be resolved internally. Asset reconstruction companies offer a market mechanism whereby assets of distressed state-owned enterprises or public conglomerates can be bundled and sold into a market, as often as not seeking real property opportunities for development. Then there are the plethora of risk management devices in the private market, ranging from rating agencies to informal workout mechanisms and asset restructuring companies, all of which are actually or potentially subject to regulation.

Trade creditors are also part of an IRM system, for their level of credit is usually proportionally high compared to other creditors, and they often have closer monitoring capacities and more flexibility to adjust to difficulties faced by debtors. Whether countries introduce laws to protect trade creditors through retention of title is part of the mix.

If the number of potential design elements in an IRM system were not complicated enough, the design of each element and their weighting in relation to each other varies widely across countries. In advanced economies, for instance, the weightings differ considerably. In the United States, courts, professions (lawyers) and out-of-court practices are prominent, but government agencies are less so. In England, professions (accountants, insolvency practitioners), government agencies, and out-of-court practices are prominent, but courts less so. In France, courts and professions are key. In Australia, professions and out-of-court practices are dominant and court involvement is limited. If this variation occurs in a relatively small number of countries with advanced economies that have strong trading relationships with each other, we should expect even more variation across countries that differ by history, culture, colonial heritage, religion, resources, race and integration into the world economy.

What will we count as a successful insolvency risk management system? Effective insolvency systems arise from the process of institutional design and lawmaking as well as the outcomes from implementation. A successful process for institutional design is more likely to follow from legitimate bargaining amongst all stakeholders, usually through an open legislative process. This will produce stability, predictability, and certainty (*i.e.* change along predictable paths). Successful outcomes will include: (a) stimulating capital flows (financial and human capital); (b) stimulating entrepreneurship (*e.g.* through encouragement of business development and business recovery through the second chances of company rehabilitation or fresh starts); (c) a shrinking of market uncertainty and its replacement by calculable risk-management mechanisms; (d) efficiently distinguishing between companies that should be liquidated versus those that have hope of rehabilitation; (e) early detection and prevention of economic crises; and (f) long-term economic growth without sacrificing social and political stability. The last criterion makes clear that an IRM system that produces widespread hardship, extreme inequality and immiseration will ultimately produce more rather than less uncertainty.

Risk management experiments in East Asia

Since 1997, numerous institutional experiments demonstrate that implementation of an effective insolvency institution depends on the interplay of initial design, lawmaking and translation of the design into practice. Research shows that institution building and implementation have failed because one or more of these elements has been ignored, taken for granted or under-estimated.

Courts: Heavy reliance on courts requires sustained political will to redistribute power in most nations

Insolvency reforms in Asia are commonly caught in much more difficult political circumstances than many would-be reformers conventionally acknowledge. An effective insolvency system appears to require both certainty that the failure of debtors to negotiate restructurings in good faith will lead to liquidation, and that basic standards of fairness and the public interest are served in insolvency processes. In advanced countries, courts usually satisfy these functions, or, if not, recourse to courts is possible for aggrieved parties. But, historically, many countries in Asia have given little prestige or power to legal institutions and courts are poorly equipped either to deliver competent law or to maintain independence when financial stakes are high, especially when political leaders often have financial interests in outcomes. While every insolvency system would therefore seem to be best served with courts as its backstop, the implantation of a powerful, competent and independent court system will vary radically in its success across countries.

Efforts to erect insolvency court systems in Asia have met widely variable fates. The results are directly related to the institutional contexts in which the new structures are implanted. Where legal education, lawyers and judges, a concept of the rule-of-law and courts are highly respected, even in previously limited substantive areas, then a court-backed insolvency system can be erected effectively in a relatively short term. Where these conditions are missing, however, the effective establishment of what amounts to a new second or third force in politics (alongside executive and legislative power) remains fraught with difficulty.

Korea

In 1997, Korea had in place a developed court system that attracted the best and brightest law students into judicial careers. A sophisticated and prestigious—albeit tiny—legal profession supported the courts. Moreover, because it had made a successful democratic transition some years earlier, the prospects of the rule of law, including judicial independence, were quite high. Most corruption had also been stamped out of the court system. In this context it made sense to design a system where large commercial insolvencies were moved away from direct government interventions and onto the courts and to re-orient private workouts by banking institutions to the threat of liquidation in the courts. The Korean government facilitated the process by creating a *de facto* specialised insolvency court within the Seoul District Court so it could ensure that experienced judges with commercial competency would preside over corporate liquidations and reorganisations. While it has confronted a number of difficulties in shifting commercial matters away from direct government control and into the courts, the institutional capacities of Korean courts and legal professions that were already in place enabled a shift in degree rather than in kind. All of these transitions towards a court-centred insolvency system have proceeded relatively smoothly. In other words, the design was well suited to prospects of implementation because the institutional fit was appropriate.

Indonesia

By contrast, Indonesia, in 1997, had a thoroughly institutionalised disrespect for law, a weak, barely competent, corrupted court system, a dearth of research institutions that could inform policymakers with reliable data, a corrupted state bureaucracy with limited institutional capacity and an enormous problem of governing a vast, heterogeneous population spread over thousands of islands.[11] At the heart of Indonesia's economy lay an incipient conflict between the Chinese, who were disproportionately represented in the heights of the economy, and ethnic Indonesians, who far overwhelmed them in numbers and who controlled the heights of the state and the military. In this context, the prospect of successfully implanting an entire risk management system built around law

was low at the outset. Nevertheless, international organisations sought to do so by the modernisation of bankruptcy law, the reform of courts, the creation of bank restructuring (Indonesian Bank Restructuring Agency) and out-of-court restructuring agencies (Jakarta Initiative Task Force) and the creation of a new receivers' profession.

Establishment of the Commercial Court in 1998 illustrates the difficulties of implanting what was effectively an alien institution in unpropitious domestic soil.[12] There are positive aspects to its founding and functioning. The IMF and its Indonesian partners saw the court as a key element of a fairly comprehensive IRM system that would include out-of-court processes and a new profession. The publicity given its trials and tribulations has put the issue of corruption and the prospects for rule of law before wider public. The IMF may well have been successful in its bold plan to drive a wedge for the rule of law into the whole court system via the Commercial Court, certainly as a symbolic gesture around which reform groups in society might rally.[13]

For practical purposes, however, foreign creditors have abandoned the Commercial Court because they have no ability to predict its outcomes. Perhaps less a matter of competence than of corruption, the court has made enough notable "puzzling" decisions to undermine legal certainty. Yet, given the problem of fit this might have been predicted, for the court was expected to radically alter a path dependent trajectory of disrespect for law, of uncertain enforcement and of corruption. In addition, the court was implicated in what could be construed as an effort to shift control of the conglomerates away from their Chinese owners to the state, or foreign or ethnic Indonesian interests.[14]

In short, a concept that looked good in design was undermined by lawmaking and implementation. Parties critical to the success of the design—debtor corporations and Chinese business leaders—were marginalised in the lawmaking and not integrated into the design of a process they could accept as legitimate, fair and feasible. Design occurred without fully appreciating the implementation hurdles of corruption, of placing a new court inside a compromised and ineffective existing court system and of finding qualified judges. The actual practice of implementation required many compensatory measures to try to remedy each of these, but often it was a matter of too little too late.[15]

China

The inertial power of path dependency makes a court-oriented risk management system in China even more problematic. The current version of the Draft Bankruptcy Law anticipates a key role for courts in each of the insolvency procedures it offers. In this respect, it reflects the more optimistic prognoses of commentators on China's legal development.[16] Yet, the history of China's legal and political institutions casts doubt on how sensible it is to expect such a radical change in course.[17] Historically, courts and law had much lower status in Chinese governance than public administration (Lubman 1999). Apart from punitive criminal law, law has not been a social ordering mechanism. Compounding this problem is the structure of a one-party state in which the Chinese Communist Party (CCP) maintains its power over all significant policy decisions. A one-party state and a judiciary that offers legal certainty are incompatible, since any issue before the court can be trumped by party interests or on grounds of state security or state secrets.[18] Moreover, in China a tight relationship of mutual patronage at local levels among political, law enforcement, and business leaders casts considerable doubt on Beijing's ability to develop independent courts that can produce predictable decisions, even if it were so inclined.[19] Given this combination of an historically weak judiciary, the under-development of professions, the limited control of Beijing over the provinces, and above all, the dominant role of the CCP, it is very difficult to conceive of the implantation of a risk management system heavily reliant on courts in the near to intermediate term. Because of this, most foreign companies operating in China choose to contract around Chinese courts and seek to avoid them if at all possible.

In sum, an internationally approved design for an insolvency system contains internal flaws for it fails to address the deep institutional weaknesses of the courts as they presently exist. It skirts around the fundamental problem that the envisaged reforms, to be effective, would require a fundamental change in the power structure of Chinese politics. The ten-year long lawmaking process has consistently improved the design in matters of substantive law, but protracted struggles within the National People's Congress and State Council reveal considerable rifts within the Chinese leadership.[20] Moreover, as in Indonesia, key parties to insolvency risk management systems (most notably private business) have been largely absent from the design and lawmaking. As a result, implementation is likely to be more symbolic than real and, if the government can exercise sustained political will around a consensus within the party-state, will require many recursive cycles of reforms over a long period to institutionalise an effective system.

Insolvency reforms that aim to significantly enhance the powers of courts thereby are likely to create political controversy that far exceeds issues of corporate reorganisation. The shifting of powers to courts demands that states shed power, usually from executives historically unaccustomed to being checked by an institution that is seen to be subservient to the power of the executive.

Private insolvency professions: Institutionalising insolvency professions requires as much focus as reforming substantive law

Designers of IRM systems too often place most emphasis on substantive and procedural law at the expense of building professional capacity. Yet, we are not aware of any effective insolvency and risk management system that operates without competent and honest professionals. It is conceivable for an insolvency system to function with minimal interventions by courts or government agencies. It is not conceivable for such a system to function effectively without specialists, especially for reorganisation. "The probability of effective reorganisation increases when agents of reorganisation have the capacity to (a) decide whether rescuing business is feasible and to advise on alternative courses of action (liquidation, reorganisation, creative combinations of these); and (b) to reorganise the company itself…."[21] Such capacities depend on a sufficient supply of expert labour. Public policy must therefore: (a) find means to bring the best and brightest into the debt restructuring area; (b) regulate competition to constrain costs and reduce conflicts of interest; (c) remove financial and reputational barriers to insolvency professions; and (d) develop a regulatory system that delivers competency and integrity.[22]

There is historical precedence in advanced economies for the centrality of professions. The opportunities for corporate reorganisation that were built into the 1978 US Bankruptcy Code were only possible because the new law built a critical compensation provision into it. Rather than being paid by the hour, lawyers could be compensated proportionally by the size of the estate they could cobble together to effect reorganisation. The combination of a new intellectual challenge opened up by the law plus significant economic incentives produced one of the most radical instances of upward mobility of any professional sub-specialty. In a very short period, bankruptcy practice went from a marginal, low-status field that was of interest only to small boutique law firms to a highly compensated, highly prestigious field in which every major law firm established a specialised practice. As a result, many of the best and brightest in law made corporate reorganisation a dynamic and creative field. In Britain, too, the Insolvency Act of 1986 fully professionalised insolvency practitioners. Once again, a relatively marginal field became an important department in every major accounting firm, thus bringing broad expertise into company risk management in the shadow of insolvency. However, the government cleverly included a capacity to intervene in the regulation of the profession if it used its self-regulatory power to consolidate its monopoly at the expense of clients. In other words, the viability of the entire rehabilitative enterprise depended on the quality of private practitioners that could be drawn into the field.

But the development of the private market for professional services in developing or transitional economies can be fraught with problems. The bundle of reforms in Indonesia included establishment of a receivers' profession that would represent parties to insolvency and act as trustees upon court appointment. This course of action made eminent sense because the scope of restructuring envisaged in Indonesia required an expert profession whose credentials matched the magnitude and complexity of the challenge.

The experiment has fallen on hard times. While the IMF hoped that foreign experts would be eligible to expand the pool of experts available in the renovated insolvency system, government regulations restricted certification to those who could pass an Indonesian language test. While the original fees were to be set on a proportion basis to size of estates, this was later changed to a receiver's regular hourly rate outside insolvency. Judges increased uncertainty for receivers by making a determination of their fees at the end of the case with the result that receivers could not predict the value of a case when they took it on. Receivers have little co-operation from banks. Most receivers have difficulty obtaining information from debtors. Moreover, an appearance of collusion appears to exist where judges expect kickbacks from receivers they appoint.[23] Of the original 116 certified receivers, only 32 have been appointed, and many of these several times. The lawyer-receivers come from small firms and the accountant-receivers come from only one Big Four firm. Furthermore, the professional association is very weak, exercising little regulatory control, offering no continuing education, and providing no communications among members or protection of members.[24, 25]

The limited success of the Indonesian receivers' profession demonstrates how a good design can be subverted through problematic lawmaking and implementation. Lawmaking through regulation permitted the Ministry of Justice to institute a receivers' profession that excluded all foreign expertise, even in the short term. That, in turn, limited the impact of the reforms severely, although it was not so surprising since professional protectionism exists in many countries. In its implementation, the regulatory structure set up to organise the local profession, received little external support and failed to exercise any of the conventional functions of a self-regulatory body in advanced countries. In this respect, the regulation of insolvency practitioners reflected some of the inadequacies of professional regulation in other fields such as law.

This is not only a problem for Indonesia. The Chinese government has been working steadily to upgrade professions, including law and accounting, and appears fundamentally committed to develop what it calls intermediary organisations--a policy intended to devolve some administrative functions from the state to the market. However, it is not clear that the level of deep planning for professional institution building has occurred at anything like the level of sophistication that has gone into the drafting of the new bankruptcy law. Here the design of an insolvency profession remains primitive and it can be expected that lawmaking will be messy as disparate professions of lawyers and accountants compete for potential work. The impediments to implementation do not appear to have been confronted forthrightly.

Similarly, while Korea has undertaken many insolvency reforms through to the present, the nature of the professional monopoly, which many observers believe benefits lawyers more than a fully functioning IRM system, has not been confronted adequately.[26] In lawmaking, the government has been heavily influenced by the professional lobby that has sought to maintain a strict monopoly, certainly over the entry of foreign professionals into the Korean market for professional services. The monopoly has allowed a greater influx of new Korean lawyers into the profession. However, to some foreign corporations and creditors, implementation still appears to allow more conflicts of interest, which can be avoided in larger, more competitive professional markets

Without an expert, independent profession that can handle demand, an IRM system will be on shaky ground. The design of the private professional part of the system must therefore be as central as the substantive provisions, for the latter will not function without the former. In fact, it can be argued that even if substantive law is wanting, skilled and creative professionals can fill in the gaps and craft solutions that fit the problems not adequately treated by the law. It is for this reason that the IMF and World Bank standards both emphasise this institutional foundation of an insolvency system. Nation-states reforming their IRM system should treat professions not as a necessary afterthought, but as integral parts of an interdependent system that will fail without strong professional services.

Relatedly, it should be recognised that in some jurisdictions insolvency professions affect risk-taking by companies through regulatory responsibilities they must undertake as a condition of their license to practice. In the United Kingdom the Insolvency Act of 1986 included provisions to motivate directors to limit risk to creditors by closely monitoring their financial affairs, by seeking professional advice earlier rather than too late, and by activating insolvency proceedings before most assets were dissipated. Provisions on wrongful trading (directors could be held personally liable for the loss of assets if they continued trading when they knew or should have known that they were technically insolvent) and disqualification of directors worked together to compel directors to limit the risk they were taking with creditors' money. These threats against directors energised business associations, such as the Institute of Directors and accounting firms to offer educational campaigns to inform directors of their potential personal risk if they failed to follow prudent practices.[27]

State mediation agencies: effective implementation requires a systemic approach with close attention to the lawmaking process

The lines of demarcation between state and market-dominated risk management systems (Figure 1) reflect the historical development of particular institutions and credit culture. As Vassiliou (2003) has pointed out, in the economic development of advanced countries, liquidation measures long preceded rehabilitation.[28] Efforts to save companies could all take for granted a threshold condition—that a strict liquidation law provided a predictable alternative. The same can be said for out-of-court processes. For private restructurings to work, a powerful negative sanction needs to cast a shadow over proceedings; in the case of failure, secured creditors can seize assets and dismember the business, or courts can order the liquidation of a firm's assets or sale of the firm as a going concern. If there is any uncertainty about this terminal outcome, then leverage over debtors to bring them to the bargaining table is largely lost.[29]

Since 1997, Asian reform programmes have instituted both reorganisation provisions within insolvency law and restructurings through out-of-court processes without the assurance that creditors will enforce their security or courts will act decisively to liquidate a firm.

The adverse effects of a weak court combined with limited negative sanctions for non-cooperation can be observed in the Jakarta Initiative Task Force, which was set up as an independent governmental agency in September 1998 to restructure debt outside of the Commercial Court.[30] The logic of this out-of-court process made good sense: it conformed with Indonesian modes of dispute settlement; it enabled companies to save face in private rather than public proceedings; and it took pressure off newly established courts. Companies with assets in excess of USD[31] 10 million could negotiate restructuring agreements with creditors under the guidance of experienced mediators, many of them from overseas.

However, what was intended as a voluntary scheme that would relieve pressure on the courts fell far short of expectations because debtors had few incentives to come to the table. The Government removed various impediments by eliminating various tax or regulatory impediments to restructuring

and it provided substantial tax concessions for parties who negotiated in good faith.[32] However, the government was reluctant to institute negative sanctions against debtors that refused to either come to the table or negotiate in good faith.[33] In the absence of a "hammer" to get debtors into negotiations, or any real threat of liquidation if negotiations foundered, creditors and conciliators could rely on little more than persuasion. Debtors also knew that court-driven liquidation was not a viable threat since the court often enough showed itself to be more sympathetic to debtors than creditors. As a result, while the official records show the "restructuring" of enormous amounts of debt, in fact, creditors were compelled to take huge haircuts and to conclude fictive long-term agreements for postponement of debt repayment that they never expected to see.[34, 35]

In short, reorganisation without effective liquidation in Asia creates perverse insolvency systems. If liquidation provisions are not credible, then bankruptcy law does not do its work; if reorganisation provisions are not practicable, then companies are liquidated unnecessarily. Uncertainty results in either case.

Here the moral is clear: while private elements of an IRM system may be integral to an effective holistic approach to financial risk, they may function effectively only when the formal law is designed with great care to modulate the relations among elements of the risk management system. If those elements are not well balanced—courts without predictable liquidation standards or out-of-court processes that lack positive or negative sanctions—then the system as a whole is deformed. However, to design a system where all the parts are implemented in harmony depends on the institutional conditions mentioned earlier. Institutional design is therefore a very contingent enterprise—easy enough in theory, but extremely difficult unless attributes of nation-states are conducive to all elements of the system.

There are other lessons that demonstrate the dangers in lawmaking and implementation. Lawmaking of the Jakarta Initiative was taken without consulting and integrating corporations into the decision-making process. Put another way, one of the key parties to effective implementation—the debtors—were given no opportunity to express their views or to help forge a process that might satisfy some of their concerns.[36] Moreover, what could be seen as a technical problem, in fact, had far-reaching political and social implications. Some commentators observe that the Jakarta Initiative could be seen as another way to transfer control of Indonesian corporations to foreign interests, or to take the reins of many prominent businesses away from Chinese owners and hand them to non-Chinese ethnic Indonesians. For all these reasons the Jakarta Initiative generated passive and active resistance by debtors, some of which could plausibly have been reduced if the Jakarta Initiative had been designed in collaboration with industry and obtained some legitimacy at the outset from industry groups. Exclusion of debtors is common in insolvency lawmaking, but it frequently results in the subversion of risk management institutions by an interested class of actors that were never given a role or the respect to assist in their design.[37] It should hardly be surprising that implementation then becomes the site for rear-guard struggles by debtors to resist provisions in which they had no hand in designing. The problems faced by the Commercial Court in Indonesia resulted not only from a failure in institution building and resources, but by the choice of debtors, who had been excluded from the political process, to use the courts as a rear-guard battleground to subvert the intent of lawmakers.

Monitoring and market workout mechanisms: Multi-directional monitoring of all risk management institutions keeps them accountable to key constituencies

Without close monitoring of changes and the ways law comes to operate in practice, perverse and deviant patterns may quickly take hold and be all the more difficult to extinguish. Laws are often passed and ignored, especially when they are passed under the duress of external influence or in response to a public outcry that requires at least a symbolic response. The attention span of politicians

is often fleeting. For all these reasons, monitoring of actual implementation by interested parties can ensure that the law-on-the-books is taken seriously in practice.

Monitoring can reside in several places in an insolvency risk management system. Monitoring can be institutionalised within firms through accounting regulations and corporate transparency provisions. Although monitoring can be left to firms themselves, monitoring of clients by banks can be mandated by banking regulators or by explicit statutory charges. Monitoring may be instituted in all elements of the insolvency system–debtor corporations, creditors, and the institutions of mediation, restructuring and liquidation.

Korea

In 2001, the Ministry of Finance and Economy (MOFE) pushed through the National Assembly a law intended to facilitate bank-led out-of-court restructurings entitled the Corporate Restructuring Promotion Act (CRPA or Act). The market in Korea lacked a voluntary mechanism to co-ordinate conflicting interests among creditors and debtors in order to restructure companies in financial difficulty. Banks in Korea had long been accustomed to act as agents for their political principal—the government of Korea. Government-led banking ensured that commercial criteria for lending were subservient to policy guidance, whatever the financial merits of a given borrower. Banks did not have effective credit risk evaluation mechanisms since credit risk was not a primary basis for lending. The deficiencies in banking practice extended to inadequate methods for early detection of financial difficulties, in part, because the lack of accounting transparency of borrowers made risk evaluations and monitoring difficult. If companies were in distress, no prompt mechanisms existed for action. In addition, under existing mechanisms, workouts were not binding on foreign creditors, which created a problem of free riders and holdouts.[38]

Rather than set up a government agency, the Act created a set of mechanisms and responsibilities for creditor institutions over firms with debts of more than KRW[39] 50 billion (934 companies). The Act took aim at accounting procedures in firms and monitoring procedures by banks. It legalised a set of internal accounting procedures in companies to improve their transparency to banks. It mandated that banks institute Corporate Credit Risk Evaluation Programmes in which they undertook quarterly reviews of key financial data of their corporate clients. If corporate clients failed prescribed tests, a lead bank was charged with convening a council of major creditors to produce a restructuring plan, under time constraints, that could be imposed on all creditors by vote of creditors carrying more than 75% of a company's debt. Troubled companies were compelled to submit to the restructuring plan, subject to certain protections.[40]

The Act built in several negative sanctions. If a memorandum of understanding (MOU) were not concluded within the grace period, then bankruptcy procedures would be invoked (and by this time courts were liquidating even very large companies). Credit institutions would be subject to compensatory liability if they failed to act on resolutions for which they had voted. Moreover, failed creditors were required to compensate other creditors for the damages they inflicted upon them. Monitoring provisions for quarterly evaluations of compliance with the MOU were built into the Act. Various arbitration and conflict resolution procedures in the market were built in for all parties. If the private market solution failed, then normal bankruptcy procedures would apply.[41]

It is too soon to evaluate how well the new risk management provisions will work in the longer term and how effectively the Act will promote restructurings. Initial steps were faltering. In the first six months, only 20 firms went into formal workouts under the Act and it appeared that the quiet hand of government technocrats continued to be informally guiding some proceedings, especially in those banks where the government was a majority stockholder. Legal critics argue that, by removing

restructurings from a court-driven process, the Act effectively diminishes the rule of law in the economy and reduces the rights of creditors. Moreover, since banks are vulnerable to continuing bureaucratic "guidance" the market itself is deformed by arbitrary political interventions.[42]

Monitoring by professions offers another option. In insolvency, this can involve professional monitoring of firms and professional monitoring of insolvency institutions for procedure and outcomes. The former can be mandated by law or regulation or follow from normal professional practices. The latter represents one way that professions can exercise a civic professionalism that holds institutions accountable in which professions have an expert interest, technical authority, and privileged access. Yet another source of monitoring can come from civil society groups such as the Centre for Law and Policy in Indonesia, which has been monitoring court decisions[43] or the Korean Development Institute, whose economists track quantitative indicators with close attention and much sophistication.[44] Monitoring can be mandated by government or international organisations and contracted out to law or accounting firms, or think tanks. This is the approach taken by the Team 7, which was charged with analysing every insolvency decision of the commercial judges. As a prelude to Team 7, the IMF also funded an internal report by a leading Jakarta law firm on all cases in the Commercial Court to date, but it was never released to the public.[45] In exceptional circumstances, monitoring may be mandated by international financial institutions, such as the statistical reports to the IMF from the JITF.

Monitoring is not simply a matter of diagnosis through the gathering of firm evidence of changes, problems or progress. Monitoring is a powerful stimulus to institutions that find themselves accountable and transparent to public review and critique.[46] An analysis of court decisions, for instance, shows that actually naming judges whose cases seem deviant or seem to systematically favour a particular category of parties, (see Suyudi's findings)[47] is a very powerful sanctioning mechanism. When the monitors can ally with the media, then a strong coalition enables the activation of public opinion, which, in turn, adds further pressure on new institutions.

An insolvency risk management system that builds cross-cutting or reciprocal monitoring into the relations among its elements builds a strong foundation of accountability, particularly when economic or ideological interests give monitors strong encouragement to exercise vigilance. More attention is needed to the structure and dynamics of such a comprehensive design. Presently, designers give priority to monitoring in one place or another (*e.g.* bank regulators of banks, banks of lenders) but do not envisage a broader pattern where many elements of the system can systematically observe the behaviour of other elements, whether it be civil society groups, or the media monitoring the judiciary or professionals managing directors. There is no reason why industry groups should not also monitor creditors, courts and mediation agencies.

Nevertheless, lawmaking over monitoring may be divisive—no party likes a spotlight to be shone publicly on its activities—and dilute the potency of monitoring responsibilities, sometimes because powerful lobbies resist either exercising or being accountable to monitoring efforts. In practice, implementation requires more than a metric of evaluation and regular reports. It requires informed scrutiny to be sure that reports are meaningful. Objects of monitoring frequently use the well-attested technique of symbolic compliance to offer apparently impressive results that are hollow upon closer inspection. Whether these are false or incomplete sets of accounts, or artificially boosted statistics of restructuring success, or impressive-sounding statistics on memorandums of understanding, only informed and vigilant monitors will be able to distinguish the symbolic from the real.

Conclusions and caveats

International organisations ritually repeat the maxim that "one size does not fit all" in international transplants of laws and legal institutions. The maxim is entirely correct, but in practice it is heeded less consistently because there are many pressures on international organisations and developed countries to export legal models without due awareness of their fit in particular national situations. On the one side, there are pressures for harmonisation in the belief that it will produce certainty and investment. Strict harmonisation, at least of rules and institutions, abrogates the principle of different sizes for different contexts. On the other side, international institutions and often nation-states do not know what conditions will support laws and institutions that are imported from other countries or based on models promulgated by international organisations. For symbolic or well-intentioned reasons they may mistakenly import models poorly suited to local situations. This problem is compounded because the experts on whom international organisations and nation-states usually rely do not have expertise in the behaviour of institutions and the conditions under which they will take root and grow.[48] Our conclusions and warnings therefore reinforce the maxim that "one size does not fit all" with its corollary that variability of insolvency systems is not only inevitable but also desirable.[49]

Poorly adapted legal transplants will likely fail

Design of an effective IRM system faces several difficulties all of which turn on the puzzle of how to combine the general with the particular, the universal with the local and the foreign with the domestic situation. By accident or design, nations often import foreign or global models that are entirely inappropriate, given their history, institutional capacities, and economic and legal development, with the result that they produce more rather than less uncertainty. The success of models in other situations can be beguiling. Even if adequate research establishes that ostensible success is both real and lasting, success elsewhere depends on a specific set of circumstances in that country. Without identifying the salient conditions of success, nations risk bad transplants and resulting uncertainty in the law and market. Failures of transplants abound when "best practices" are carried from one country to another without full awareness of the conditions under which they succeed or fail. Imports must come with a conditional account of the circumstances that were conducive to their success. That is no easy matter.

For instance, the London Approach, championed initially by the Bank of England, seems to offer a clean, quick, effective way of restructuring debt out of court and thus appears to introduce welcome efficiencies into private or quasi-private risk management. What were the circumstances of its origin and the conditions of its success?[50] England boasted an independent Central Bank of enormous authority. Most secured lending to corporations flowed from a handful of the UK's domestic clearing banks whose head offices were within walking distance of the Bank of England. The Bank of England had little difficulty "inviting" major credit institutions to sit around a conference table and forge a "gentlemen's agreement" to restructure a failing company's debt with every expectation that the power of informal sanctions in the tight English world of private banking would make agreements effectively binding on all parties.

It is entirely plausible to extrapolate from the UK experience and develop principles that might be applied to all countries, as INSOL has effectively done. But that extrapolation only works when it is known which of the conditions of the London Approach[51] were critical to its success or it is known what conditions are most propitious for the application of the INSOL workout principles. What if a country's central bank is neither independent nor authoritative? What if the role of co-ordination is given to a lead commercial bank? What if the number of financial creditors is very large? If some are domestic and many are foreign? If some are long-term lenders and others are bondholders who sell

into secondary markets? If non-financial creditors want a seat at the negotiating table? If debtors demand to be part of the restructuring negotiations? If no mechanism exists for making agreements binding? At least one experienced World Bank official has argued that the conditions that would make a London Approach work do not usually pertain in East Asia, and thus, it must be creatively adapted to local circumstances.[52]

This argument is not to dismiss the potential value of out-of-court mechanisms for risk management. It is to maintain that a global model or foreign import is not sufficient in itself to warrant adoption. Global models and foreign imports must always be accompanied by the contingencies under which they are likely to work. So far, that knowledge seems to exist, perhaps, only in the tacit understandings of some international institutions that are experienced in the cross-fertilisation of models from one national context to another.

Government is the ultimate risk manager

This paper rests on the premise that government is the ultimate risk manager. In his brilliant recent book, David Moss of Harvard Business School has shown that government manages risk by either reducing or allocating risk to different segments of the government, market and society.[53] In the economic development of the United States, for instance, Moss shows that the first phase of development involved the extensive involvement of government in creating a secure business environment. This did not necessarily imply direct government intervention or an increase in the size of government, though it always had a regulatory component. From 1789 to 1900, the government introduced protections for property rights, established a common internal currency, required deposit insurance, passed limited liability law for corporations and later fixed exchange rates. In so doing, the government mobilised its generic powers of compulsion to solve recurring problems in private markets.[54] The passage of successive bankruptcy laws was an integral part of the government's efforts to create a risk management system, in this case that stimulated entrepreneurial risk-taking by company owners, managers and directors.[55]

The configurations of an insolvency risk management system are a public policy decision on how and where risk will be reduced or allocated. Of course, to say that government is the ultimate risk manager does not determine which institutions will be given what kinds of responsibility for reducing, managing or stimulating risk.[56] It is to say that economic development may benefit when government takes a macroscopic and long-term view of the risk management problem and acts holistically to design a comprehensive, integrated system to solve that problem.

Neither is the US experience normative for other countries. Global and contextual conditions have changed radically from US 19th century economic development. The US economy, legal system and polity have long been acknowledged by scholars for their exceptionalism rather than their normalcy among the world's nation-states. For symbolic or pragmatic reasons, other nations often borrow from the US or claim their reforms resemble US institutions. It is common in developing countries to be told that insolvency reforms are following Chapter 11 of the US Bankruptcy Code on reorganisation of companies. Most often, this means only that countries are incorporating into their law provisions for the rehabilitation of companies. To follow Chapter 11 closely, with its institutional assumptions of powerful and competent courts, huge and prestigious pools of professional expertise in law and accounting and a legal culture that favours debtors, would doom the rehabilitation experiments of most countries to failure. Government can be the ultimate risk manager without either mimicking the US's own economic development or patterning a developing country's nascent legal institutions on those in the US where circumstances, history and legal culture are radically different.

National circumstances must determine where each country places the boundary between state and market responsibility for insolvency risk management

We have argued that the design of insolvency risk management systems must be holistic. The extensive experiences of advanced nations and experimentation in developing and transitional countries show that a fully-defined system comprises many elements that extend all the way from pure state entities through the market and out into civil society (*cf.* Figure 1). If governments are the ultimate risk managers, they are more likely to meet with success in lawmaking and implementation when their design of the systems views all parts in relation to the whole.

Perhaps the most fundamental institutional issue is the policy decision about the appropriate line of demarcation between risk management processes located within the state and those located primarily within the market. Every government locates this line in a different place and often the policy debates are fierce for they can be tantamount to decisions over whether civil servants or private parties will have jurisdiction over areas of work. There can be no *a priori* decision about where this line should be drawn. Research on several transitional and developing economies casts doubt on how much can be handled by state agencies and courts where these are deformed, corrupted, or undeveloped. Research indicates that establishment of independent competent courts is a rare achievement.[57] If countries have deformed state institutions, then it may make more sense to push a larger burden of the risk management responsibility onto the market, albeit regulated by the state. On the other hand, where governments have respected courts and/or substantial administrative capacities, then bureaucratic solutions might also work. In several developmental states, however, part of the larger move towards an open political and economic society may require a wresting of power away from powerful state agencies and the allocation of those powers to strengthened courts or private sector institutions, as has been the case in Korea.[58]

Figure 1 can therefore look quite different—and should look quite different—in countries where the state has competently driven economic development, or where the market is vibrant but the state is ossified and corrupt, or where law is a principal ordering mechanism in social relations versus where law historically has been marginal to social and economic control. We represent diagrammatically variants in Figures 2a and 2b. In Figure 2a, it is the state that dominates because it has done so historically (*cf.* France) and because markets or civil society may be institutionally underdeveloped. The reform trajectory of such nations will likely follow a progressive devolution of state functions to the market and civil society through a downsizing or retraction of the state. This will strengthen other institutions and spread the options for allocating risk across institutions but is unlikely to remove the dominance of the state as risk manager overall.

In Figure 2b, it is the market that dominates because the state may be deformed (*e.g.* corrupt, incompetent, lacking legitimacy) whereas the market is more dynamic, more open to experimentation, more successful in recruiting personnel skilled in corporate rehabilitation and the like. Markets always require regulation and state monitoring. The government remains the ultimate risk manager, but it may allocate most risk management to market institutions that it creates or confirms and regulates. The reform trajectory of such nations will likely require a progressive strengthening of state regulatory capacities and its judicial functions, but the centre of restructuring and risk management will remain in the market (*cf.* Britain).

Figure 2a. State-centred insolvency risk management system

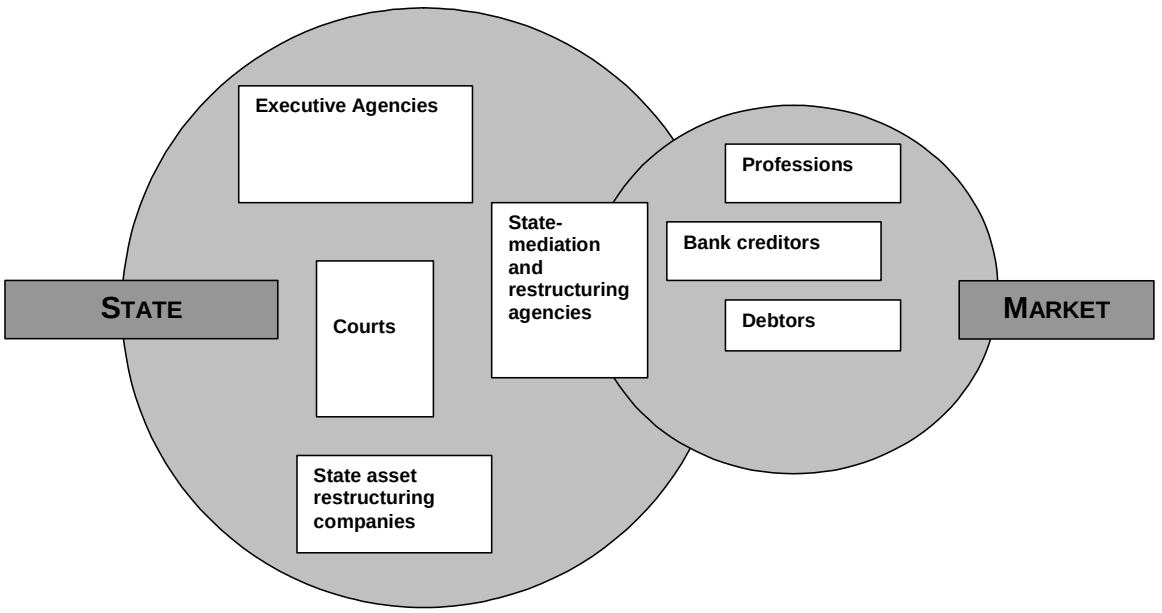
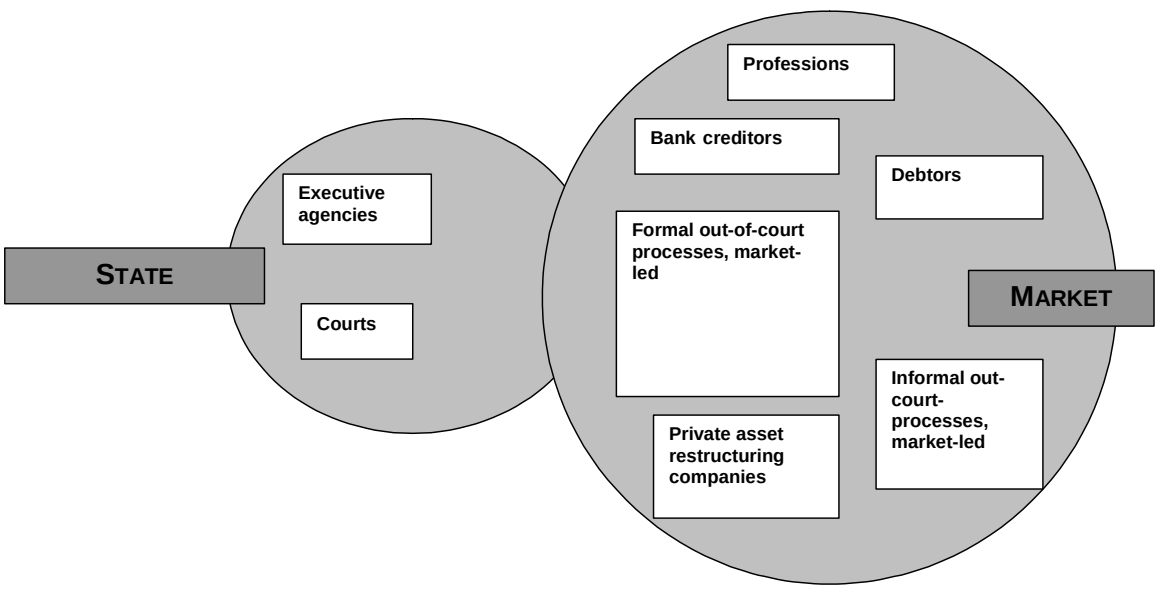


Figure 2b. Market-centred insolvency risk management system



In short, design must fit each system uniquely to its double context: national path dependency and global norms. This strongly implies an incremental rather than radical strategy of reform.[59] Since it is very difficult to move a nation too radically away from paradigms that have governed it for decades or generations, or from established institutional trajectories, any reforms must take the time to reflect on the vexing issues of how to fit an innovation within governing paradigms and taken-for-granted meanings about states and markets, obligations and rights, and relations and agreements that pervade every society. This is not only a matter of design but of implementation, for changes require acceptance by their primary constituencies and acceptance comes only when the framing of change is meaningful within a cultural context.[60]

The strategy of the Chinese government to follow an incremental path with its insolvency reforms illustrates this approach well. For a decade, China's State Council has preferred to deal with the liquidation and reorganisation of its formerly pervasive state-owned enterprises through incremental steps of small, local experiments that were modified and expanded geographically as successes or failures demanded. Only in 2004, ten years after drafting began on a new, comprehensive bankruptcy law, does it envisage placing all companies under the umbrella of a law-driven rather than bureaucratic-driven risk management process. But, even now, the draft law, currently being reviewed by the National Peoples Congress, has excluded between 1 000-2 000 significant state-owned enterprises, all partnerships and many small enterprises because the State Council is doubtful that a law-governed, court-based system can manage some of the potential dislocations that might better be treated through administrative discretion.

Insolvency risk management systems fail when institutional designers do not give proper recognition to lawmaking processes and conditions of implementation

Disproportionate attention is given to design by most institution-builders. Yet lawmaking and implementation can subvert the best conceived plans. As a result, it is impossible for builders of effective risk management systems to avoid the politics of lawmaking or the pragmatics of implementation.

Effective reforms must be legitimate. Arguably, the more legitimate the process, the more likely reforms will be accepted by all parties. The legitimacy of legal systems, even in underdeveloped systems of political representation, depends on participation in the political process. If major parties to reforms are excluded from deliberation over the design of reforms, then they are likely to perceive reforms as potentially hostile or at least alien. In insolvency reforms it is a mistake to exclude, as frequently happens, debtor corporations, business elites, workers and trade creditors among others. Their exclusion may not be a matter of conscious rejection. Excluded parties may not have recognised their own interests in reforms, or they may have recognised their interests but have been unable to mobilise during the lawmaking process. Moreover, it can be more than a matter of interests; good lawmaking benefits from extensive information on the conditions under which the law will work. Broader participation by affected parties is likely to generate this information. Whatever the reason for exclusion from participation, however, the most admirable design is likely to be undermined if lawmaking is perceived to be "crammed down" on one set of actors in the credit network by another set of actors, or by one profession (*e.g.* economists) on another (*e.g.* lawyers), or by one government department upon another. This problem is intensified the more well-placed the "losing" party is to stall or frustrate implementation

Effective reforms also require that reformers anticipate and analyse the factors and actors that will facilitate or inhibit implementation. At the very least, it requires that lawmakers consider what interested parties are in a position to frustrate successful implementation. These will certainly include practitioners, creditors or debtors, and courts. If their experiences, cultural orientations, and interests

are not integrated into the design and lawmaking, then they are likely to turn into active or passive resisters of reform. The internal politics of implementing actors also cannot be ignored. In China, professionalisation is still in its infancy. Much fragmentation, conflict, and jurisdictional contestation takes place among poorly regulated, not very autonomous professions. System design and institution building may be subverted incidentally by competition among professions—between elites and non-elites, between well institutionalised and newly formed professions, between accountants and lawyers. A similar fragmentation and competition has bedevilled Indonesian systemic reforms.

Furthermore, implementation is the "location" where external organisations (*e.g.* international financial institutions, overseas aid institutions) and even national government agencies have least impact. It is the place where the weak can retreat and resist. It is the location for guerrilla warfare in law reform. As a vast scholarly literature on regulation demonstrates, without a culturally adapted, co-operatively designed framework of regulation, its practitioners can effectively nullify reforms. Thus, it is a matter of pragmatism to elevate considerations of implementation and its primary actors into the front rank of lawmaking for insolvency systems. This requires sophistication in the design of other-monitoring and self-monitoring systems. It also requires a system adapted to a particular national context so that all elements of the system are balanced within the state, within the market, and between them. Each country will respond to problems of design and implementation by drawing the line between state and market regulation in a different place.

Best practices are never best everywhere

Transnational and global institutions, international organisations and professions, now offer an array of norms, ranging from the global consensus of UNCITRAL and the global consultations of the World Bank to the practices of professions and other countries. We have argued that there are many pragmatic reasons to situate an IRM system inside the parameters of global norms, not least that they represent a distillation of expertise and experience from many situations. The universality of the global, however, must be converted into the particularity of the local. Lack of understanding of what will be legitimate and meaningful and practical in the unique circumstances of a particular country, will lead system designers into a morass which breeds uncertainty and confusion. It must be emphasised emphatically that "best practices" are never best everywhere; they are "best" only in specifiable circumstances. Unless those contingencies accompany a best practice model, then it requires a great deal of skill and luck to adapt it successfully in local circumstances.

Varieties of capitalism, varieties of insolvency systems

These conclusions lead to modest expectations about what is possible, particularly in the short term. They lead to a more contingent expectation of what happens when the transnational is brought to the national, or the global to the local situation. They also point to major gaps that still exist in the global movements towards effective IRM system. Arguably, the most important gap is that no systematic comparative framework exists as yet on varieties of capitalism and the varieties of insolvency risk management systems, and the matching of one to the other. In brief, we need to get to the point where we know what kind of insolvency risk management system has an adaptive affinity with the particular variety of capitalism practiced by this particular nation-state. Just as advanced economies divide between co-ordinated market economies, which emphasise a strong co-ordinative role for the state and usually a social welfare function, versus those that are liberal market economies, which allow principally firms to co-ordinate their activities through hierarchies and markets,[61] so we can expect that there will be considerable variation across Asia in the amount of co-ordination of risk that will be centred in the state or market respectively. As yet, however, little is written of these varieties of capitalism and even less about how they might affect insolvency systems.

Finally, just as insolvency systems are as much policy domains as technocratic constructions, so too it is a mistake to divorce the efficiency and effectiveness of an insolvency system from issues of what is equitable. Since policy approaches to insolvency regimes vary substantially across advanced countries because of differences in distributive concerns about secured and unsecured creditors, workers, tax authorities, and other stakeholders, such as single-company towns, it can be expected that even more variation will occur in Asia and other regions. Many of the implementation problems that we have observed in Asia arise from unacknowledged or veiled conflicts over equity—between workers and owners, between local creditors and foreigner investors, between national sovereignty and global hegemony, between rust-belt regions and fast-growth regions.[62] While insolvency reformers are most comfortable dealing with the technical aspects of risk management, policymakers and parties-in-practice know that every design decision carries distributive consequences. Confronting inequities and distributive consequences not only makes good policy sense, but also good practical sense, for manifestly inequitable decisions, however conceived, will undermine certainty in the market sooner or later.

Notes

1 *E.g.* IMF, World Bank, Asian Development Bank, INSOL, International Bar Association.

2 UNCITRAL (UN Commission on International Trade Law) (2004), *Legislative Guide on Insolvency Law (Final Provisional version)*. Approved by the UNCITRAL Commission, New York, June 2004.

3 World Bank, (2001), P*rinciples and Guidelines for Effective Insolvency and Creditor Rights Systems*.

4 Halliday, Terence C. and Bruce G. Carruthers (2004), *The Recursivity of Law: Global Norm-Making and National Law-Making in the Globalisation of Corporate Insolvency Regimes*, Working Paper, American Bar Foundation.

5 This paper draws on four sets of empirical research: (1) original research on insolvency reforms in China, Indonesia and Korea; and secondary research on other South and East Asian countries; (2) original research on the development of global and regional norms by international organisations (World Bank, IMF, Asian Development, UNCITRAL, International Bar Association, INSOL); (3) secondary research on Central and Eastern Europe and CIS countries; and (4) earlier research on insolvency lawmaking in the US and UK.

6 For an excellent summary of this research, see Campbell, John L. (2004), *Institutional Change and Globalisation*, Princeton, Princeton University Press.

7 Most of the models promulgated by international organisations such as the World Bank, the IMF and UNCITRAL explicitly or implicitly refer to these five as the core of an insolvency system. See, for example, IMF (1999), *Orderly and Effective Insolvency Procedures*, Legal Department, Washington DC; World Bank (April 2001), *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*; Asian Development Bank, RETA (TA No. 5795-REG).

8 It should be clear that we do not believe that all risk management emanates from the state, since a great deal of risk mitigation occurs within civil society, communities, tribes and families. Part of the problem in designing risk management regimes is to identify these alternatives and to decide how to integrate or substitute for them in a government regulated system.

9 If these agencies are housed within government ministries and staffed by career civil servants, then we locate them within the state. If they are given an independent status and are substantially staffed by private professionals who are seconded for a short period to the agency, we consider them to be at the intersection of the state and market.

10 Op.cit., note 4, UNCITRAL Legislative Guide.

11 Daniel Lev speaks of the challenge as enormous, "nothing less than re-creating an effective, responsive, accountable institutional base from the ground up." The institutional problems, he says, are compounded by religious and ethnic incipient conflicts. (Talk given to the North-South Institute, Ottawa, 19-20 June 1998). However, Lev also notes that leading Indonesians did aspire to a rule-of-law state in the 1950s and advanced some distance towards it until Sukarno took the nation in a different direction.

12 Daniel Lev maintains that a concept of rule of law did exist in Indonesia in the 1950s, which was effectively eroded in intervening decades.

13 Interview 2305.

14 Interviews 2267, 2032.

15 Halliday, Terence C. and Bruce G. Carruthers, *Conformity, Contestation and Culture in the Globalisation of Insolvency Regimes: International Institutions and Law-Making in Indonesia and China*, ABF Working Paper 2214.

16 *Cf.* Peerenboom, Randall (2002), *China's Long March toward Rule of Law*, New York, Cambridge University Press. Peerenboom argues that China is well advanced towards a "thin rule of law."

17 *Cf.* long time China specialist, Stanley Lubman wonders if China has a legal system at all, in the technical sense of that word. Lubman, Stanley (1999), *Bird in a Cage: Legal Reform in China after Mao*, Stanford, Stanford University Press.

18 Very few one-party states have managed over a long period to develop commercial courts that are relatively free of arbitrary executive intervention, the most notable being Singapore. However, the circumstances of a tiny island nation (or of Korea or Taiwan) are so radically different from China that any extrapolation is implausible on its face.

19 Central government officials in major government agencies complain about their ability to control their provincial and municipal counterparts that are often beholden to local political and commercial interests.

20 Halliday, Terence C. and Bruce Carruthers (May 2004), *Legal Certainty, Market Uncertainty, and Social Instability: The Confounding Case of Stalled Bankruptcy Law in China*, Paper read at the annual meeting of the Law and Society Association, Chicago.

21 Carruthers, Bruce G. and Terence C. Halliday (1998), *Rescuing Business: The Making of Bankruptcy Law in Britain and the United States*, Oxford, Oxford University Press, p. 374.

22 Ibid., pp. 373-377, chapters 8, 9, and 10.

23 This pattern is quite similar to the so-called "bankruptcy ring" which operated between judges and lawyers appointed as trustees in the US before the 1978 reforms.

24 *Survey of Receivers: Final Report*, Interviews 2265, 2276.

25 Roman Tomasic maintains, "it is vital that private insolvency practitioners are in a position to influence decision-making processes of the Commercial Court." Tomasic, R. (2001), *Some Challenges for Insolvency System Reform in Indonesia*, Paper presented at FAIR II, Insolvency Reform in Asia: An Assessment of the Recent Developments and Role of Judiciary, Bali, 7-8 February 2001.

26 Korea is slowly expanding the size of the legal profession by admitting a higher proportion of applicants to bar into practice. See Yoon Dae-Kyu, *The Paralysis of Legal Education in Legal Reform in Korea*, Tom Ginsburg (Ed.), New York, Routledge Curzon Press, Table 3.3, p. 41.

27 Halliday, Terence C. and Bruce G. Carruthers (1996), *The Moral Regulation of Markets: Professions, Privatisation and the English Insolvency Act 1986*, Accounting, Organisations and Society, Vol. 21, No. 4, 1996, pp. 371-413.

28 Vassiliou, Lampros (2003), *The Asian Recovery: Progress and Pitfalls*, Global Forum on Insolvency Risk Management, Washington, DC, 28-29 January 2003.

29 This view is widely shared by international financial institutions. *Cf.* the IMF Report on Indonesia (November 2000), that identifies, as the most important obstacle to corporate restructuring, the failure of the legal system "to pose a credible threat to debtors that refuse to restructure", p. 53. See also Mako, William P. (2003), *Uses and Limitations of Out-of-Court Workouts: Lessons from East Asia*, Paper read at the Global Forum on Insolvency Risk Management, World Bank, Washington DC, 29 January 2003, p. 19.

30 Iskander, Magdi, Gerald Meyerman, Dale F. Gray, and Sean Hagan (1999), *Corporate Structuring and Governance in East Asia*.

31 United States dollar (USD).

32 These included punitive tax burdens, regulations governing creditors, obligations to sell equity after debt-equity swaps, and deferral of value-added taxes on debt/asset swaps (Mako (2003): 18-19).

33 Regulations were amended in April 2000 to shift JITF from a purely voluntary to a more regulated process that gave mediators some powers to facilitate mediation on a time-bound schedule with the threat that recalcitrant debtors would be referred to the Attorney General for initiation of bankruptcy proceedings or civil suit, but this was not a credible threat since neither the Financial Sector Policy Committee nor the Attorney General were prepared to act decisively. In principle, government agencies could also revoke licenses or concessions. EKUIN Decree No. 10/2000 also permitted the Financial Sector Policy Committee to publish names of non-cooperative parties, but this threat also rang hollow. See the Letter of Intent from the Government of Indonesia and Bank Indonesia to the IMF, 17 May 2000 (Accessed at www.thejakartapost.com/special/imf_loi2.asp; last accessed 19/10/2004).

34 At the time of its closure in December 2003, the Chairman of the Jakarta Initiative reported that it had successfully restructured financially 96 companies with debts that totalled USD 20.5 billion. Companies reduced their debt by approximately 50%. (JITF Press Release, 18 December 2003). As of May 2000, about 57% of the debt was rescheduled, 28% was converted into equity and the rest was converted into convertible bonds, or otherwise dealt with as cash payments, debt buy-backs, debt/asset swaps or debt cancellation. (JITF Quarterly Report, June 2001). The success of JITF may be read as a glass half empty or a glass half full. In the latter interpretation, it might be celebrated that despite the obvious limitations in what was accomplished, it was no small achievement—in the absence of effective sanctions—to bring creditors and debtors into an unfamiliar mediation forum and restructure half the debt load of major companies. Or, in the words of one old hand at crisis management by international financial institutions, any step forward should be counted as a success (Interview 3002).

35 Interview 2251.

36 It is the case that debtors or industry groups are usually absent from the politics of insolvency lawmaking. In the United States reforms of 1978, this was less of a problem because US legal culture is already sympathetic to debtors. Some of the provisions of the US Bankruptcy Code that are most debtor friendly were intended to help small debtors. In the 1980s, in UK insolvency reforms, industry eventually did get actively involved in reforms after it became plain that they would place new obligations on directors for wrongful trading that could lead to director disqualification and personal liability for company debts. (Carruthers and Halliday, 1998, op.cit.)

37 It should be observed that exclusion occurs often because parties do not recognise their interests or are unable to mobilise effectively.

38 Presentation slides, *Law for Promotion of Corporate Restructuring*, Ministry of Finance and Economy, 9 August 2001. Oh, Soogeun, (2002), *Government Intervention in Corporate Exit Mechanisms: The Corporate Restructuring Promotion Act of Korea*, presentation to Hong Kong University Faculty of Law, 18-19 April 2002.

39 Korean won (KRW).

40 Mako op.cit., Oh, Soogeun (2003), *Setting Insolvency Rules: A Course of Understanding and Persuasion*, presentation to OECD FAIR III, Seoul Korea 10-11 November 2003.

41 Presentation slides, *Law for Promotion of Corporate Restructuring*, Ministry of Finance and Economy, 9 August 2001.

42 Oh, (2002), op.cit.

43 See Aria Suyudi's jurimetric analysis of the Commercial Court in these proceedings.

44 Korea Development Institute Conference, 13 November 2003.

45 Interview 2250.

46 A leading Indonesian reformer maintains that the strength of a legal profession relates directly to limits on court misuse and abuse. Reksodiputro, M. (2000), *Bankruptcy Reform: Lessons from the First Nine Months*, in Lindsey, op.cit., p. 50.

47 These proceedings.

48 For a social science analysis of the complexities of institutional change, see Campbell (2004), op.cit.

49 One way to solve the incipient tension between global norms and national variability is to formulate global norms as binding principles with the expectation that their application will take the form of locally adapted non-binding rules. Braithwaite, John Bradford (2002), *Rules and Principles: A Theory of Legal Certainty*, Australian Journal of Legal Philosophy, Vol. 27, pp. 47-82.

50 There is a need for independent research that establishes the degree of its success in a scientific manner.

51 In practice, it seems that the label "London Approach" is used as a rhetorical shorthand for any more or less voluntary out-of-court workout process, even if the details of the process differ radically from those that made the original Bank of England interventions distinctive. This is not unlike the idiomatic use of "Chapter Eleven" by lawmakers as a form of legitimating any reorganisation provisions in bankruptcy law, no matter how much they deviate from the actual provisions of Chapter 11 in the US Bankruptcy Code.

52 IFI officials involved in the design of the Jakarta Initiative quickly realised that a pure London Approach could not work in Indonesia, since most of an English infrastructure was missing. The JITF needed to be tailored in ways that compensated for the lack of institutional supports (Interview 3002). See also Meyerman, Gerald E. (2000), *The London Approach and Corporate Debt Restructuring in East Asia*, Paper read at a conference on Emerging Markets in the New Financial System: Managing Financial and Corporate Stress, New Jersey, 30 March –1 April 2000.

53 Moss, David A. (2002), *When All Else Fails: Government as the Ultimate Risk Manager*, Cambridge, MA, Harvard University Press.

54 These were: (a) information problems, where government solved the adverse selection problem by forcing everyone into the pool, and the moral hazard problem, by extending its investigatory and enforcement capacities; (b) perception problems, where government engaged in public information campaigns; (c) commitment problems, where government used its taxing powers to spread risk; and (d) externalisation problems, where government internalised externalities through liability measures. Moss, op.cit., chapter 2.

55 These were followed in a second phase of reforms between 1900-1960 with measures to create a secure environment for workers, through workplace safety regulation, workers' compensation, old age insurance, unemployment insurance and the like.

56 It must be emphasised that government's role as a risk manager is quite independent of whether a country has a *laissez-faire* economy or a welfare state. It is only to say that government (*e.g.* Mrs. Thatcher's Conservative Party) designs as a matter of public policy what risk will be reduced and in how risk will be allocated.

57 Garth, Bryant (2002), *Building Strong and Independent Judiciaries Through the New Law and Development: Behind the Paradox of Consensus Programmes and Perpetually Disappointing Results*, 52 DePaul Law Review, pp. 383-400.

58 Halliday, Terence C. and Bruce G. Carruthers (2004), *Epistemological Conflicts and Institutional Impediments: The Rocky Road to Corporate Bankruptcy Reforms in Korea*, Legal Reform in Korea, Tom Ginsburg (Ed.), New York, Routledge Curzon Press, pp. 114-133.

59 Occasionally, there are historical moments when a radical break seems possible and can be sustained, but these are rare. See Campbell (2004), pp.33-35.

60 Campbell, John (2004), chap. 4.

61 Hall, Peter A. and David Soskice, (2001), *An Introduction to Varieties of Capitalism*, in Peter A. Hall and David Soskice (eds.), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford, Oxford University Press, pp. 1-68.

62 Note Linnan's (2000) comments on Indonesia: "There are technical problems with Indonesian bankruptcy law, but the over-riding issue is whether Indonesian society believes that functioning bankruptcy law serves Indonesia's interests rather than solely those of foreign creditors…." Linnan, David (2000), *Bankruptcy Policy and Reform: Reconciling Efficiency and Economic Nationalism*, in Lindsey, T. (ed.), Indonesia, Bankruptcy, Law Reform and the Commercial Court, Sydney, Desert Pea Press, p. 94. See Linnan 1999:132-3 on the conflict between economic liberalism and national sovereignty. Oddly enough, after showing how bankruptcy law involves major issues of public policy, he can then conclude that "bankruptcy law is not a moral matter, but rather one of allocative efficiency," as if the latter were not a moral claim in itself.

RISK MANAGEMENT SYSTEMS: THE FRAMEWORK AND PRACTICE IN ASIA

by
Morgan Kelly*

> These days, the business of banking is risk management. Risk management tools aren't a substitute for risk management…it's important that it helps us to manage and that we don't wind up by having it managing us.
>
> ***Sir Dennis Weatherstone***
> *Retired Chairman, JP Morgan & Co.*

Introduction - Credit access: the lifeblood of the economy

Any discussion of insolvency and risk management can be very dry. 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 bank's 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 person's life, their job, their family's welfare. It represents economic growth, development and improvement of a nations economy.

Sometimes it pretends to be one of these things and, in fact, is a rich businessman's Porsche or helicopter, or funding of an extravagant lifestyle backed by non-existent collateral. 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 its usefulness or relevance has passed.

A loan is, ideally, cash advanced to a business that needs it to grow and develop. A bad loan or a non-performing loan (NPL)[1] 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 are 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

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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. One can 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 NPLs are clots in the blood of the banking network. It is our business to stop these clots from occurring and, when they do, find them and unblock them so cash gets to where it is meant to go: supporting viable and real businesses to create jobs, to grow the economy and improve the standard of living of a nation. By protecting credit access we are helping generate wealth and improving lives, making sure that every business idea has a chance for success and sustainable economic growth is realised.

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 that 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 from that of a credit recovery officer) upstream processes and procedures are inevitably less thorough and sophisticated than 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 that involves risk of some kind. Results can involve expected or unexpected levels of losses. 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 preempts losses within an expected and tolerable range, and avoids unexpected losses.
- *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

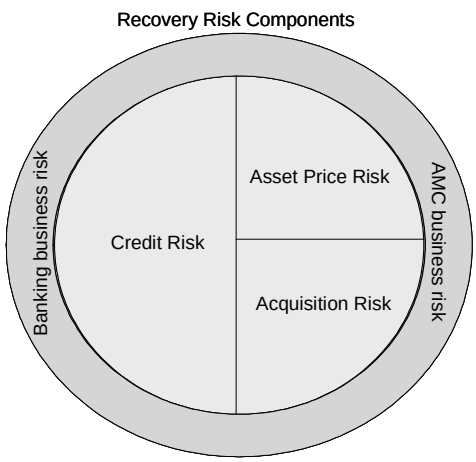
loss to the financial institution advancing the credit of principle, interest or other fee revenue with respect to the borrower's obligations to the lending financial institution. Default can be a result of fraud or insolvency. These are the risks a bank faces from normal operations and trading.

- *Asset price risk* refers to the risk that the prices of traded credit exposures (purchased NPLs), 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 (AMCs).

Everything to lose: Different risks are faced by banks and AMCs

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, the different risks overlap: some banks operate like AMCs, and some AMCs 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 resale.

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 has already 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 recognised in relation to credit differs. For a bank, there is everything to lose, while an AMC can choose how it will calculate its 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 AMCs 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 problems,[2] 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 specialised skills that improve returns from recovery and/or rehabilitation. Concentrating and focusing these skill sets and experience within a specialised team in a bank greatly enhances recoveries to financial institutions. An LMU is a division within a bank that exists only to deal with NPLs for that bank. It is not an independent agency and, in the first instance, deals solely with the NPLs for the bank it is a part of (although in some cases LMUs do purchase new NPLs from other institutions).

Need for improved risk management practices in Asia: General trends and traditional risk factors

Some Asia-specific developments

Oil prices edging towards USD[3] 50 per 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.[4] 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 USD 10 prolonged spike would reduce Asian GDP by 0.8%. 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; last year oil demand rose by 24.6% to 6.48 million barrels per day.[5]

The EIU country risk rating report for Asia,[6] 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, and 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 programmes have been initiated by many banks in the region, focussed on know your client (KYC) policies, and several banks have already suffered penalties through correspondent bank relationships under the USA PATRIOT Act[7].

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 needs a new engine. Private consumption is a likely candidate yet it is possible that consumption will not pick up sharply in 2005 thus slowing overall GDP growth.[8]

Insolvency risk management factors in Asia

To try to capture the risk factors as they face insolvency and business risk is a large task. Furthermore, it is almost impossible to summarise them definitively. The profiles and nature of countries across Asia are too diverse and the challenges in each are wildly different. However, the following key areas are important broad factors facing Asian 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

High levels of fraud and corruption

The impact of fraud and corruption on insolvency and workout procedures is well known. The Transparency International Corruption Perceptions Index[9] charts levels of corruption in 133 countries as seen by business people, academics and risk analysts, and ranks them 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, China	14	8.0
Japan	21	7.0
Chinese Taipei	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 NPLs 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

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 is presently considering for the first time the systematic declaration of all assets and liabilities of high court judges. Although a small step on its own, it can, in conjunction with other steps, move to fight corruption. Fraud and corruption remain a crucial area to deal with in creating an environment where an effective insolvency and workout regime can develop.

Weak insolvency frameworks and recovery regimes

Although not the subject of this paper, effective laws and regulations, courts, judges and legal frameworks are critical components of a working insolvency regime. 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, in Thailand, for example, this is partially due to the relatively recent introduction of insolvency laws which business practice has not yet accepted.

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:

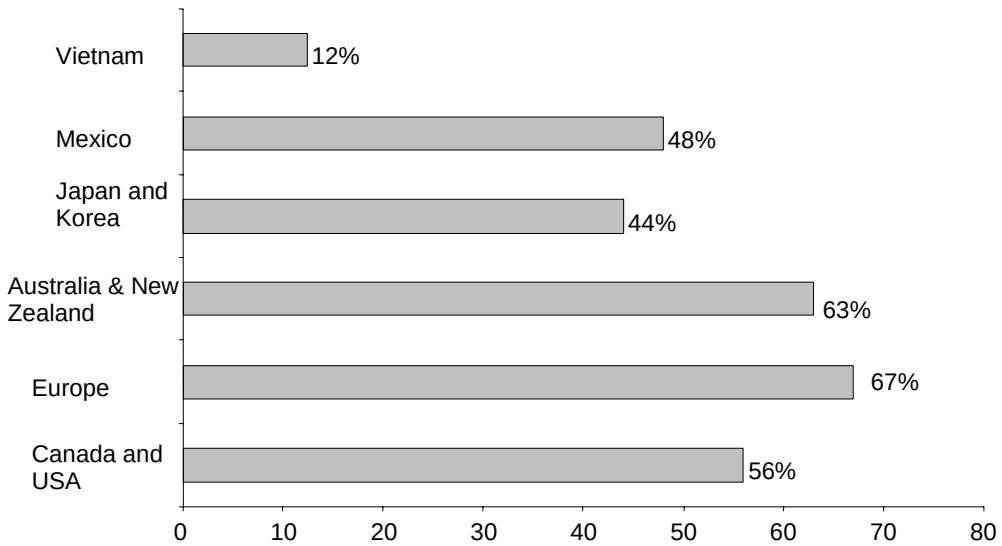
- Not normal business practice
- Personal physical risk
- Perception that legal rights are ineffective
- Risk of personal liability for losses for some state bank employees

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

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:

Fee to interest income ratio: comparative



Source: Profitability and Competition in Banking Markets: An aggregate Cross Country Approach, Horst Gischer and D. Johanes 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 as a key indicator of profitability and competitiveness in the international banking market.[10] A well-developed non-credit services market indicates diversification of income for banks. 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, thus 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. These overlap into credit access and customer service generally: less people are using the banking system and do not know what services are available or potentially available. This is often the case in countries that have traditional cash economies. Development of services such as:

- Deposit services;
- ATMs;
- Trade finance;
- Drafts and remittances;
- Cheques; and
- 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*.

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 lent

Low participation in the banking sector also increases the seriousness of the risk of a run on the banks, as cash economies are generally 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.

The evolution of the LMU and the AMC: Importance of workout procedures for risk management and resolution of distressed assets

A good way to illustrate the importance of workout and workout skills within a loans management unit (LMU) or an AMC is to discuss the relative merits of selling NPLs 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. Modern risk management is:

- 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 versus targets and benchmarks;
- High integrity; and
- Rigorous, systematic processes to accomplish objectives.

Workout versus 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 proactive and regular review risk assessment and risk grading system. An AMCs experience with NPLs is thorough and extensive. AMC staff have significant experience in dealing with NPLs and an AMC's database or experience skill set contains substantial data that 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 AMCs "data" into "information" helps AMCs create a vastly more accurate risk-rating system and assists in more accurately quantifying recovery risk or, alternatively, 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, asset-by-asset targets and benchmarks to measure risk and to judge accomplishments/performance.

Important considerations in this area are the concepts of "cost of capital", "funding drag" and ongoing funding costs, or holding costs. They need to be factored into 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 reduces volatility as a bank or AMC moves to a new "recovery" stage of activity. It allows for:

- More effective bidding for acquisitions;
- More effective realisation of NPL values; and
- 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 NPLs:

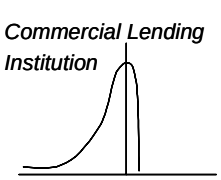
- Rapid resolution by sale of NPLs; and
- Internal workout and restructuring.

As AMCs 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:

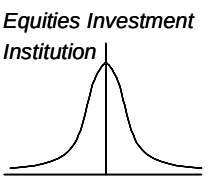
	Sale and outsource approach	Internal management and workout approach
Description of approach:	This involves the strategic "quick fix" approach involving the sale and packaging of NPLs to external parties. Usually this includes packaging loans into tranches grouped with like characteristics to make the 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:	Sales skills, asset due diligence and packaging for targeted bidders are the key skills 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 cash flow analysis. This is because decisions need to be made quickly regarding loan classification. They need to be correct so that 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?	•Speed of recovery and asset turnover •Quantum of return versus OPB or acquisition cost •Holding costs incurred •Discounts or prices achieved •Distribution of recoveries (returns to originating banks)	•Speed of recovery and asset turnover •Levels of returns on NPV basis versus acquisition cost •Opportunity costs or funding drag (over time) and operating costs •Proportion of negotiated workouts versus litigated ones

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

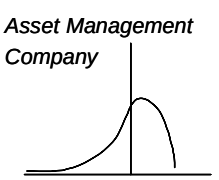
Chart 1. Commercial banks, investment institutions and AMCs compared



Returns for a commercial lending institution are skewed. The reason why they are skewed is because although a commercial lending institution can make losses, through bad lending decisions or failure of a debtor, the profits that a lending institution can realise are no more than interest charged and any associated fees. The most that can be realised is recovery of principal, and interest charged at a commercial rate.



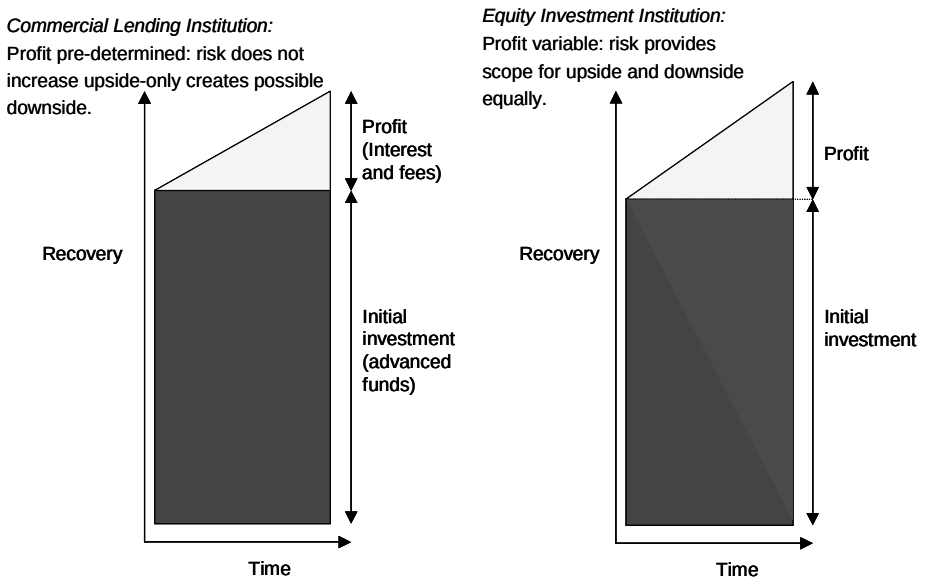
Returns realised by an equity investment company are (almost) normally distributed (in a perfect market for this heavily simplified analysis). This is because the equity investor, given a random selection of equities or an inherited portfolio, has an equal chance of realising profits as incurring losses, and influences such as market forces impact on the performance of the portfolio as well as individual company performance.



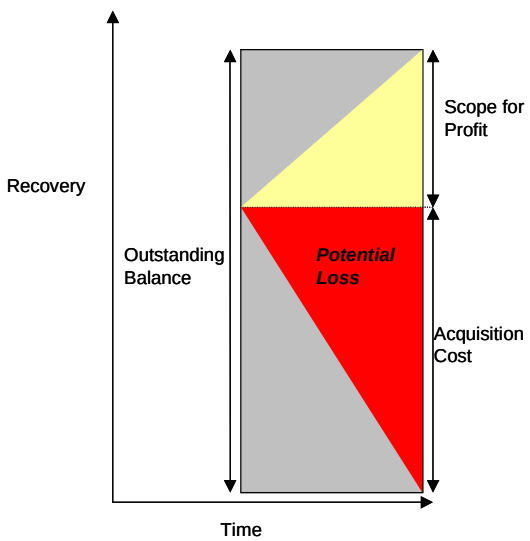
Returns for an AMC are also skewed, but are a combination of a lending institution and an equity investor. As an AMC acquires assets at (usually) less than the outstanding principal, an AMC has the scope to recover the excess outstanding principal, as well as accrued and new interest. The "cap" or limit lending institutions are subjected to does not strictly apply. Although losses occur for the same reasons as banks, there is a larger profit scope for an AMC for certain assets.

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

Simplified comparison of commercial lending versus equity investment institution



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 and to ensure that, wherever possible, this upside is realised.

Where NPLs are sold 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 on 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 that the profits that can be realised (NPLs with high potential for recovery and workout) are given every opportunity to perform, and that focussed efforts are made to restore the debtor to financial health and viability as quickly as possible. Realised profits must exceed losses.

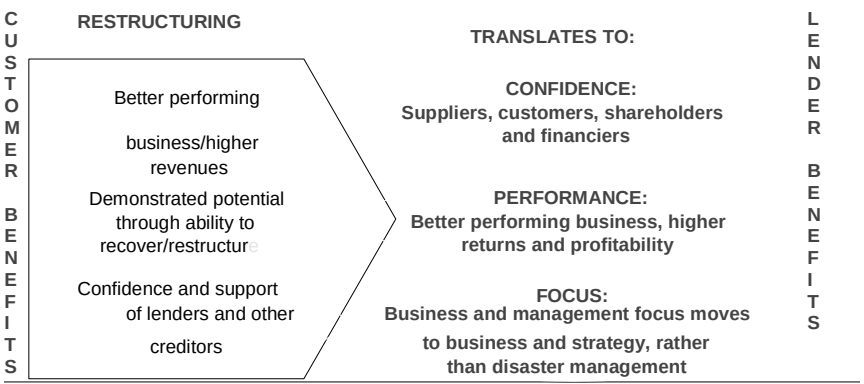
	Stage One **Asset Acquisition and Disposition**	***Stage Two*** **Managing Ongoing Assets**
Principal activities	Pricing acquisitions. Packaging assets attractively for auction or negotiated sale. Legal actions to realise available collateral.	Working with distressed companies to improve operations and 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 realised. Debtor company management resistant to change or other creditors prevent action.
Risk measurements and accounting	Asset turnover; realised prices versus book values. Assets often not held for very long so auction experience probably more important than a detailed fair valuation analysis.	Realisation 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.

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, or restore viable businesses to performing status or to recognise losses when and where they have occurred.

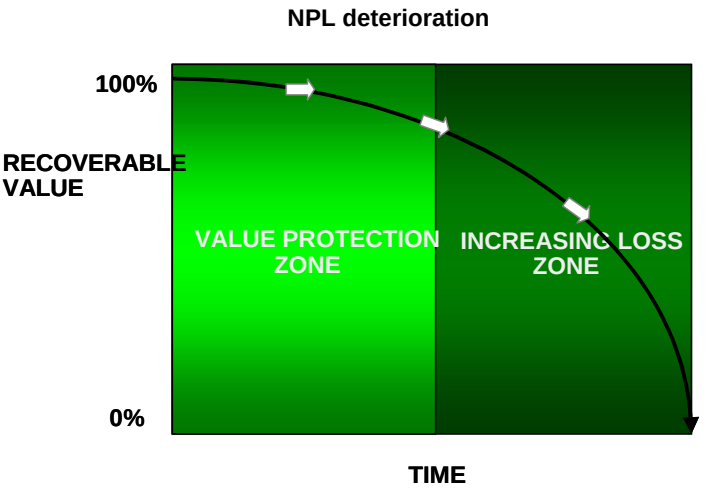
The benefits of restructuring and workout are equally beneficial to a an LMU or financial institution based AMC as they are to a government agency or central AMC:



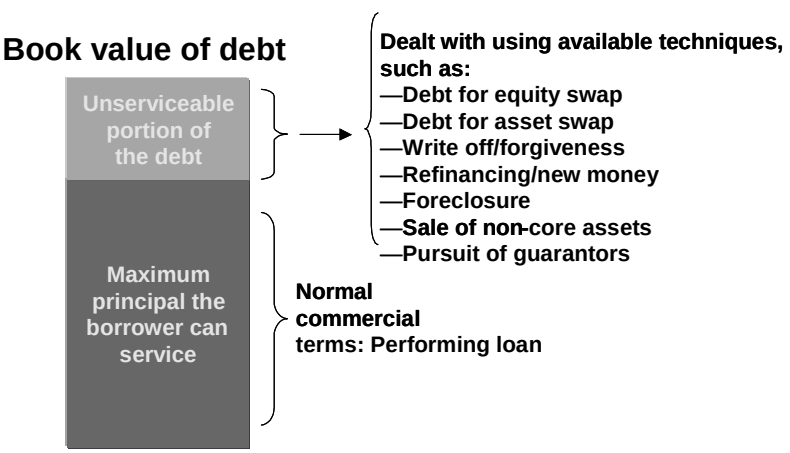
When acting as an "incubator" an LMU or AMC needs to take ownership of their NPLs and to be proactive in the NPL management process. AMCs and LMUs need to educate debtors to work with them in achieving essentially the same goal: improvement of the cash flows of the assets and businesses underlying NPLs.

The most important advantage to workout over restructuring 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 workout improves dramatically. Unfortunately, workout is not always a viable option 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 that the remaining debt can be dealt with and the loan returned to performing status as a genuine performing loan.



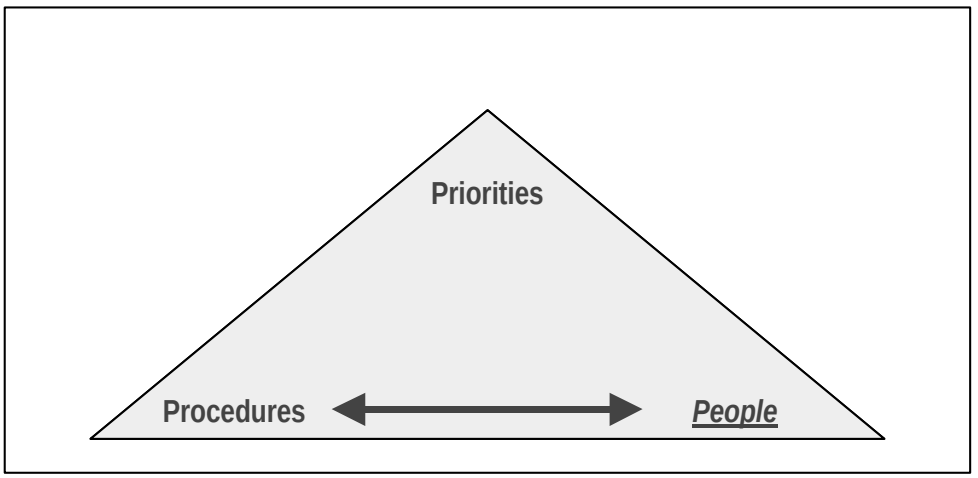
AMC culture is changing, and needs to continue evolving. AMCs need to take a more holistic and hands on approach to solving NPL problems. How these are captured in practice is considered in the next section.

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.

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Drivers of effective performance



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 is that acquisition costs will not be recovered from the sales proceeds realised.

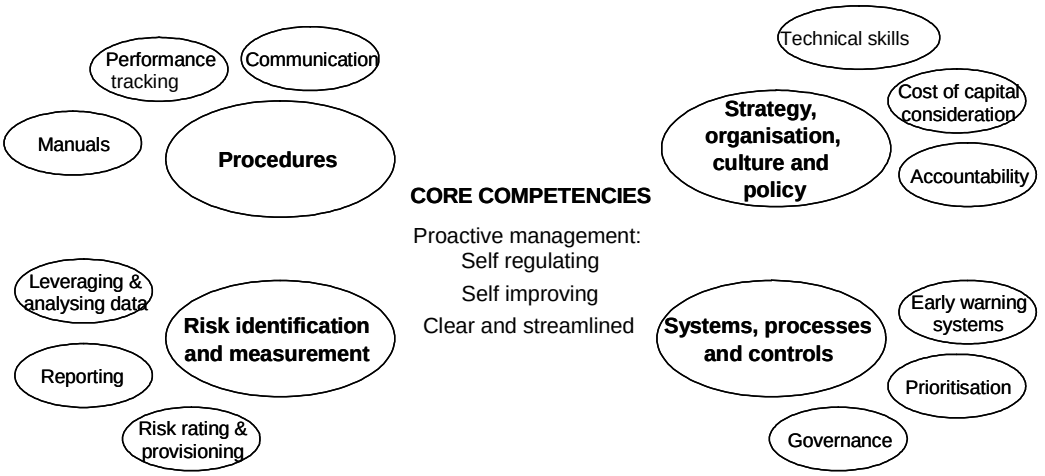
Where a bank or AMC moves to Stage Two Competency, credit risk becomes increasingly important. NPLs will be retained for longer periods and recoveries will be spread over time, linked to the reorganisation and restructuring skills that are applied to particular loans. Rather than considering the liquidation 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.

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 directives for formulating procedures.



Proactive management

The concept of proactive management is critical for managing NPLs. 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 NPLs carry recovery risk. We also mentioned that circumstances are always changing. For this reason, management of the portfolio must be proactive 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 attempt 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); and
- Regulatory issues (taxation issues, tariffs and other protection mechanisms).

Frequent, aggressive and proactive 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 NPLs of specific categories, variances are almost certain to arise due to unforeseen vagaries in the analysis and factors not yet attributed risk status. As analysis of newly gathered data proceeds, the system generates "lessons learned" analyses that allow recovery risk quantification and accuracy to be progressively refined and 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 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, which is managing and restructuring distressed loans.

Strategy, organisation, culture and policy

Technical skills

In order to be able to carry out their tasks effectively, account officers must have sufficient technical skills to recover loans effectively. Skills, knowledge, practical experience and overall competency for each account officer must coincide with the level of complexity or difficulty of the various NPLs being managed within that account officer's portfolio. "Matching" of skills to tasks 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. In addition to on the job training, specifically focussed training and staff education is needed to bring technical skills into Stage Two.

Finally, there is a large number of specific skill sets of which an account officer cannot have more than a basic knowledge. 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 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, one must either retain appropriately skilled lawyers as part of its own staff or outsource these requirements; and
- 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 to 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 such as, for example:

- Encouragement of staff in continually identifying profit-making opportunities; and
- 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 such as, 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; and
- Formalising an intra-departmental communication channel for support and assistance.

Procedures

Procedures refer to the overall approach and philosophy utilised in conducting day-to-day business. The approach or philosophy must incorporate 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 proactively, for example:

- Establishing formalised regular performance measurement reports (against benchmarks and targets rather than acquisition cost);
- Formalising follow up and reassessment procedures for NPLs failing to meet targets;
- Development of a risk rating systems; and
- 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 a critical part. ***Manuals***

Process manuals are a critical component of the overall recovery risk management framework. However, it is extremely important to remember that these are not stand-alone tools. As with 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 built. 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) is, it is simply a part of the entire recovery risk management system and 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 NPLs or industry trends.

As information gathered over time grows in volume, the progression or evolution of raw data to useful and valuable information becomes increasingly an effective and meaningful recovery risk management tool both from 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, make best use of the available data historically, and also update it as new data 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; 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 versus 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 LMUs 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
- Cash flow forecasting and business planning.

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 memoranda at each step of the process.

The key features of this system that 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 others. 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 NPLs that are not worth restructuring, either due to financial non-viability or lack of co-operation, are ejected from the process or 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 workflow 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 NPLs:* 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 NPLs are enhanced.

Development of the secondary debt markets in Asia and their importance for insolvency risk management

Bulk sales of NPLs have been effectively used in a number of jurisdictions throughout Asia, and AMCs have traditionally played key co-ordinating roles. Debt trading has become a thriving business in Asia, and financial institutions seeking to remove NPLs 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 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.

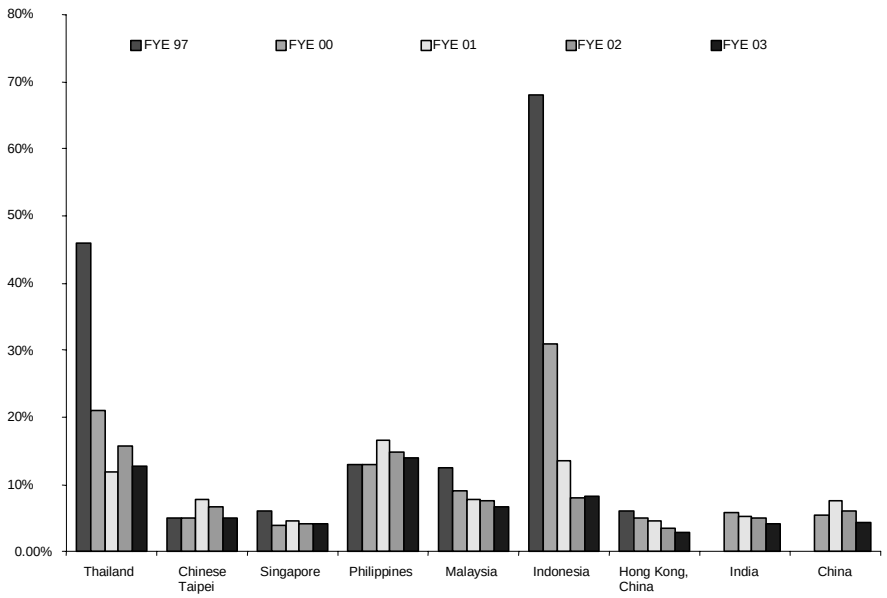
When, as a result of the crisis, borrowers began to cease repaying their loans on time, banks were slow to react forcefully, not wanting to endanger relationships with key clients. The use of bulk NPL sales is to a degree a reaction to this. Drastic steps need to be taken to address a large and entrenched problem.The NPL situation in Asia is gradually improving. 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.

Although improvements are generally 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 NPLs still exist even though the reported ratios are improving. 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.

Asian NPL ratio trends



Source: various central banks

Secondary debt markets and insolvency risk management

It is important to note that in the absence of a viable insolvency legal framework, the use of the secondary debt market is often the only alternative available to banks in dealing with NPLs. Secondary debt markets can act as a catalyst for workout 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 workout. 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.

NPLs reduce bank profitability as well as available reserves, and create "funding drag", a combination of opportunity cost and real cost. Elimination or transfer of NPLs from the books removes this funding drag. By eliminating, selling or transferring NPLs away from a bank, the NPLs are converted to cash, eliminating the funding drag. This is a quick fix substitute for conducting a workout 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, *i.e.* the cost of raising funds from capital and deposits. Since NPLs generate little or no revenue, 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.

AMC structures are popular because they:

- 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 allow 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 workout or sale, and concentrate skills;
- Allow for many NPLs to be combined and dealt with simultaneously (tranche sales); and
- Convert NPLs from "blockages" to cash.

Dangers and benefits associated with conducting NPL sales through the secondary market

The benefits of conducting bulk sales of NPLs 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 an adverse marketplace 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 AMCs have special powers;
- Potential for securitisation of asset pools;
- Centralised ownership of collateral: enhances enforcement and 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 NPLs 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 delays;
- AMCs 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; andLoans, 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 impacted by flooding the market with underpriced non-performing assets attached to NPLs. Care must be taken when determining a strategy for NPL disposal to address this.

Another obvious risk 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.

Banks always think the NPL is worth more and are usually suspicious of a 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 is usually under pressure to resolve the NPL and eliminate the funding drag. In the absence of downstream insolvency processes and procedures or work out skills, the lender has no other option.

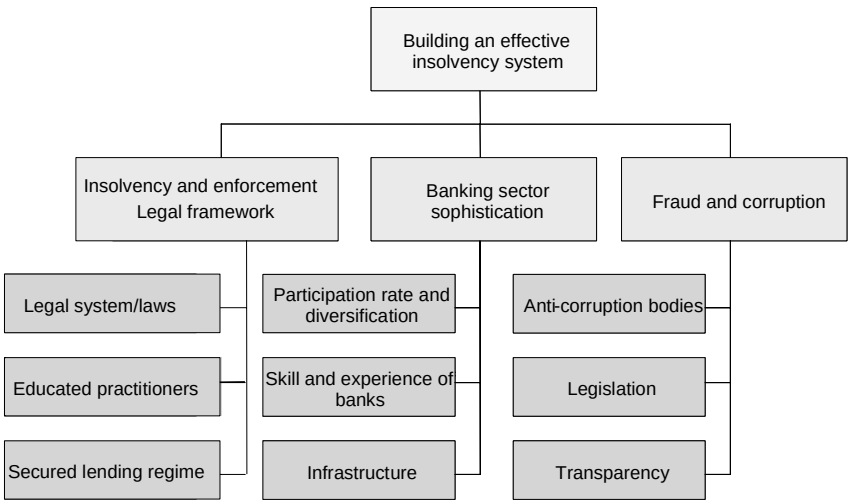
Some conclusions

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

The effective procedures for proper insolvency risk management and resolution section of this chapter 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? Getting answers to these questions is a very useful exercise and, in an organised framework, assists banks to focus and prioritise their efforts.

Section of this chapter detailing the need for improvements in risk management practices in Asia: trends and traditional risk factors, 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 in order 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 NPLs 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 workout is present. For a private institution, accountability to investors and shareholders is often sufficient to ensure high levels of commitment to maximising returns through workout. 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 AMCs; in this environment, the potential profits from workout will not be lost.

Notes

1 Some commonly used acronyms in this paper are: NPL (Non-performing loan); AMC (Asset management company); CMU (Credit management unit); and LMU (Loans management unit).

2 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 NPLs 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.

3 United States dollar (USD).

4 Switzer, Peter, (October 2004), *Over a Barrel*, Charter Magazine, vol. 75 No.9.

5 *Ibid*.

6 Economist Intelligence Unit Country Risk Service: Risk Ratings Review, July 2004.

7 Acronym for: Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001.

8 Economist Intelligence Unit Country Risk Service: Risk Ratings Review, July 2004.

9 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.

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

RISK MANAGEMENT PRACTICES IN ASIA AND THEIR INTERFACE WITH INSOLVENCY SYSTEMS

by
Philip D. Sherman*

We all know that the purpose of credit risk management is to ensure that financial institutions extend and monitor credits to borrowers who are, within predefined risk parameters, prepared to and predictably likely to be able to pay them back. In this sense, the intent of a bank's risk management processes–and here we refer both to the management of credit and operational risk–is to avoid having an unacceptable number of credits that go into insolvency, workout, restructuring, etc. and then to minimise the actual losses. One of the key outcomes of this conference will be to gather insights from the insolvency process that shed light onto the risk processes that failed to control the credits that did go into insolvency--a sort of "forensic pathology."

Banks in Southeast Asia have made relatively little progress in the area on which this paper focuses, namely, managing the so-called loss given default (LGD) as part of their overall approach to credit. Thus, this paper will be a call for action rather than an extensive report on accomplishments to date.

Despite this call for the insolvency community to help banks reduce their bad loans by improving their processes, there will still be plenty of work left for insolvency specialists. Indeed, better insolvency regimes will support larger loan volumes, which are ultimately good for everybody because there will always be some workouts and insolvencies.

The credit process

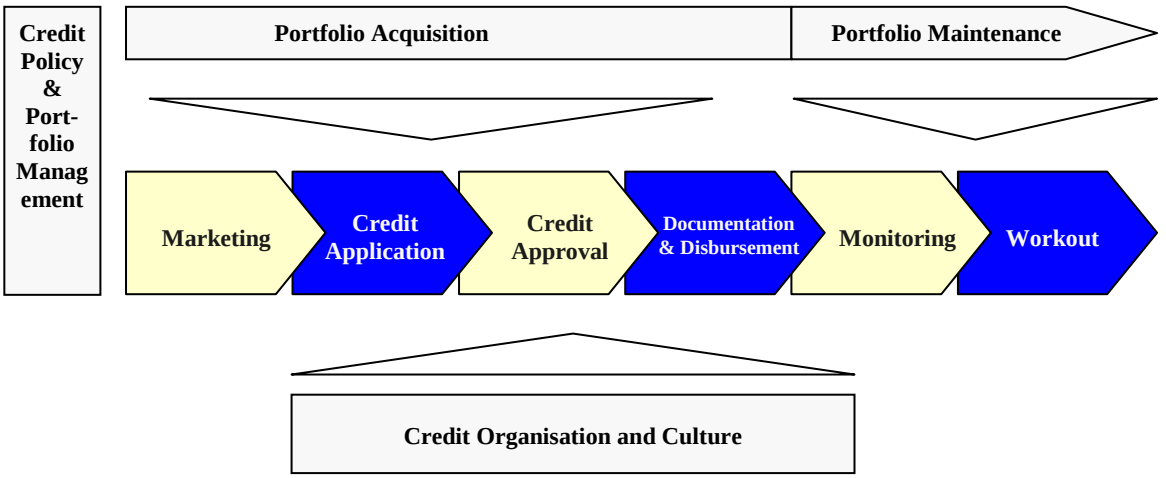
The credit process summarised in the figure below (taken from a Southeast Asian Bank but conforming to general practice) is the drill by which banks determine which clients they: deal with; develop; analyse; approve the risks of; and then administer and monitor the credits through to repayment (or, if necessary, special collection methods and special asset management).

The New Basel Capital Accord as a credit process standard

The generalised performance standard for this process is that set out in the new Basel Capital Accord, issued by the Basel Committee on Bank Supervision.[1] The new accord is called Basel II and takes a much broader approach to setting capital requirements than Basel I. Asian banks are, directly or indirectly, adopting the basic concepts of the Basel Accord. In addition, it is a good proxy for a regulatory and institutional framework, and a good practical set of standards for the credit process globally.

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Illustration of the credit process



The Basel Accord has three pillars for the calculation of capital adequacy, supervision and risk disclosure by banks. The methodology for calculating capital to support credit risk in Pillar I has a pervasive influence over how we look at the credit process shown in the schematic above. There are two basic methods for calculating capital under Pillar I: the standardised method, which is prescribed by the regulators; and the internal ratings based methodology (IRB) where banks do their own calculations under regulatory examination. In Pillar II there is a paper entitled Principles for the Management of Credit Risk (1999), which lays out 17 process standards (including Principle 16 which is of particular pertinence to us and states that banks must have a system in place for managing problem credits and various other workout situations).

Credit processes and the Basel Accord can consume many days of discussion so this paper will focus on one particular aspect of the process, the management of LGDs (loss given defaults). LGDs are part of the capital requirements equation employed in Pillar I and the subject of Principle 16 of the Pillar II Credit Risk paper cited above. A second Pillar I equation term, exposure at default (EAD), will be addressed briefly.

If one had to summarise the Basel requirements (which are generic best practice banking requirements written in regulators' language) it would be that banks must:

- Have an organised, systematic, professional and imaginative process for the management of their credit business from beginning to end.
- Measure their risk in as precise, and quantitative a manner possible. This is facilitated by a good general credit risk management process and, in turn, impacts on that process by defining the risks (and therefore the process requirements for managing the credits) as well as setting capital levels.

Basel determines capital requirements through a process of "risk weighting" of assets. A "risk weight" is a percentage of the asset that must be added into a total of "risk-weighted assets" which determines the total amount of capital needed. This is, roughly speaking, 8% of the risk-weighted total. An AAA credit such as General Electric would get a low risk weight (say 20%) whereas a very risky company might get a higher one (say 150%) reflecting its higher risk. Capital (and therefore required income to earn a given return on capital) costs less for good risks than difficult ones. The following table showing the Basel Accord I standardised method illustrates this point.

CREDIT RISK AND CREDIT ACCESS IN ASIA – ISBN-92-64-03597-4 © OECD 2006

Capital requirements of two different banks

		Bank A		Bank B	
Asset Category	Weight	Nominal Assets	Weighted Assets	Nominal Assets	Weighted Assets
Government Securities (OECD)	0%	100	0	300	0
Bank Placements	20%	300	60	100	20
Residential Mortgages	50%	200	100	400	200
Commercial Loans	100%	400	400	200	200
Total	--	1000	560	1000	420
Capital Requirement			**45**		**34**

Note: Note that two banks with the same total assets have different capital requirements.

The "credit equation"

The underlying way of determining risk weight (which is used in effect for the standardised method and must obviously be used for the IRB) is embodied in the following generic equation.

Expected Loss (EL) = Probability of Default (PD) X Exposure at Default (EAD) X Loss Given Default (LGD)

with correction factors for tenor and portfolio effects

Banks implementing IRB use this equation. Banks not implementing IRB but wanting to improve their risk evaluation process will use it anyway, at least for some time, even though their capital may be determined by the standardised method.

The following example shows the basic terms of the equation in practice. There are far more complications which will be addressed later.

Example of expected loss calculation

Term Loan: USD 5 million to BBB rated company, five year term, unsecured, no amortization

Principal	X	PoD X	EAD	X	LGD =	**EL**
USD 5 million	X	**[**1.8% X	100%	X	50%**] =**	**USD 45 000**

S & P 5 years cumulative Default Rate

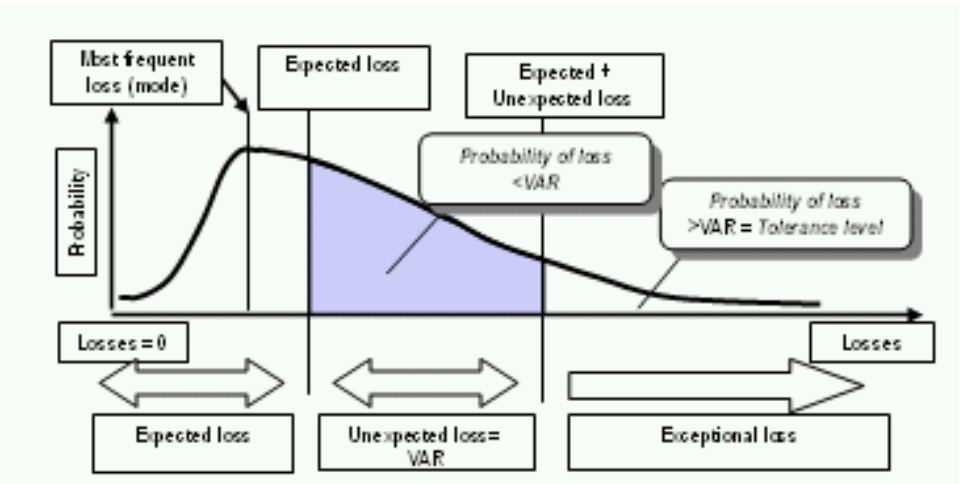
USD 5 MM – Term Loan Always Drawn

Bank's Estimate

The purpose of the equation is to derive an expected loss (EL) that would be expected of this credit "on average" (given the coefficients of the three terms of the equation plus the further correcting factors). If the bank were to earn a spread of say 1% per annum over five years, its income of USD[2] 250 000 would comfortably exceed the expected loss although it would probably not earn an adequate return on capital.

The amount of capital required under Basel to support this loan is a multiple of expected loss, *e.g.* 12.5 times the proper Basel number. The conceptual mathematics behind this capital requirement are illustrated by the following graphic:

Conceptual mathematics behind capital requirement calculation



Although the expected loss is the long run average, the actual amount of loss and the occurrence of loss do not occur "on average" and therefore can fluctuate from very high to very low. This is measured by the skewed loss distribution shown in the chart. Bank capital is that amount needed to ensure that (at a given confidence level) it will equal or exceed the possible loss level and ensure that the bank can continue to function. Usually, the confidence levels (the degree of certainty that a given level of loss will not be exceeded) are very high: 99.5 % for BBB on a one-year time horizon and 99.8% for AA–.

Parenthetically, one should note that the use of expected loss at the account or asset level is a great simplification. In fact, each single number is the mean of a distribution by itself and there is no guarantee that these distributions are "normal," *i.e.* the chances of higher or lower than the mean are equal and shaped the same way on each side of the mean. Moreover, there is a lack of evidence to support the assumption that the three terms are independent of each other. Without these simplifications, the calculation of portfolio capital would be more or less impossible in a bank of any size. The point is that the capital numbers may be more precise in appearance than in reality and that banks should err on the side of overcapitalisation.

Importance of LGD and EAD in the credit equation and the credit process

The key concept of the credit equation is that the coefficients for LGD and EAD are much higher than those for the probability of default and have a larger influence on EL and therefore overall possible loss (or unexpected loss [UL]). In commercial lending, it is unlikely that professionally managed banks will make loans with double digit probabilities of default, or even probabilities much above mid-single digits. However, once those loans are agreed, the chance that there will be high outstandings at default

seems very strong; experience with LGD is well into double digits. Moreover, even where banks focus properly on relatively low PD situations, it is well known that even the best credit evaluations can go wrong. If so, then the bank faces the high coefficient risks of EAD and LGD.

In this context, it is somewhat ironic that the principal focus of academic and industry research on the credit equation has been on the probability of default. Approaches to PD include:

- Traditional qualitative processes, which use financial and other quantitative data and are represented by the credit agency ratings.
- Mathematical processes using statistical analysis of borrower financial and other data including macroeconomic data.
- Approaches under the so-called Merton model, which use market prices of borrower equity to value the borrower's assets and compare the value to the fixed value of borrower debts.

The reasons for focusing on EAD and LGD would appear to be simple:

- *EAD*: You only lose what you have outstanding. Early action to correct a credit failure is almost always better for the bank, if not the borrower. Thus, monitoring of clients (the management of EAD) is crucial to bank success. Economic and business conditions and client situations evolve and banks that do not follow them carefully lose. One large international bank in the region recently commented that it felt that fully 70% of its losses in the financial crisis were due to poor monitoring rather than to the client or the value of the underlying collateral.
- *LGD:* You only lose what you lose. Structuring credits with a view to avoiding problems at the far end, taking and monitoring collateral and other "alternatives ways out" of the credit and, finally, a strong restructuring and insolvency process all seem obvious.

For reference, the following schematic relates the credit equation to the terms used above to describe the generic credit process:

Process Element	**Credit Equation Term**
Credit Policy	Uses all
Marketing	Based on policy
Credit Application	PD
Credit Approval	PD
Documentation & Disbursement	LGD
Monitoring	EAD, PD
Workout	LGD

Implementation of the credit equation and process

What follows is an outline of the way the Basel Committee translates its requirements into capital requirements and the ways in which banks are taking the Basel conceptual framework for expected loss into their credit processes. Basel translates this risk weighting concept into two basic methods for capital requirements:

- *Under the Standardised Method*, Basel prescribes risk weightings for given levels of agency credit ratings and has a 100% weight for non-rated names (which are most Asian borrowers). The Basel risk weights for rated entities are as follows:

Rating	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Risk Weight	20%	50%	100%	150%	100%
Pillar I Capital	1.6%	4%	8%	12%	8%

There are other weighting schemes for governments, multilateral banks, commercial banks and others. Since most Asian banks lend mainly to unrated companies, the standardised method will not be much different from Basel I in terms of results.

- *Under the Internal Ratings Based (IRB) method*, banks use their own framework within Basel conditions. The foundation IRB allows banks to use their own PDs but with LGDs set by the regulator, whereas the advanced IRB leaves it to the banks to determine LGD too. Basel has a complex algorithm for converting the PDs and LGDs into risk weights. The Basel calculation has been altered over time, but a reasonable comparison with the standardised method follows.

Rating	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Standard Capital	1.6%	4%	8%	12%	8%
IRB Capital*	1-2%	2-4%	4-11%	11-30%	NA

*Based on LGD assumptions

As illustrated, the big western banks with investment grade portfolios will have a much easier time on capital than Asian banks under either system since, on international standards, Asian lenders focus mainly on lower rated borrowers

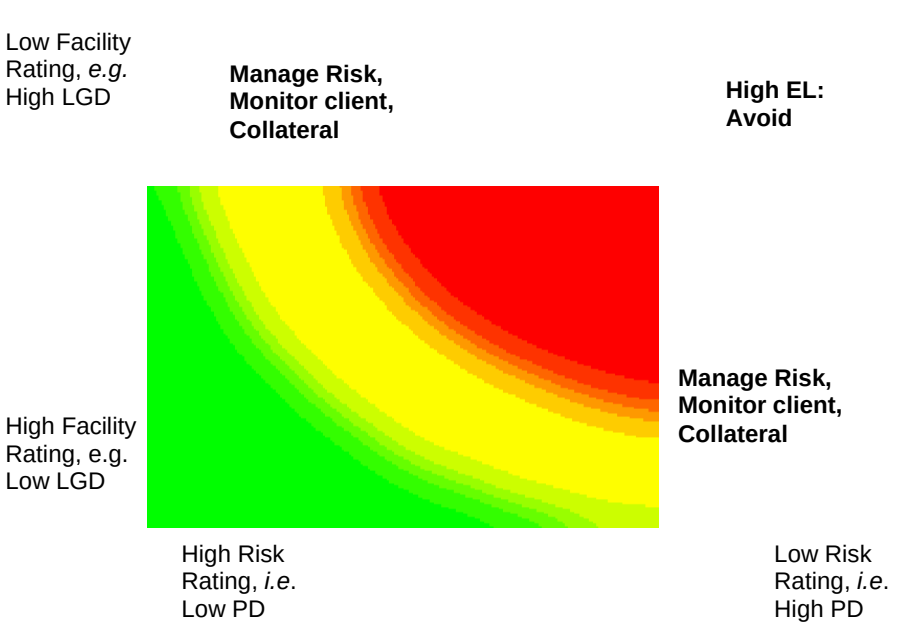
At the cutting edge, some banks are calculating expected losses for each of their credits or, in some cases, portfolios and then using portfolio management technology to create a view on expected and unexpected loss for the credit book. Based on the unexpected loss and the credit rating they wish to achieve, they then allocate capital to individual clients, businesses and products, and gauge whether those clients/businesses/products are earning an adequate return. This is called risk-adjusted performance management (Rap-M) and the principal metric is risk-adjusted return on capital (RAROC). In most cases in Southeast Asia, banks have simplified the operation of the system using risk ratings and, in a few cases, facility rating rather than full expected loss.

Risk ratings are a kind of shorthand, similar but not identical to agency credit ratings. They usually involve a series of numerical grades (perhaps ten, including three grades for non-performing loans (NPLs) and losses). Clients are assigned grades and the calculation of EL, UL and capital uses the probabilities that are associated with such grades. The system is somewhat less precise than calculating actual PDs for expected losses but, on the other hand, probably reflects a reasonable approach. Risk ratings are akin to agency credit ratings but they normally represent the PD for the one-year horizon of Basel rather than the "over the cycle" approach of the rating agencies. Many banks calibrate their risk ratings with agency ratings.

Facility ratings build on risk ratings as a shorthand way to incorporate information about EAD and LGD into the system and generate a rough expected loss. Normally, a facility rating is determined by modifying the obligor risk rating to a higher or lower level based on facts specific to the facility. For example, a letter of credit line, which is secured by goods in transit, would normally get a better facility rating than the obligor's risk rating because the bank would be able to sell the goods as long as it retains the title documents. This might be further calibrated to take into account the kind of goods being financed. In contrast, a medium-term loan would be considered more risky–remember, the PD is normally with a one-year horizon–and get a lower rating. The presence of collateral of all kinds would be covered by a wide variety of decision rules, as would guarantees, undertakings and the like. EAD can come in depending on the type of facility. Banks solve the problem, in many cases, by assuming 100% outstandings. Facility ratings can be used to translate into a sort of expected loss although, since they actually mix individual components, there are differences between the results of a facility rating and a proper expected loss calculation beyond the approximate character of the facility ratings.

Risk and facility ratings can be combined into a "heat chart" to illustrate where management should set its priorities, which kinds of loans to emphasise and the like. There is a third dimension here: size, which also figures into both risk and profitability.

Heat chart



These concepts govern not only the actual risk evaluation but also all kinds of management processes, audit frequency, return and other management issues. Although the move to a more precise measurement of risk through the expected loss and actual implementation of the equation rather than the use of proxies means that measures may become more exact, the principles are exactly the same. It is important to stress that either a risk or facility rating system is vastly superior to what went before, which was fundamentally a "yes or no" approach that did not disaggregate the risks into their generic components.

Basel requirements for LGD and EAD

The Basel requirements for LGD vary depending on the standardised or internal ratings based methodology.

Collateral is one element in the picture and there are some common requirements, including legal certainty, a robust risk management process which keeps a focus on changing valuations, lack of correlation with the borrower's own credit standing (*e.g.* shares of a borrower are not collateral), haircuts on marketable securities and a lot of technical detail.[3]

The standardised method relies on prescribed risk weights and a prescribed LGD from the central bank. There is minimal allowance for collateral as an offset: it really has to be cash or marketable securities that are independent in value from the obligor.

In the IRB approach, the regulator prescribes LGD for the foundation level but the bank works it out itself. In the foundation level, senior claims on corporates get a 50% LGD and subordinated unsecured claims 75% LGD. Financial collateral will reduce these levels per the standardised approach. Genuine commercial and residential real estate (*i.e.* not projects covered by serrate rules) can be used under specified circumstances to reduce LGD (although only to 40% and in some circumstances of low collateral levels, not at all). Specific requirements for property collateral under foundation IRB include strict definitions of the actual collateral and:

- Legal enforceability;
- Objective market value;
- Frequent revaluation;
- First claim;
- Clear credit policy for collateral;
- Appropriate liquidation analysis in credit approvals;
- Distinct operational unit to manage collateral;
- Adequate insurance;
- Property monitoring, *e.g.* to ensure taxes paid; and
- Environmental liability risk management.

In order to manage LGD, banks need to view collateral as a portfolio and manage it by type, location and other critical factors just as they would loans.

In the advanced IRB method, the same basic rules apply but the banks model the experience that supports their LGD estimates. Basel sets some granularity and differentiation requirements for grading LGD, taking account of many factors including:

- Estimates have to be used in the management process for pricing, management reporting, capital adequacy assessment, reserving, profitability analysis and credit risk. The bank must have a track record in using the data for at least three years.
- Assessment of principal drivers of LGD supported by analysis
- Adequate time frame
- Historical experience/empirical evidence
- Adequate statistical base and analysis, with consistent application and with appropriate validation procedures
- External comparisons to determine plausibility
- Stress testing
- Comprehensive view of "loss"
- Consistency of default definition
- Key characteristics of both borrower and facility/product
- Country and industry factors
- Legal factors including insolvency regime
- Procedure for overrides of grades
- Collateral analysis including:
  - Dependence between borrower and collateral value
  - Currency mismatch
  - Conservative perspective in valuation/estimation of workout period
  - Conservatism
  - Clear and consistent collateral policy
  - Keeping in mind creditworthiness of obligor
  - Robust collateral management systems
  - Concentration monitoring and action
  - Policies on appropriateness of collateral, liquidation potential and revaluation procedures

The model is broad but does not seem to take internal recovery processes into account. It is quite safe to say that whilst Southeast Asian banks may take these factors broadly into consideration, none of them has done the analysis, or has a comprehensive policy framework to conform to the advanced IRB requirements at this time.

Definitions

Let us start off with two definitions that are not as simple as they might seem, those of "loss" and "default". We can use the Basel definition of "default" (set out for the purpose of "consistent estimation" rather than a legal definition) as the starting point. Per paragraph 272 of the final accord document, a default occurs when one or more of the following conditions pertain:

- It is determined the obligor is unlikely to pay its debt obligations (principal, interest, fees) in full;

- A credit loss associated with any obligation of the obligor, such as charge-off, specific provision, interest or fees;
- The obligor is more than 90 days past due on any credit obligation; and
- The obligor has filed for bankruptcy of similar protection from creditors.

This is a wide definition with the first term affording a degree of discretion that puts the onus on banks to look realistically at their portfolios. It is tougher than the definitions generally prevalent in Asia, which stress the actual occurrence of events. The Basel "at least one of" approach deals with the possibility of fudging through discretion; there is a minimum that must be respected.

Obviously a major question is the amount of losses that banks have incurred but, before asking that question, we need to define what a loss is. The Basel definition is "economic loss":

> This should include the discount effects, funding costs and direct and indirect costs associated with collecting on the instrument in the determination of loss. Banks should not simply measure the loss recorded in accounting records, although they should be able to compare the two.
>
> (Basel Accord, paragraph 339)

This makes data collection much more complicated, but also much more realistic. Who can say that a 15-year fixed rate loan at a rate below market and no principal payment for ten years does not represent an economic loss?

The Basel Committee has issued some clarifications about its LGD commentary:

- Estimates should reflect economic downturn conditions where necessary, and look at the effects on particular types of exposures with data from downturn periods, scenario analysis and other technique being employed. It is very early in the study of LGD to do this very precisely.
- The LGD cannot be lower than the long run, default-weighted average LGD of the bank.
- When the banks hold defaulted assets, differences between their economic downturn LGD and the banks' best estimates of losses will be treated as unexpected loss for capital purposes, which means that two LGDs have to be calculated.

Studies of LGD and EAD

The academic and market studies on LGD (and later on EAD) are thin relative to copious material available on PD. There would appear to be several reasons for this:

- PD studies can focus on external data, client financials and market prices of securities, much of which is easily available in digital form. Obviously, the quality of the PDs owes a lot to the quality and frequency of the underlying data. In consumer credits, where statistical PD analysis has been particularly successful, the required variables are simple and relatively easy to collect.
- PD studies are concentrated in the OECD area and often cover the same ground in different ways than the rating agency analyses, which are a type of benchmark for individual PD systems, which normally calibrate against ratings but claim to recognise problems sooner.

Asian banks are now developing PD studies that tend to focus on company statistics since equity and other prices are not considered good indicators in illiquid markets. Some Asian banks still have purely qualitative processes that use "structured judgement" to ensure that they systematically cover all important aspects.

By contrast, EAD and LGD studies are very thin. This is not surprising:

- There is a shortage of data. In contrast to PD studies, which rely on widely-known information, bank EADs and defaults are known in detail only to banks. Bond defaults tend to be relatively few, although, in the junk bond market, they are more extensive and there has been more study.
- Many definitions and algorithms, particularly "default" and "loss," are far from being agreed or implemented. Data gathering is thus complicated.
- Individual bank universes of defaults are much narrower than the total market numbers of defaults, which suggests industry-wide study, which is only just starting.
- There is a basic difference between studies of losses "when all is said and done" and losses as measured by security prices at some discrete interval after default. Since the trading community drives a lot of quantification, trading losses are important to them, but much less so than to banks which make loans.
- Both EAD and LGD are reflective of the bank credit process, quality and willpower.
- In Asia, there are wide differences by country.

Let us look at the available published LGD literature to see what research has shown about these factors. The results are not entirely consistent, but this should not be surprising since LGD is understudied and a good intellectual consensus has yet to emerge.

First, there is the Standard & Poor's (S&P) Loss Stats Database which covers 1 900 defaulted instruments from 600 borrowers (all from the US). Not surprisingly, as this chart shows, banks came out the best:

Type	Recovery 1988-2001	Recovery 1998-2002	Recovery 2003
Bank	84%	74%	72%
Senior Secured Bond	69	46	29
Senior Unsecured Bond	52	37	21
Senior Subordinated Bond	35	21	NA
Subordinated Bond	30	15	NA
Junior Subordinated Bond	17	3	NA

Source: Charles Smithson

Losses by industry ranged from more than 60% in autos to 40% in publishing and print, and food and beverage. The regression analysis of the data showed that the statistically significant determinants of recovery were:

- Seniority of facility
- Collateral
- Time in default
- Debt cushion

The 1998-2003 relationship of the explanatory variables to recovery is shown in the following table:

Available	**Ultimate Recovery**
Debt below (*i.e.* how senior?)	16%
Collateral	13
Debt above	10
Aggregate default rate	7
Industry factor	7
GDP	0

The Fitch Ratings Loan Loss database (also US) gives similar information:

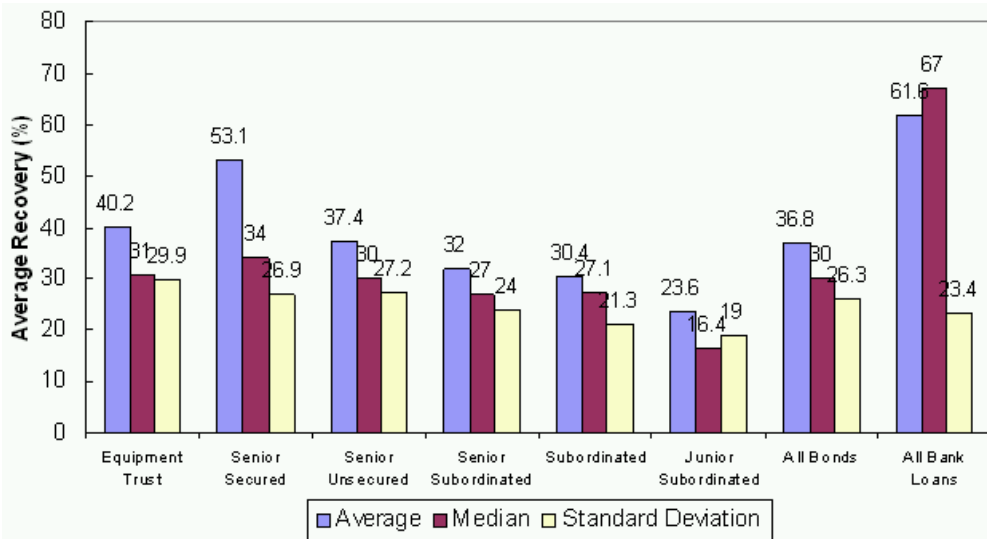
Type Senior:	**Loan Recovery**	**Bond Recovery**
Secured	72%	62%
Unsecured	52	42

The Fitch data, however, adds a significant insight. About 40% of the credits in the database have recoveries of 90-100% with about 15% at 0-10% and a large group in the middle. Thus, the average numbers may not have much meaning.

Moody's has also studied losses and their data on recovery is shown in the graphic below, which, over a longer period than S&P, shows performance that is broadly the same shape as S&P, but lower than S&P in the bank loan area, perhaps due to the different sample period.

Moody's, like S&P, has developed distributions and shows that the recovery rates on speculative grade bonds vary quite a lot over time with default rates being correlated inversely with losses, *i.e.* fewer defaults and better recovery which makes intuitive sense since economic conditions are probably better and the speculative US bond market tends to finance particular industries, which all get into trouble at once, such as telecoms and cineplexes.

This last point is taken up by Edward Altman[4] of New York University and colleagues, who are leaders in the academic study of default and who have done a lot of work on bond markets using bond prices for default proxies. These are not pertinent measures for banks generally, although still an indicator which is not very different from the rating agencies. His latest work is Default Recovery Rates in Credit Risk Modelling: A Review of the Literature and Empirical Evidence, the abstract of which is reproduced below:



Source: Charles Smithson

Evidence from many countries in recent years suggests that collateral values and recovery rates on corporate defaults can be volatile and, moreover, that they tend to go down just when the number of defaults goes up in economic downturns. This link between recovery rates and default rates has traditionally been neglected by credit risk models, as most of them focused on default risk and adopted static loss assumptions, treating the recovery rate either as a constant parameter or as a stochastic variable independent from the probability of default. This traditional focus on default analysis has been partly reversed by the recent significant increase in the number of studies dedicated to the subject of recovery rate estimation and the relationship between default and recovery rates. This paper presents a detailed review of the way credit risk models, developed during the last thirty years, treat the recovery rate and, more specifically, its relationship with the probability of default of an obligor. Recent empirical evidence concerning this issue is also presented and discussed.

This is consistent with the Moody's conclusion stated above.Both Moody's and Standard & Poor's have developed quantitative models for LGD forecasting. The S&P model projects, through the Maximum Expected Utility methodology, a distribution of loss rates conditioned on explanatory variables and deriving from the US LossStats database. The variables are:

- Collateral, broken down into 16 categories
- Percentage of total debt above and below class being evaluated
- Aggregate default rates
- Industry factors: the industry default rate versus aggregate default rates

Moody's KMV's LossCalc puts emphasis on changes in performance over the credit cycle and incorporates forward-looking data. It correlates default risk and recoveries. It incorporates macroeconomic information, industry and firm specific data, based on 1 800 recovery observations back to 1981. Numbers are produced for immediate and one-year time horizons. Moody's takes into account a relationship between default rates and recoveries. Fitch makes its loss database available through its Data Analysis Reporting Tool (DART), which enables banks to do their own work.[5]

Finally, attention is drawn to a public model of LGD published in the May 2004 edition of the RMA Journal by two BearingPoint consultants. The study used a variety of variables as shown in the chart below. The authors believe that their model is not only a good fit statistically but also intuitive and in line with economic good sense. Risky loans carry higher LGDs and higher leverage tends to increase losses, conclusions that are in line with the agency and academic studies cited above. The authors' analysis and claims are best studied in detail, but the model is an example of what some are doing inside banks.

Best-fitting LGD Regression Results

Variable	Coefficient Sign
Constant	-
Collateral Value Outstanding at Default	-
Authorized Balance at Default	+
Risk Rating at Default	+ *
Revenue	- *
Leverage	+ *
Profitability	+ *
Current Ratio	- *
Interest Coverage	-
Agriculture/Food Industry	-
Construction Industry	-
Manufacturing Industry	+
Services Industry	- *
Wholesale Industry	+ *
Facility Type	-
GDP	- *
Collateral Type	+
Covenant Tightness	- *
Seniority	-
R-squared	62%
Adjusted R-squared	51%
P-value of Regression's F-statistic	0.0

*indicates coefficients that are significant at the 10% level or higher.

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This approach leads to different (but not incompatible) results from those of the rating agency analyses, which focus, it would appear, on larger companies where capital structure and other elements are relatively more important than in a commercial banking universe. It does not deal with internal process issues, which are hard to model generically.

Internal bank studies of LGD

These studies focus on the external aspects of LGD, *i.e.* the macro and customer factors. They do not cover the internal factors, *i.e.* how the bank performs. Moreover, the high reliance on financial structure is probably not too relevant to the Asian market since most lending is done on a much less formal basis (with secured versus non-secured and various forms of guarantees as the primary differentiators) rather than the complex capital structures, which appear only in the largest names such as Asian Pulp & Paper.

The Risk Management Association LGD studies, now being run on a co-operative basis in the US, Canada and Europe, are examples of what might be done to develop more information that would help banks. In the European study, for example, the following data is collected:

- Facility and customer number
- Type of company
- Syndication indicator
- Country
- Facility risk rating
- Obligor risk rating
- Authorised limit
- Amount outstanding at default
- Spread index and percent
- Industry
- Collateral
- Collateral value and evaluation frequency
- Unfunded risk protection information
- Credit mitigation
- Facility type
- Seniority
- Facility purpose
- Credit event
- Cash flow information
- Expense information
- Resolution event

There are extensive breakdowns within categories. The methodology to calculate actual economic losses is defined in some detail as well as is the event of default, which, for purpose of this study, includes:

- Past due
- Unlikely to pay
  - Non-accrual
  - Credit loss
  - Facility sale
  - Distressed restructuring
  - Bank-filed bankruptcy
  - Obligor-filed bankruptcy
  - Unknown

This is consistent with the Basel Accord and makes clear the depth of data to be collected. It is not surprising that, as we turn to Southeast Asia, there is relatively little progress in this important area.

Participants in the LGD studies sponsored by the RMA and various partners have indicated that collecting the LGD data for the project has helped them in managing the process internally. It gives the participants a benchmark on data collection and helps them determine how current their collection systems are vis-à-vis a peer group.

In addition, when a question arises or when an LGD seems out of kilter, a group exists to try to come to a consensus on what might be happening. For example, in the US effort, LGDs for a facility secured by cash and marketable securities seemed high given the liquidity of the collateral. It turned out that for a facility to default with cash and marketable securities as its collateral, the collateral must be either weak or the collateral is for stock in a company that is heading toward bankruptcy so that the collateral is no longer saleable. Otherwise, the collateral would have been liquidated to keep the customer from defaulting.

Furthermore, reporting the data to a third party often raises questions on the data that lead to the data being cleaned even further. Participating in an outside study allows for an independent audit of the data and reinforces the quality of the data.

The US survey has been running longest and contains approximately 1 600 resolved observations and 400 more unresolved observations. Results take time to work out, which is a good reason to start collecting data sooner than later. RMA continually adds new members to its project and is continually working with the new participants to co-ordinate. Once the banks gain experience, it becomes an easier collection process.

Exposure at default (EAD)

Among the EAD literature, there are only two published studies: one from Citibank and one from JPMorgan, each using similar methodologies (indeed, done by some of the same people).

The JPMorgan study by Mitch Araten and Michael Jacobs Jr. entitled Loan Equivalents for Revolving and Advised Lines was published in the Risk Management Association Journal of May 2001. "Loan equivalents" are the proportion of the still undrawn commitment that would likely be drawn between today and default. It does not cover the whole amount of drawdown since this is meant for predictive purposes only. Current drawdowns are covered by existing capital allocations. The conclusions of this study indicate that:

- Average LEQ of 43%: high LEQs for higher ratings presumably because they draw down less to begin with and then deteriorate.
- LEQs rise with time.
- LEQs have high volatility.
- LEQs are not significantly affected by lending organisation, commitment type, size of commitment, domestic versus foreign borrower, or industry.

Since the study was internal to JPMorgan (which has a fairly homogeneous base) one could discount the conclusion on whether drawdowns are affected by organisation or not. They are. EAD is something to which every bank should pay a lot of attention. The workout team will be able to assist in this process because it will have spent quite a bit of time reviewing the credit and its evolution. One

can appreciate that the workout teams want to get on with their work, but they are employed by the same employer, and they will have a deep and independent view of what went wrong which may be as simple as: "from the file, it does not appear we paid any attention to the evolution of this client; we seemed to think we were okay based on collateral, which we also did not monitor; and we took no action to reduce or improve the quality of our exposure."

A Risk Management Association best practices study in 2002 indicated that banks apply EAD estimates of around 65-70% to committed revolving credits and commercial paper back-up facilities and factors of 20-25% to uncommitted lines, presumably on the basis that they can monitor these adequately.

As indicated above, despite the lack of study, EAD is a critical affair for banks since it is the way they control outstandings. A presentation from Standard Chartered Bank is cited here to drive the point home. It is the only public description of a bank's credit performance in recent years. The presenter, Quresh Bengali, currently of the Malaysian subsidiary, listed the following "common examples of credit problems" at a conference of the Institute Bank Bank Malaysia (IBBM):

- Concentrations–correlated risks
- Poor credit assessment/ineffective review process
- Poor monitoring of obligors and collateral values
- Fraud
- Lending against non-financial assets
- Business cycle effects

Mr. Bengali stated that 70% of Standard Chartered Bank's business loan losses could be attributed to poor monitoring either of clients or collateral, or both and, of course, failure to take action.

Southeast Asia

At present, the view of Southeast Asian and neighbouring regulators on Basel Pillar I, the capital adequacy calculation, is as follows:

Country	Response
Singapore	The three banks will use IRB
Hong Kong, China	Big banks to use IRB and flexibility for smaller banks
Malaysia	Implementation over time with Standardised by 2008 and IRB (voluntarily) by 2010
Indonesia	Basel-like framework introduced but details to come
Thailand	Appears will adopt Basel II but details still to come
Philippines	Standardised method till 2007, IRB possibly by 2010
China/India/Sri Lanka	Not hostile to Basel II but will stick to Basel I for the present

In terms of detailed studies, the situation in Southeast Asia is not very different than that of larger OECD countries as indicated by the LGD or EAD studies which focus on the US market where the data is good and where there are, relatively speaking, many defaults. There are no public information

studies about banks specifically. Moreover, there are no published studies that dig into bank processes as opposed to objective ways in which to estimate numbers for the credit equation.

The three Singapore banks have teamed up with Standard & Poor's to conduct an industry-wide study of LGD. Singapore has had relatively few defaults in the last years and probably has a more homogeneous management structure amongst banks, so a joint study will likely shed light. The initial work has just been finished but results are not yet available. No other Southeast Asian banks seem to have done very much about LGD. They are concentrating mainly on PD. The problems that have surfaced in Southeast Asia in terms of studying LGD include:

- Poor historical data; it has been lost, was never created, and is difficult to locate and extract.
- Mergers mean data is either lost or non-comparable.
- Data on paper not digitised.
- Definition difficulties.
- Problems in defining what needs to be measured; some elements, *e.g.* management willpower, are hard to compare.

The situation is further confused because there have been substantial asset sales to third parties, including both asset management companies and debt traders, and it is not clear what the ultimate LGD results were. Debt trading levels are to some extent public data, but it is not clear whether they are "good numbers" to use for evaluating bank LGD. Finally, there can be no question that default rates correlate inversely with recoveries irrespective of how the latter are defined.

One country that is fairly advanced in LGD (as well as EAD studies) is Chinese Taipei, where the Joint Credit Information Centre[6] (JCIC) takes a leading role in these matters. JCIC is a quasi-official body to which all the banks belong, which carries out a variety of collective credit information collection tasks and develops analyses. JCIC is not yet prepared to share results as it is still at work looking at the following considerations:

Cash Flow	Behaviour
Recovery	Opportunity cost
Seniority	Moral hazard
Collateral type	Adverse selection
	APR rule
Direct Costs	
Legal/Trustee Fees	Choice of auctioning versus restructuring
Accountant	
Indirect Costs	
Management fee	
Duration of workout	

The preliminary indications seem to show that losses are quite high.

Actual LGD management in Southeast Asia

Although there is no good information in the region (too much of the activity is subject to unclear accounting and information standards, much of it has happened with foreign banks, and actual

outcomes from loans sold off are not very clear) it is possible to draw a large picture, as has been done by Standard & Poor's.

Throughout the Asian financial crisis, one of the regulatory tactics for dealing with the dangers to banks was to manipulate standards for non-performing loans (NPLs). One appreciates that the job of regulators is not to destroy the economy by drastic regulatory decisions but, now that the crisis is past, it would seem that such arguments have lost validity and the region should move to international standards, or explain why. At the end of 2002, Standard & Poor's looked at the issue with the following comments on Southeast Asia and some other countries:

Country	2002 Average NPL	2003 Estimate NPL	Comment
Singapore	8%	7-7%	"Reliability ahead of region." S&P would add back recently restructured loans, but no big change.
Hong Kong, China	5	5-6	Same as Singapore.
Malaysia	16	13-14	"Numbers fairly reliable" 16% on three-month basis, disclosed by regulator for whole industry although bank standard is six months. Some other adjustments required.
Thailand	30	28-9	"Impaired assets 75% above official levels" which were 16.5%. Loose rules on loan rescheduling to avoid default, which is at 90 days.
Philippines	32	30	Similar to Thailand. S&P includes large volume of real estate collateral owned by banks and not easily saleable.
Chinese Taipei	13	10	"Impaired assets twice official levels" of 6.4%, which are, however, low by Asian standards. Interest can be allowed to run for 180 days not 90 for NPL status. Added back restructured loans, collateral assets, etc.
Indonesia	20 *46* *Incl. Ibra*	15-17	"Impaired assets 150% above official levels" of 8%. S&P adds back restructured loans, notes complexities in declaring various statuses or impairment. Most bad loans were shipped off to IBRA and the low industry number reflects the low level of lending.
India	23	30	Indian NPL rules set at 180 days although change planned for 2004.

Another indicator of the quality of default declarations would be the level at which restructured loans, which avoid going into default or get out the borrower of a default, fell back into default. Comprehensive figures on this are not available.

In terms of actual LGD and recovery, S&P's 2003 estimates based on 2002 numbers were:

Country	Estimated Recovery
Hong Kong, China	50%
India	30
Indonesia	15
Malaysia	45
Philippines	25
Singapore	75
Chinese Taipei	40
Thailand	30

These are low numbers compared to the North American bank loan numbers seen in rating agency studies in the 70s and 80s, and suggest there is a lot of room for improvement. On the other hand, these defaults occurred during a "hundred year storm" and (whilst the Asian banking system, including foreigners, should not be let off the hook for bad performance arising from a voracious risk appetite) defaults need to be put into the context of the negative correlation between LGD and default rates cited by Ed Altman and Moody's in their studies. Moreover, Asian lending was much more real estate heavy than North American lending. Real estate has been the downfall of bankers for centuries.

LGD and EAD management

Looking at LGD, and to some extent EAD, let us evaluate the results of the various studies in terms of what the primary drivers of LGD are before restructuring and insolvency. The paper will look at factors that affect the overall credit process in order to avoid, if possible, getting to the point of insolvency/restructuring when LGD then looms large. Disaggregation is useful as it can then lead to specific guidance and "to dos" for banks and regulators. The list is the following:

External factors

- *Economic environment:* The data suggests some correlation between default levels and LGD. However, the research is mainly North American covering periods since 1981, since when the economy has generally been satisfactory although, recently, LGD has increased. More broadly, it is hard to imagine that LGD does not have a relationship to the general economic environment. The Basel Committee, indeed, wants LGD and collateral value estimates to reflect downturn conditions.
- *Conclusions for LGD management:* Careful monitoring of the environment and anticipatory action to reduce risky exposures and to ensure collateral is adequate.
- *Legal environment:* This needs no explanation in Asia. The immediate drivers may not always be the same between public and private sector obligors, but they usually get down to the moral hazard of borrowers not co-operating and courts not enforcing for various reasons.
- *Conclusions for LGD management:* Vary by country, but mutual interest trumps technical legal issues in many markets.
- *Financial market environment:* Action is often constrained by general industry practice especially when, as in 1998 in Asia, defaults are so widespread that moral hazard comes into play. Financial markets have a tendency to "group think" and thus over-lend, in general, or to an industry, in particular. One is likely to see too many similar defaulters and too much of the same kind of collateral. This is particularly the case during real estate financing booms.

  Conclusion for LGD management: "Get off the train" when there is time; strong bank lending is usually a leading indicator of trouble. At a minimum, raise credit acceptance and collateral *minima.*

"Banking" factors

- *Structure of facilities:* The North American research points clearly to differences between bank loans and bonds (bank loans do better) and amongst bonds (senior and secured do better than junior and unsecured). Asian finance is less complex, although seniority is created by way of collateral. Although, in some cases, facilities with sophisticated structures did help recovery, in other cases, structures were either overwhelmed by primary risks (one

thinks immediately of infrastructure with its voluminous documentation) or were too aggressive or not understandable and presentable in local judicial systems.

Conclusion for LGD management: It is not true that one can structure one's way out of all risks, especially in Asia. Credit decisions should remain focused on basics. At the same time, old reliables such as L/C lines definitely have less risk and better recovery chances.

- *Structure of borrowing groups:* In Asia, with widespread family businesses, banks often extend credit to large numbers of related companies which are subsidiaries of one top company. They take joint collateral, extend lines jointly to various entities, and have numerous sub-limits and the like. Ideally, these complex groups are mutually supporting internally, but they are hard to understand and feel comfortable about. This very much compounds the problems of setting risk/facility ratings or ELs as well as, ultimately, collecting. Moreover, Asian borrowing groups are not constructed transparently and facilitation of collateral repossession is a significant goal.

  Conclusion for LGD management: Caution should be exercised with overly complex groups and multiple borrowers with the same collateral. This kind of business is probably unavoidable, but needs to be undertaken with great care. Attention needs to be paid to the internal family relationships of the borrowing group.

- S*tructure of lending group(s):* This is not a topic that requires a lot of detail in this context. However, many workouts and insolvencies take quite a long time to come together. To the extent a complex bank group with different goals and constraints compounds the problems of enforcement to minimise LGD, it is a factor to look at in terms of facility rating or EL estimate. There is no doubt that having professionals on both sides of the table improves bank chances of getting paid.

  Conclusion for LGD management: The lending alignment makes a significant difference. Stay away from overly diverse and complex lending groups without strong and determined main banks.

- *Documentation:* Some of the early problem banks seemed to have serious documentation problems. What the file said and what was in the vault did not match. Speaking to Asian banks, one does not get a lot of feedback that missing or defective documentation was a major factor in determining LGD. The only explanation is that perhaps in some jurisdictions the legal framework is so poor that even good documentation is not worth much.

  Conclusions for LGD management: No premium for poor or incomplete documentation anywhere, or lack of registration and the like. As legal environments improve, documentation will become more important since it can actually be litigated, as is now the case in some Southeast Asian countries such as Singapore and Malaysia.

- *Collateral:* Collateral values were based on continually rising property markets, which, in turn, reflect the Asian liking for landed assets. There was inadequate consideration of the dynamic effects of markets, which overshoot--none more often or more drastically than real estate. Moreover, much financing was for development where the collateral value was a second way out only in the sense of protection against unsecured lenders and, perhaps, a call on the owners' not wanting to lose properties. Legal issues, of course, are just as important in collateral litigation as in loan litigation itself.

  Conclusion for LGD management: Collateral, unless cash or highly marketable securities under the bank's name or to its order, is always the second way out.

Internal management factors

- *Monitoring the process of credits that have not defaulted (EAD):* One only loses what one has outstanding--although in Indonesia that confidence is being tested. In some sense, this is a matter of measuring losses versus approved facilities, although the more bad loans a bank has, the more it is going to lose. One international bank in the region cited monitoring shortcomings as the primary cause of problems; action was not taken early to avoid problems. Monitoring is, however, the credit officers' and bankers' number one job.

  Conclusion for LGD management: This is the single most important thing to be done. Use the heat chart approach to determine focus and follow up relentlessly

- *Valuation and collateral management:* Asia is a collateral-based banking market. We saw in 1998, however, that collateral is no better than the loan book itself under crisis conditions. Even so, valuations and valuation methods did tend towards optimism. Detailed studies of valuations and valuation methods are indicated. Particularly rigorous will be valuations of collateral, the value of which is determined by the quality of the loan--PD and valuation (and therefore LGD) are clearly related, especially in a context of heavy lending to a particular industry which gives its own assets as collateral. Diversification of collateral is, in principle, important in a collateral rating systems based on liquidity. However, during booms, even prudent lenders get badly hurt. The Basel Committee is adopting the valuation standard that collateral valuations used for advanced IRB purposes should reflect economic downturn conditions, where necessary, and data from the economic downturn period. Valuation cannot be less than the long-run default-weighted average loss rate given default. Values change and if they drop, or threaten to drop, it is an action indicator. Ideally, loans should be indexed to security value where security is important. Process and process quality for valuation and collateral management need to be assessed and information developed on collateral on a portfolio basis. Although valuers should not have access to the underlying transactions for which they are valuing collateral, bank policies should certainly ensure careful looks at risky loans with illiquid collateral.

  Conclusion for LGD management: Bank valuation and collateral management need a good deal of attention, although collateral is no substitute for common sense in lending. Collateral portfolio management is needed even though, in an extreme downturn, all collateral is adversely affected.

- *Decision-making and willpower:* Managers and directors must take tough decisions in workouts and insolvencies. What is emphasised here, however, is taking decisions prior to the time of workout and insolvency, *i.e.* pulling the plug on bad risks, forcing early restructuring and the like.

These ideas were field-tested by conducting an informal poll among people in the Southeast Asian banking markets**.** The approach was unscientific but since the poll group represents a wide variety of Asian banks and international Banks in Asia and significant credit experience, perhaps useful. The words in the right hand column represent the responses.

EAD/LGD Factors	Importance for Reducing LGD in Asia, 1998-2004
Too many or too diverse banks or too unstructured banking groups to the borrower(s)	Higher
No truly lead bank group	Higher
Local legal environment did not support collection/restructuring efforts	Higher
Deal documents missing	Lower
Deal documents poorly drawn	Higher
Security documents missing	Lower
Securities not properly registered	Lower
Security documents poorly drawn	Medium
Unrealistic collateral valuations	Medium
Security value is the same as the enterprise value, *e.g.* machinery, building project	Lower
Collateral deteriorated in liquidation value but this was not recognised through monitoring prior to the 1997-1998 crash	Medium
Collateral monitoring, especially property, did not take account of the risk of "boom" prices	Medium
Collateral concentrations	Medium
Deal structure too aggressive in terms of local law and regulations	Medium
Deal structure too complicated	Medium
Group financial structure too complex and hard to understand/control	Higher
Inadequate general credit monitoring allowed advances to be made which could have been avoided	Medium

Notes: An underlying assumption is that some of these matters could have been evaluated in advance. None of the factors were viewed as unimportant and (as there is some degree of overlap) the relatives should be viewed carefully.

If we take a simple view, the biggest problems arose with lending structure, and deal and lender complexity. These are factors that can be weighed in advance. Security is less cited although no one would call it unimportant. It may be that the experience of the people was less oriented to collateralised lending, or perhaps they thought they had checked the collateral boxes enough.

Closing notes

It is fair to say that the shock of 1997-1998 has now receded, that Asian banks are regaining their composure and, more important, gaining the will to improve their business models, particularly in the risk management area. Banks and consultants have not really got to LGD in any serious way yet and there remains evidence that they are still not inclined to dig too deeply into what was a heart-rending experience to develop the practical lessons to use in better times. Moreover, issues remain in terms of

getting risk management and its basic requirements infused into banks at the working level. We can now see the regulators themselves on the move. Some of the reasons for delay have been the Basel delays since Asian countries want to conform to the international model as much as they reasonable can. There remains a lot of work, not least of which in the LGD area, and we have some time before the Asian banking systems will meet "best practice" international standards in an active and forthcoming way.

Recommendations for action

Given that LGD is intuitively obvious as a key factor in bank credit management (going back to capital adequacy, process quality and ability to lend actively in the future) it is important that banks and regulators adopt appropriate policies even in the absence of shared data on LGD:

i. All significant Asian banks should be required to develop and analyse appropriate LGD statistics and measurements on an ongoing basis. Where feasible this should be done on a national consortium bases (with a neutral data collector and data available to the regulators and to the participants) because LGD is a critical element in the credit equation and LGD data is very hard to collect.

It is necessary for this effort to start immediately. It would appear that historical analysis will not produce appropriate LGD data because the needed components have not been collected and are not collectible. Even current data collection is difficult. Lack of automation is, however, no excuse. If the database starts with reasonably current defaults, data can be collected by hand without overburdening the institution. Data collection can be based on existing models such as those from the RMA and credit rating agencies supplemented by local factors and some imagination. The JCIC effort in Chinese Taipei is an example of what might be done.

Asian regulators should announce the LGD assumptions to their markets sooner rather than later. Nothing concentrates the minds in banking so much as a potentially onerous regulatory requirement to be renegotiated. Although Asian regulators criticised the early drafts of the New Basel Accord for short-changing consideration of collateral other than financial instruments in the standardised approach, there is no reason why they cannot themselves dig into the issues and come up with solutions of their own that reflect Asian markets.

Asian regulators can also work on regulations for property and other collateral used to support commercial credit. In their initial feedback on Basel II, the Asian regulators commented that Basel II gave little attention to what is the predominant form of lending in Asia. Asia does not want to be too different from Basel. Nevertheless, the Basel process should be reflective of the markets it covers. Stress testing should be applied to collateral as well as to base credits. Indeed, it is probably easier to "stress" collateral than trying to guess at developments under difficult economic conditions.

Asian banks, bankers associations and regulators have to join forces to work for a better legal environment. It does not need a large study to show that LGD is far higher than it needs to be because of problems of enforcement. One can wonder if it will be possible to even have a financial system in some countries based on their legal systems. To say that all loans should be considered "unsecured" is not a sufficient way to reason around this problem because laws do not adequately deal with moral hazard. As part of this effort, development/improvement of collateral registration for both fixed and floating collateral (similar to UCC filings) would also be important.

Asian regulators are now publishing consultative and other papers on credit risk management in their markets before issuing standards. These should include coverage of the workout and recovery

process. MAS, for example, has done this in a draft paper on credit risk management that was put out on its website for comment.

One aspect of recommendations is capacity building, which means public programmes for general benefit financed by bilateral and multilateral aid and financing. Obviously, there are a lot of things about LGD and insolvency management that need to be improved and are subject to capacity building, including:

- Co-operative LGD and EAD measurement projects
- Legal system improvements of all types
- Training for personnel involved in general banking, collateral appraisal, problem loans, restructuring and insolvency, etc. (Of course, there has already been a lot of "learning by doing," and international players have passed skills onto local institutions both by example and by personnel turnover.)

Carrying out some or all of this work on a community basis, often with third party intervention, may be a good way to make progress. Any sum that could be spent on these matters pales in comparison to the losses borne by the banking system and ultimately the taxpayer from poor management of credit risk in general and insolvency in particular. Thus, there is little excuse for not paying for this kind of capacity building. Banks, through their associations, need to realise that poor risk management hurts everyone and that relatively minor items, such as a community study of LGD, are actually trivial in face of the kinds of losses they have endured.

Notes

1 See the Bank for International Settlements website (www.bis.org) in the Basel Committee section.

2 United States dollar (USD).

3 Final Basel Accord document, paragraphs 64-111.

4 Prof. Altman's work can be found on the NYU website at: http://pages.stern.nyu.edu/~ealtman/.

5 The agencies' products can be seen in greater detail on their websites. Moody's and S&P produce distributions, not just single numbers.

6 Website: www.jcic.org.tw.

THE LACK OF ADEQUATE INSOLVENCY FRAMEWORKS FOR MAJOR CORPORATE COLLAPSES IN ASIA

by
Michael Sloan*

Introduction

Countries across Asia, whether they have developed or emerging economies, have at least one thing in common: they do not have adequate laws to deal with the insolvency of multi-national corporate collapse.

Cross-border insolvencies by their very nature involve large corporate entities with multiple subsidiaries and assets spread across jurisdictions. With globalisation continuing apace and the emergence of China as an economic powerhouse, there will be an increasing number of major corporations based in Asia with operations throughout the region. It is not sufficient merely to have laws that provide for the creation of such multi-nationals; there must also be legal frameworks to accommodate the restructuring and insolvency of such groups in the event of collapse.

It makes sense to deal with the affairs of an insolvent enterprise as a whole rather than individually and in fragments, thereby maximising the value of the insolvent enterprise. That is the principal basis upon which domestic insolvency law regimes operate. If the affairs of an insolvent enterprise involve more than one jurisdiction, it makes equally good sense to endeavour to deal with those affairs as a whole rather than individually. The division of the assets of a debtor on a territorial basis is arbitrary and is highly likely to result in discrimination between creditors. The inability to deal with the assets of a company as a whole, in most cases, will lead to a lower return to creditors. The reason for this is that the assets of a business are, more often than not, more valuable as a collective whole because of "added value factors" (or to put it another way, there is likely to be an erosion of value associated with the disintegration of those assets). The affairs of an insolvent enterprise cannot be dealt with as a whole at present in Asia.

The implementation of reforms such as the adoption of a regional cross-border insolvency treaty and the adoption of informal workout principles form part of the macroeconomic reforms necessary to manage legal risk in the region. The adoption of reforms would serve as an incentive for greater foreign investment and regional trade.

Lack of adequate insolvency regimes

Much has been written about the inadequacy of functioning Asian insolvency regimes. Further, despite the lessons learned from the 1997 financial crisis, Asian countries have been slow to enact

* Asian Development Bank Consultant from Blake Dawson Waldron, the lead consulting firm for the ADB RETA 5975: Promoting Regional Co-operation in the Development of Insolvency Law Reform in Asian (see http://adb.bdw.com).

cross-border insolvency regimes. The table below highlights the general inadequacy of cross-border insolvency laws throughout Asia (with the exception of Japan).

Table 1. The inadequacy of Asian cross-border insolvency law

COUNTRY	CROSS-BORDER INSOLVENCY LEGISLATION?
Bangladesh	No.
Bhutan	No.
Brunei	No.
Burma	No.
Cambodia	No.
Hong Kong, China	No. Under Hong Kong, China law, there are no statutory provisions governing the recognition of foreign insolvencies. Hong Kong, China relies on a common law approach of comity.
India	No.
Indonesia	No.
Japan	Yes. Under the law regarding Recognition and Assistance of Foreign Insolvency Procedures (2000), the court will give a recognition order for a qualified foreign insolvency proceeding.
Laos	No.
Malaysia	No.
Nepal	No.
Korea	No. Proposed reforms include the Act on Rehabilitation and Bankruptcy of Debtor (ARBD) which will allow a foreign liquidator appointed in a foreign jurisdiction to approach a court in Korea to request recognition of insolvency proceedings commenced in a foreign jurisdiction.
Pakistan	No.
China	No. Proposed reforms include the New Draft Bankruptcy Law (2002 draft) where foreign judgments in relation to foreign liquidations, reorganisation or composition proceedings "shall be subject to the approval by the People's Court".
Philippines	No. However, reform along the lines of Section 304 of the United States Bankruptcy Code is being considered at present.
Singapore	No. A foreign judgment has no direct operation in Singapore. Singapore courts apply the principles of comity.
Sri Lanka	No.
Chinese Taipei	No.
Thailand	No.
Vietnam	No.

The economic case for reform

From the mid 1980s (and in particular, the early 1990s) there was a surge in private capital inflows from industrial to developing countries. That surge slowed during the Asian financial crisis. However, the foreign capital inflows and outflows prior to and following that crisis demonstrate the positive and negative impact that globalisation can have on economies.

Another response to globalisation and, in some cases, a development that anticipated the trend to a borderless global economy, was the development of regional trading blocs. The Association of Southeast Asian Nations (ASEAN)–including its promotion of an Asia Free Trade Agreement–is a regional example of this wider, global trend.

The major issue facing Asian economies following the 1997 financial crisis has been the quest to revive foreign capital inflows. In its report entitled Effects of Financial Globalisation on Developing Countries: Some Empirical Evidence[1] the International Monetary Fund (IMF) recorded that:

> Preliminary evidence also supports the view that in addition to sound macroeconomic policies, improved governance and institutions have an important impact upon a country's ability to attract less volatile capital inflows and its vulnerability to crisis.

That is to say, trade and commerce benefit from the application of clear and predictable laws. If a country's laws and commercial practices are unpredictable, foreign investors will either not invest at all, or increase the cost of finance to reflect the greater risk that they face. "Quality" laws, however, are not sufficient in themselves. Institutional capacity to enforce such laws must also exist.

A sound system of insolvency law and the effective administration of that law, including a fair and efficient regime for recognising cross-border insolvencies, would form part of the improved governance of a country.

The importance of having sound insolvency laws has been confirmed by a further economic survey conducted by the IMF. The IMF investigated the correlation between the "quality" of various Asian countries' insolvency laws, and the depth and duration of the financial crisis experienced by each of them following the 1997 crash. The 1999 report entitled Corporate Insolvency Procedures and Bank Behaviour: A Study of Selected Asian Economies[2] concluded that there was a correlation between the quality of a country's insolvency laws and the depth and duration of the economic recession which it experienced.

In 2003, APEC commissioned a study on debt collection and litigation/arbitration in APEC economies. The consultants surveyed Japanese affiliated companies and also conducted field surveys. The study found that foreign investors are still hesitant to extend credit with security interests, and tend to rely on cash payment on delivery because of the difficulties of acquisition and execution of security interests. The study illustrates that the lack of adequate insolvency laws directly impacts upon the provision of debt capital.

The Country Report for the Philippines stated:

> More than a few have expressed the view that one reason for the continuing reluctance of banks to lend is the unclear insolvency regime existing in the country at present.... There have been reports that the difficulties being encountered in the debt relief petition of Philippines Airlines, export credit agencies are not inclined to extend credit to Philippine countries for fear that recovery...may be difficult....

However, the most compelling reason for reform is that there are no means of dealing with cross-border insolvencies in Asia. When a multibillion-dollar collapse occurs in Asia, creditors are left with little alternative but to attempt an informal restructuring. As no cross-border insolvency regime exists, there is no credible alternative or credible threat to an informal restructuring. Where a company operating in a number of countries becomes insolvent, the absence of a regime that enables the recognition of cross-border administrations can result in its dismemberment. This is so even where good commercial sense and the interests of company creditors dictate that its affairs be managed on a "whole of company or business" basis. In these circumstances, the only option is an informal approach to the company's administration. There being only one option, though, means that there is no effective means of securing the participation of all interested parties in that approach.

A case study is used to highlight the need for implementing insolvency law reform in the Asian region. The saga of the Asian Pulp and Paper Group (AP&P) exemplifies the need for cross-border insolvency law reform, the adoption of informal workout principles and the introduction of measures to strengthen institutional capacity.

AP&P: A case study

In 2001, AP&P collapsed under the weight of a USD[3] 13.9 billion debt. AP&P's headquarters were in Singapore. Its subsidiaries (which held the major assets) were primarily located in at least China, India and Indonesia. Its parent company was incorporated in Singapore. Its principal operating subsidiaries were incorporated in Indonesia (which produced wood pulp and paper) and China (which manufactured paper using supplies of wood pulp sourced from their related companies in Indonesia).

There was a degree of operational interdependence between companies in the group. There were also subsidiaries of AP&P in other jurisdictions, including Malaysia (which also supplied wood pulp to other companies in the group) and India (which produced paper). The capacity of AP&P to service its obligations (which included not only its borrowings as a principal, but also its liabilities as a guarantor) depended upon service fees paid by its subsidiaries as well as interest in their net equity (if any).

The AP&P Group is one example of an apparently substantial group of companies with headquarters in the Asian region and operations in a number of jurisdictions. Beyond that, it relied heavily upon international equity and debt capital markets.

As to its equity capital, there was international participation in its shares through its American Depository Shares which were listed on the New York Stock Exchange with the result that its principal shareholders, other than members of the Widjaja family, were from: China, France, Germany, Indonesia, Japan, the Netherlands, Singapore, Switzerland, the United Kingdom, and the United States.

The AP&P Group also borrowed heavily from international financiers with the result that at the time that the group announced its debt repayment standstill, its outstanding borrowings were from: Bahrain, China, Chinese Taipei, the Euro area, Indonesia, Japan, North America, Singapore, South Africa and Thailand. These borrowings represented approximately 30% of the group's total indebtedness at that time.

Accordingly, at least so far as the AP&P Group was concerned, foreign equity and debt investment had been crucial to its development.

The absence of predictability of outcome was a significant, if not crucial, consideration in the decision on the application to appoint a judicial manager to AP&P. The applicants for that appointment contended that the judicial manager would be able to secure control of AP&P's various subsidiaries, particularly its Chinese and Indonesian subsidiaries, by exercising the rights enjoyed by AP&P as a shareholder in those subsidiaries. A case study of AP&P is provided in an appendix to this paper. On the topic of expert evidence concerning the state of the relevant laws of those countries, her Honour Justice Lai concluded that there was no certainty that such an outcome could be achieved. Moreover, on the evidence, even if that were the end result of the judicial manager's efforts, it would only come about in the absence of co-operation from the AP&P Group after extensive and protracted litigation.

Without it reflecting in any way on the correctness of the decision of Justice Lai or that of the Singapore Court of Appeal (which affirmed her Honour's decision), the result of this application supports a conclusion that the fate of any attempt by the creditors of a group such as the AP&P Group to have an administrator appointed to deal with a group of companies operating in the Asian region may be unpredictable.

Commentators have observed that without a doubt, the arguments of AP&P and the difficulties faced by the court in the petition, underscore the need for an international insolvency code or convention with sufficient teeth, under which there is reciprocal enforcement of insolvency orders in a simplified and efficient manner, much in the same way as money judgments of Commonwealth countries are enforceable in each other's jurisdictions, or arbitration awards are enforceable by signatory countries to the New York Convention.

No administrator has been appointed to the group of companies and the debtor has remained in possession of the group's assets. The creditors of AP&P have fought AP&P's unilateral standstill to no avail.

The absence of any regional cross-border insolvency laws meant that a single administrator could not be appointed to the AP&P Group. If an administrator had been appointed to the parent company in Singapore, that administrator would not have been able to obtain assistance from, for example, Indonesian courts to either run AP&P's subsidiaries in that country or realise their assets for the benefit of all creditors. Whether a formal appointment would have produced a better result than an informal restructuring is a moot point, but it is certain that the existence of a viable alternative to an informal restructuring would have provided creditors with a credible threat to the debtor and, thus, a means of advancing their interests.

A case study of AP&P is attached to this paper.

The European experience

In May 2002, the European Union (EU) introduced a cross-border insolvency regulation. The regulation provides that if an insolvency proceeding commences in a member state, the proceeding is automatically recognised in other member states. The applicable law is the law of the jurisdiction in which the proceeding began. The regulation applies to 25 member states (Denmark is the only exception; the regulation binds all accession states).

Since the adoption of the regulation in 2002, there have been a number of significant decisions in relation to European collapses such as Parmalat and Daisytek. It should be noted that many decisions in relation to the treaty are unreported and that, at present, statistical information concerning the number and type of cases is not available. However, a case study arising out of the Parmalat collapse is discussed below. The main issue that has arisen in the operation of the regulation is to establish where the "centre of main interest" lies which, in turn, determines the jurisdiction of the courts of the member states.

Article 3.1 deals solely with cases of insolvency in which the debtor has its centre of main interest or an establishment in at least one of the member states and provides as follows:

> The courts of a Member State within the territory of which the "centre of a debtor's main interests is situated" shall have jurisdiction to open insolvency proceedings. In the case of a company or legal person, the "place of the registered office" shall be presumed to be the "centre of main interests" in the absence of proof to the contrary.

Recital 13 to the preamble of the European regulation states:

> The centre of main interests should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties.

Article 4 states that the:

> …law applicable to an insolvency proceeding shall be the law of the Member State in which the proceedings are opened.

Article 16 states that:

> …any judgment opening proceedings that is handed down in a Member State shall be recognised in all other Member States.

Article 26 states that:

> …a Member State may refuse to recognise insolvency proceedings opened in another state…if the effects of such recognition…would be manifestly "contrary to the state's public policy and….its fundamental principles or the constitutional rights and liberties of the individual.

The main impediment to such reform in Asia is that there is not economic union to the same degree as in Europe. Notwithstanding the absence of a regional trading bloc, the recent experience of the implementation of the treaty by European courts suggests that it does not adequately deal with the particular issues posed by major corporate groups.

Parmalat/Eurofood

Parmalat Spa was incorporated in Italy. It started life in Collecchio, Italy as a producer of dairy products. Though itself controlled by a family group, Parmalat spread throughout Europe, South America, Asia and Australia. It performed this growth through an acquisitions policy over 20 years. That policy was financed through offshore financing vehicles, including Eurofood IFSC Limited (Eurofood). Eurofood was incorporated in Ireland. It was a single purpose vehicle formed for the purpose of raising USD 150 million through a bond issue. It is a wholly owned subsidiary of Parmalat Spa.

The factual background set out below is drawn from the recent judgment of the Supreme Court of Ireland. This decision of the Supreme Court illustrates the factual difficulties that can arise in cross-border insolvency even in cases where a regime is in place and, in particular, the difficulty of establishing which law should prevail, or what is known under the regulation as the centre of main interests.

On 24 December 2003, an extraordinary administrator, Dr. Enrico Bondi, was appointed in Italy to Parmalat Spa. On 27 January 2004, Bank of America filed a winding up petition against Eurofood in the High Court of Ireland. On the same day, the court appointed a provisional liquidator to Eurofood. On 9 February 2004 the Italian government purported to place Eurofood under extraordinary administration and appointed Mr. Bondi as special commissioner (subsequently confirmed by an Italian court on 20 February 2004). A conflict therefore arose as to the administration of Eurofood.

On 23 January 2004, Eurofood wrote to its creditors giving notice of the possibility of the appointment by Parmalat of new directors and that this might affect the location of Eurofood's management and the jurisdiction in which procedures might be commenced. Both Italian directors of Eurofood had, by then, resigned.

On 27 January 2004, Bank of America presented its petition to the High Court in Ireland. On an *ex parte* application, that court appointed Mr. Pearse Farrell to be provisional liquidator of Eurofood. It gave him powers to:

- Take possession of the assets of the company;
- Manage the affairs of the company;
- Open a bank account in the name of the company; and
- Retain the services of a solicitor.

On 30 January 2004, Mr. Farrell notified the certificate holders and the appellant of his appointment.

On 9 February 2004, the Italian Ministry of Productive Activities (*Ministero delle Attivita Produttive*) admitted Eurofood as a group company to the extraordinary administration of Parmalat Spa pursuant to Italian law.

On 10 February 2004, the Parma Court made an order in which it acknowledged the filing of a petition to declare the insolvency of Eurofood. It scheduled an *in camera* hearing before the court for 17 February 2004 and directed that a "copy be sent to the petitioner for the communication to the parties interested to attend, if necessary also by fax, not later than 48 hours before the hearing". The reason given for the urgency was "in order not to jeopardise the measures aimed at protecting the creditors".

On 10 February 2004, Mr. Farrell received a fax communication from Parmalat Spa purporting to appoint three new Italian directors to the Board of the Company and to remove one Irish director (Ms. Catherine Meenaghan) with immediate effect.

On Friday 13 February 2004, Mr. Farrell, without any prior notice from or communication from Mr. Bondi, was personally served with a copy (dated 13 February 2004) of the notice of an urgent hearing before the Parma Court on Tuesday 17 February 2004. Mr. Farrell was not, however, served (as had been clearly ordered by the Parma Court), with any copy of the petition or copies of the papers upon which the extraordinary administrator proposed to rely.

On 16 February 2004, the Bank of America, the petitioning creditor, relying on a report of an investigation of the affairs of Eurofood, which showed it to be insolvent, applied to the High Court for an order to bring forward the date of the hearing of the winding-up petition. This application was apparently prompted by the impending application in the Parma Court. The High Court refused this application but granted liberty to Mr. Farrell to appear in the proceedings before the Parma Court. Both the petitioning creditor and Mr. Farrell were conscious of the desire and intention of Mr. Bondi to open main insolvency proceedings in Italy.

Mr. Farrell was legally represented before the Parma Court. However, he did not receive any of the documents filed with the Parma Court. Nonetheless, he filed a "defence brief" with the court on 17 February 2004. In this, he argued that he was not allowed to defend and argue properly during the hearing, since he had not been served with the petition, which he said was a breach of his

constitutional right to defend. Mr. Farrell, through his Italian lawyers, asked the Parma Court for an adjournment of the hearing. This request was refused by the court.

The Parma Court embarked on the hearing of Mr. Bondi's application in the knowledge that Mr. Farrell had not received copies of the essential papers. The court entered on discussion and argument regarding the issue of the centre of main interests of Eurofood. The presiding judge stated that the court was not prepared to defer the decision to a date that would allow the Irish court to determine the matter first.

Mr. Farrell filed a further second defence brief, and Mr. Bondi a counter brief prior to the decision of the Parma Court on 20 February 2004. There was, however, no further hearing. At the hearing on 17 February, both the question of whether the Irish court had already "opened" insolvency proceedings and the issue of centre of main interests were contested.

The Civil and Criminal Court of Parma delivered its written judgment on 20 February 2004. That judgment dealt principally, if not entirely, with the issue of where the centre of main interest of Eurofood lay.

Creditors also filed evidence in the Irish proceedings complaining about not being given the opportunity to be represented at the Parma Court hearing.

On 23 March 2004, the Irish High Court determined that:

- The Italian court lacked jurisdiction (because it could not ignore the Irish decision of January 2004);
- The centre of main interest of Eurofood was in Ireland (because it was incorporated there and because that was where its creditors believed its centre of main interest to be); and
- The decision of the Italian court was against public policy (because no notice and no opportunity were given to the Irish creditors to be heard in the Italian proceedings).

An appeal was made of the decision of the Irish Supreme Court. The Supreme Court of Ireland, although it upheld the judgment of the Irish High Court, has referred two matters to the European Court of Justice:

- Whether the Irish or Italian courts had "opened" main proceedings; and
- Whether the Irish court was entitled to invoke Article 26 of the Regulation (the "public policy" issue).

The Supreme Court of Ireland found:

> The principle of fair procedures in all judicial and administrative proceedings is, in Irish law, a principle of public policy of cardinal importance. It derives both from the rules of natural justice of the common law and from constitutional guarantees of personal and individual rights.
>
> Mr. Farrell says that he was seriously circumscribed in his ability to participate in the hearing in Parma, because of the absence of any copy of the petition. This cannot be denied and is not seriously contested by the appellant.

> This Court accepts that this must have been so. The shortness of the notice is one matter. Mr. Farrell seems to have reacted extremely well in such a short time. However, he was deprived, apparently deliberately, of the essential documents grounding the appellant's application to the Court. In a like situation, this Court would not allow a corresponding decision of any court or administrative body under its jurisdiction to stand. It would consider the want of fair procedures in itself as so manifestly contrary to public policy that it would regard it as having been made without jurisdiction and, consequently, void. Nor would that result be cured by the fact that the decision could be reopened before the same court. Such a fundamental failure to observe fair procedures would taint the entire proceeding.
>
> This Court notes that, as stated in Recital 22 to the Regulation, "recognition of judgments delivered by the courts of the Member States should be based on the principle of mutual trust" and that "grounds of non-recognition should be reduced to the minimum necessary." It must, however, be an intrinsic element in the "principle of mutual trust" that the decision whose recognition is sought has been made in respect for the general principle of Community law that everyone is entitled to fair legal process….
>
> I am satisfied that it would be manifestly contrary to public policy, as a matter of Irish law, to give recognition to the decision of the Parma Court, on the ground that Mr. Farrell was not given the protection of fundamental aspects of fair procedures by being refused any copy of the petition or any other papers which the Appellant intended to place before that Court for the purpose of the opening of insolvency proceedings.

There are two lessons to be learned from the decision in the Eurofood case that are relevant to any consideration of cross-border insolvency law reform in Asia. They are:

- That it is apparent that the EU cross-border regulation does not adequately address the issue of the centre of main interest in the context of a major international groups of companies; and
- That any cross-border insolvency regime should include provision for co-operation between courts. Even where a developed economic union exists, issues of sovereignty still arise. These can be ameliorated to an extent by the inclusion of protocols and measure to aid understanding and co-operation between the courts and insolvency practitioners in a region.

The options for reform

In the context of cross-border insolvency law reform, consideration must be given to the question of whether local laws and institutions discriminate against foreign interests and are capable of adequately responding to claims by foreign creditors. An appropriate cross-border insolvency law should answer these concerns and issues, thus striking a balance between the recognised need for sovereign states to regulate economic activity within their territorial boundaries, and the need to create a stable environment within which international trade and commerce, including foreign investment, can operate.

There are a number of approaches to cross-border insolvency laws, including:

- Unilateral discretionary legislation (the predominant means of recognition and assistance in cross-border insolvency, entailing legislative authority for a court to recognise and assist a foreign insolvency proceeding, provided certain statutory criteria are met, for example, the United States Bankruptcy Code);

- Bilateral, multilateral or regional treaty legislation (the automatic recognition in all contracting states of a bankruptcy originating in a member state, for example, the 1933 Nordic Bankruptcy Convention between Sweden, Norway and Finland);
- EU legislation (where cross-border cases originating in other countries must be dealt with under the domestic law of the country where the relevant application is made). The EU has recently adopted regulation 1346/2000, which provides for cross-border insolvency co-operation in relation to all the member states (except Denmark); and
- Global "model law" legislation; UNCITRAL has developed a legislative cross-border insolvency regime that may be adapted to and adopted by countries. The key features of the model law are that it only becomes effective if it is enacted by a country, and once enacted, it operates unilaterally. Accordingly, adoption will not, in itself, result in reciprocity. South Africa and Japan have created their own versions of the model law.

These approaches are not mutually exclusive. A regional treaty or other regional arrangement that provides for cross-border insolvency co-operation may operate harmoniously with initiatives pursued by a selected country independently of the other member countries. The legislative developments currently in progress in Korea and the Philippines would not be a barrier to them undertaking a regional treaty or other regional arrangement. Further, neither the effective operation of either the regional treaty or other regional arrangement, nor their current proposed reforms (which involve unilateral discretionary legislation) would be inhibited by such an undertaking.

The barriers to reform

There are concerns about the adoption of legislation that either facilitates the recognition of foreign judgments or permits the cross-border insolvency administration of a company in opening a country up to recognition and assistance legislation. The depth of these concerns is possibly most evident by reference to the number of countries in the Asian region that have not adopted those measures.

In essence, the concerns reflect the apprehension that exposing the citizens of one country to the processes and decisions of the courts of another country (when those citizens are physically present in the first country) detracts from the independence of the first country and its sovereign entitlement to regulate the affairs of its own citizens.

Reciprocity is another significant issue. Policy makers might be reluctant to provide for or encourage inbound requests and applications for recognition and assistance from other countries when there is no guarantee by, or obligation on, other countries to "return the favour". The absence of a requirement for reciprocity could result in "one-way" traffic. This is certainly true if a request or application is made from a state that has no legislation or other facility for recognition and assistance.

A possible solution to this problem is to limit the application of a cross-border insolvency law to countries that have similar laws. Alternatively, it may be possible to negotiate bilateral or multilateral arrangements. Policy may dictate that the application of any cross-border insolvency law should be subject to at least a real prospect, if not a guarantee, of reciprocity. In this context, it is relevant to note that the South African adoption of the UNCITRAL model law specifically provides for its application only in cases where the country from which an application for recognition and assistance is made has reciprocal law.

Having considered the different approaches referred to above, it is concluded that:

- In the first instance, recognition of cross-border insolvency administrations is most likely to be achieved by regional co-operation, which may be facilitated by an addendum to an existing regional treaty or other regional arrangement, such as that under which ASEAN was established; and
- If there were to be mutuality of recognition, then confidence in the judicial, legislative and administrative procedures of other selected countries would be imperative.

This conclusion does not militate against the desirability of the selected countries and other countries in the Asian region continuing to give attention to the possibility of unilateral reform in this area. Without limiting the range of available options, the models adopted by Japan, and those being considered by Korea and the Philippines are illustrative of regimes that could be adopted in addition to the participation by those countries in a regional arrangement.

The solution: A regional treaty

The proposed regional inter-governmental arrangement under the auspices of an organisation such as ASEAN should be pursued, based on the premises that:

- As participation is a matter for the voluntary choice of each of the countries which are party to the arrangement, its operation in any of those countries is not inconsistent with the country's sovereign power to unilaterally regulate its domestic affairs;
- Reciprocal recognition between the countries of cross-border insolvency would be an element of such an arrangement; and
- The arrangement would include agreement on what minimum provision should be made in national laws for recognition and assistance, and for co-ordination of any concurrent insolvency administrations. Some form of documentation of the agreed minimum provision would be essential to an effective arrangement, whether or not that agreement was expressed only as general principles or in more specific terms.

Institutional capacity

Before addressing the minimum content of a regional treaty, the issue of institutional capacity is addressed. Quality laws are not sufficient in themselves. Institutional capacity (that is, the capacity of a jurisdiction's judicial, political, governmental and private enterprise bodies to carry out the necessary measures to provide assistance to and recognition of foreign administrators) to enforce laws must also exist.

The Country Report for Indonesia for RETA 5975 puts the issue of institutional capacity in very stark terms (it is accepted that their comments do not necessarily apply to all countries in the region):

- Lack of fairness in the trials, due to the questionable credibility of the presiding judge(s). It is common knowledge that corruption is rampant in the courts. Judges, prosecutors, and lawyers are all involved in such dirty games.
- Many of the bankruptcy petitions submitted involve modern and sophisticated transactions of derivatives, swaps, commercial paper, etc. In many cases, the judge(s) presiding over the hearing do not quite understand the transactions. This leads to misinterpretation, or to a narrow interpretation of the documents provided by the parties.
- The unclear provisions of the Bankruptcy Law have led to problems in practice, particularly in relation to procedural matters.

The Country Report for Indonesia goes on to suggest solutions for these problems, including:

- Improving court procedures to provide for more transparent processes so that parties are aware of the process to be followed and are able to view the process;
- Making the courts and parties more publicly accountable for their actions;
- Improving the salaries of judges and other government law enforcement officials; and
- Providing the judges who are in charge of the Commercial Court with more training on modern business transactions.

Other general concerns about institutional capacity are:

- General delays in the court system. For instance, the court system in the Philippines currently has a backlog of approximately 850 000 cases;
- A lack of expert judges; and
- A lack of requirements for qualification of insolvency practitioners.

Addressing institutional capacity in general is beyond the scope of this paper. However, measures that could be adopted which are relevant to effective cross-border insolvency regulation are set out below.

Co-operation between courts

Issues for consideration include the following:

- *Communications between the courts:* It is recommended that a set of "rules" be developed to address the means of communication, the level of communication, and the circumstances in which such communication should, and should not occur.
- *Language and interpretation difficulties:* It is recommended that the difficulties associated with this issue be overcome by the employment of skilled and reliable translators.
- *A common understanding of concepts:* There is an inherent need for the courts of different countries and the participants involved, to have a common or mutual understanding of the pertinent concepts that apply. Technical assistance goes some way towards facilitating such understanding. However, judicial conferences and a continuing exchange of information will be needed in order to develop an understanding of relevant legal principles of other countries, parties to a regional treaty or other regional arrangement.
- *Time differences:* Whilst this issue is self-explanatory, it will need to be addressed in the context of facilitating communication and co-operation between the courts involved in the relevant procedures.
- *Practice and procedure generally:* It is recommended that any regional treaty or other regional arrangement account for the differences in practice and procedure between the courts of the relevant countries.
- *Use of protocols:* It is submitted that the overall administration of cross-border insolvency cases would be assisted and advanced by the development of a "protocol" dealing with both administrative and substantive matters of concern to the relevant selected countries.

Out-of-court proceedings

A premise that underpins much of the discussion in this paper is that courts are necessarily involved in all aspects of an insolvency administration, including its inception and recognition across borders. That need not be so. The companies legislation in countries that adopted the model of the United Kingdom Companies Act provides for a procedure known as creditors' voluntary liquidation. Those countries include at least: Australia; Hong Kong, China; Malaysia; New Zealand; Papua New Guinea and Singapore. That procedure is initiated by resolutions of meetings of each of the company's shareholders and its creditors. There is also the voluntary administration process which has been developed in Australia and which is proposed to be available in New Zealand. A company enters voluntary administration by, amongst other means, a resolution of its board of directors.

In the case of both forms of administration, no recourse need be had to the courts as the outworking of the relevant company's affairs is progressed. That is not to say that such recourse will always be unnecessary.

If the liquidator appointed under a creditors voluntary liquidation or the voluntary administrator of a company is recognised both in the company's place of incorporation and in all other jurisdictions in which it has assets, (either as the company's governing body or as being able to exercise the powers of its board of directors) gaining control of its assets should not necessarily be problematic.

In conclusion, the introduction of voluntary insolvency processes and the cross-border recognition of practitioners appointed under such systems may ameliorate (but not eliminate) issues surrounding institutional capacity.

The requisite content of a regional treaty

A set of proposed legislative provisions for an Asian cross-border insolvency treaty to operate should address the following points:

- The effect of recognition;
- Co-operation between courts;
- The relevant courts which should be involved;
- Ease of access to the courts;
- The need to secure recognition for both "in-bound" and "out-bound" insolvency administrations;
- The possible approaches to accommodating different types of insolvency administrations;
- Evidence required of commencement of insolvency administrations; and
- The formalities required for commencement of an application for recognition.

Evidence required for commencement of insolvency administrations

The evidence required for the commencement of an insolvency case in a foreign jurisdiction will draw upon the differences in substantive law between the selected countries.

Set procedures for establishing that the foreign representative has been appointed and is authorised to make an application will have to be developed.

The effect of recognition

Any regional treaty or other regional arrangement will need to give consideration to the effect of recognition of foreign insolvency procedures on the corporate debtor, its constituent parts and its business relationships, as well as to how the initiation of a second procedure (for example in a foreign jurisdiction involving the same corporate debtor) will affect the first initiated procedure.

Relevant courts which should be involved

Any regional treaty or other regional arrangement ought to consider the position of the courts currently involved in the legal system of the selected countries, and take account of that in determining which court should be involved.

Ease of access to the courts

This factor requires consideration of:

- Who can obtain access to the relevant court;
- The ease with which a foreign insolvency representative may obtain direct access to the courts; and
- The cost, time and formalities required.

Any regional treaty or other regional arrangement will need to deal with such disparities, and the issues associated with them. Applications for recognition will normally require to be heard within a matter of days rather than weeks or months.

The need to ensure recognition for both in-bound and out-bound insolvency administrations

Any regional treaty or other regional arrangement will have to apply to both "in-bound" and "out-bound" administrations. At present, none of the selected countries has any provisions in relation to either category of administration.

Possible approaches to accommodating different types of insolvency administrations

Any regional treaty or other regional arrangement should make provision for recognition of both informal and formal insolvency procedures.

Formalities required for commencement of application for recognition

In determining what formalities might be required to commence an application for recognition in the context of cross-border insolvency law, any regional treaty or other regional arrangement will need to address this topic as a matter of importance. Given that urgency is often required in cases of cross-border insolvencies, there should be little formality required for commencement of an application for recognition, provided that suitable evidence of the validity of the foreign appointment is given.

The formalities should also specifically address the rules for determining the centre of main interest of the company particularly where there is a large group of companies.

Conclusion

Whilst reform of cross-border insolvency laws will not be a panacea in itself for the issues facing Asian economies, some form of regional co-operation would not only benefit creditors in major corporate collapses, but could also serve as a means of promoting foreign investment and regional trade. Implementation of reforms to cross-border insolvency laws would serve an important role in managing systemic risk in the region.

Notes

1 International Monetary Fund (2003), 'Effects of Financial Globalisation on Developing Countries: Some Empirical Evidence' at p 5.

2 International Monetary Fund (1999), 'Corporate Insolvency Procedures and Bank Behaviour: A Study of Selected Asian Economies' at pp 32-35.

3 United States dollars (USD).

APPENDIX: CASE STUDY ON ASIA PULP AND PAPER GROUP

Many of the issues with which this paper is concerned can be exemplified by reference to the continuing saga of the Asia Pulp & Paper Group.

For a description of that group and its activities as well as its dealings with some of its creditors reliance has been placed on:

- The judgment of Lai Siu Chiu J. in *Deutsche Bank AG v Asia Pulp & Paper Company Limited* delivered in the High Court of Singapore on 31 October 2002;

- The judgment of Tan Lee Meng J. in *Deutsche Bank AG v Asia Pulp & Paper Company Limited* in the Singapore Court of Appeal delivered on 29 April 2003; and

- *Paper Tiger, Hidden Dragons* by Ed Matthew and Jan Willem van Gelder, published by Friends of the Earth, England, Wales and Northern Ireland.

No further attribution is given to citations from those judgments. However, where material is extracted from *Paper Tiger, Hidden Dragons* the reference is given.

These judgments were delivered in the course of an application for the appointment to Asia Pulp & Paper Company Limited (AP&P), being the parent company in the Asia Pulp & Paper Group, of a judicial manager. Such appointments are regulated by s227A and s227B of the Singapore Companies Act, which reads:

> **227A:** Where a company or where a creditor or creditors of a company consider that:
>
> (a) The company is or will be unable to pay its debts; and
>
> (b) There is a reasonable probability of rehabilitating the company or of preserving all or part of its business as a going concern or that otherwise the interests of creditors would be better served than by resorting to a winding up,
>
> an application may be made to the Court under section 227B for an order that the company should be placed under the judicial management of a judicial manager.
>
> **227B:** Where a company or its directors (pursuant to a resolution of its members or the board of directors) or a creditor or creditors (including any contingent or prospective creditor or creditors or all or any of those parties, together or separately), pursuant to section 227A, make an application by way of Petition, for an order that the company should be placed under the judicial management of a judicial manager, the Court may make a judicial management order in relation to the company if, and only if:
>
> (a) It is satisfied that the company is or will be unable to pay its debts; and

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(b) It considers that the making of the order would be likely to achieve one or more of the following purposes, namely:

(i) The survival of the company, or the whole or part of its undertaking as a going concern;

(ii) The approval under s210 of a compromise or arrangement between the company and any such persons as are mentioned in that section;

(iii) A more advantageous realisation of the company's assets would be effected than on a winding up.

Whilst the application was made in respect of AP&P alone, it was justified on the basis of:

> …the belief that there was a reasonable possibility of rehabilitating the company and the AP&P Group as a whole, of preserving its business as a going concern, by placing the company under judicial management instead of winding it up.

As will be seen in more detail below, the "AP&P Group as a whole" is a conglomerate composed of many subsidiaries and operating in a number of jurisdictions. It appears that the assumption that underpinned the application was that if AP&P together with its Indonesian and Chinese subsidiaries could be brought under the control of a judicial manager, the essential commercial integrity of the "AP&P Group as a whole" could be maintained.

AP&P is a public company that was incorporated in Singapore on 12 October 1994. Through its subsidiaries it operates mills (in Indonesia and China), which manufacture the group's products. The group is one of the largest producers of paper in the world and is the largest in Asia, outside Japan. AP&P has under its umbrella more than 150 companies incorporated in Indonesia, China, Malaysia, Mauritius, the United States and Singapore. The company derives its income (in part) from the management fees it charges its operating subsidiaries.

In *Paper Tiger, Hidden Dragons*, one further aspect of the structure of the AP&P Group is described in these terms (at p.38):

> Aggravating the situation [so far as concerned AP&P] is the fact that virtually all of AP&P's capital expenditure in China had been funded through the holding company. Profits, on the other hand, are derived from operating subsidiaries, mainly Indonesian-listed vehicles Indah Kiat and Tjiwi Kimia, and these companies are legally constrained from upstreaming enough dividends to pay down the debt coming due for the parent.

In Indonesia, AP&P has a holding company called PT Purinusa Ekapesada (Purinusa) which has four major Indonesian subsidiaries; PT Indah Kiat (Indah Kiat), PT Pabrik Kertas Tjiwi Kimia Tbk (Tjiwi Kimia), PT Pindo Deli Pulp & Paper Mills (Pindo Deli) and PT Lontar Papyrus Pulp & Paper Industry. Indah Kiat and Tjiwi Kimia are quoted on the stock exchanges of Surabaya and Jakarta respectively. Purinusa, however, does not own any timber concessions or subsidiaries that supply the wood to those four subsidiaries. The timber concessions in Sumatra and Riau Island instead belong essentially to two companies; PT Arara Abadi (Abadi) and PT Wirakarya Sakti (Sakti).

AP&P and its subsidiaries are part of a larger group of companies known as the Sinar Mas group, which is one of Indonesia's largest conglomerates, controlled by the Widjaja family. Abadi and Sakti (wood companies) belong to the Sinar Mas group.

Although it is a public company, AP&P is not listed on Singapore's stock exchange (SGX). However, it does have one subsidiary; Nippercraft Limited (listed on the SGX) and 15 other Singapore incorporated subsidiaries. AP&P 's American Depository Shares (ADS) were listed on the New York Stock Exchange until about 10 August 2001, when the shares were de-listed after the price fell for 30 consecutive days below the minimum of USD 1 required by the exchange; trading in the ADS had been suspended since 4 April 2001.

On 12 March 2001, AP&P issued a press release through its Chief Financial Officer, Hendrik Tee, announcing a debt repayment standstill. Amongst other things, the announcement said:

> On the advice of our financial advisors, Credit Suisse First Boston (CSFB), we intend to immediately cease payment of interest and principal on all holding company debt and on debt issued by our subsidiaries and affiliates, the obligations of which are funded by such subsidiaries. In order to allow our operating subsidiaries to continue normal operation, we will be giving priority to servicing our suppliers and trade creditors.
>
> …we believe it is in the best long-term interest of the Company and its creditors and we plan to seek a consensual arrangement with our creditors. We understand that a number of our creditors have initiated efforts to organise themselves globally and also separately for the China operations. We welcome these efforts. We intend to discuss the standstill and the way forward separately with each of our China operating entities and non-China creditor groups. Appropriate approaches will need to be developed for the various creditor groups based upon the particulars of their respective situations. The Company and its financial advisor will be meeting with creditor representatives to discuss the restructuring process and means for conveying information to creditors.

Creditors of AP&P, including the applicants to the High Court of Singapore for the appointment of a judicial manager, complained of its unilateral declaration of a debt standstill. Indeed, the press release was one of the reasons given for the application. Her Honour, Justice Lai in her judgment, noted that AP&P then had the dubious honour of being the largest debtor (of about USD 13.9 billion) in the emerging markets as well as being the biggest debt defaulter in Asia.

In addition to the unilateral declaration of the standstill on payments, another basis upon which the application was made was the delays in the formulation of the restructuring proposal. The applicants for the appointment of a judicial manager said that, although the press release indicated that AP&P would draw up a debt restructuring proposal within one month of the announcement, the deadline was not met. Indeed, they complained that, as at the date of the application (23 June 2003), AP&P had failed to come up with a proposal which merited serious consideration by the company's creditors–the company's debt restructuring plan dated 1 February 2002 had been rejected outright, and the creditors' counter-proposals dated 2 May 2002 were not accepted by AP&P save for four items. Beyond that, there was not even agreement between AP&P and its creditors on the basic principles of restructuring. AP&P denied these claims saying that, over and above the appointment of professional and legal advisers, 24 or more meetings had taken place with creditors up to 8 May 2002, starting with one on 6 March 2001, which was even before the press release.

It was not necessary for the Court to resolve these disputed claims. However, it is interesting to note the following observation of the Court on the impact of the application to appoint judicial managers:

> I would add that [the] perception of AP&P's more vigorous approach to restructuring since the filing of the Petition, was corroborated by none other than one of the Petitioners [which

had been complaining of a lack of activity]. In his third affidavit filed for [Deutsche Bank] Topp stated (in paragraphs 4 and 5):

"In the six weeks since the Petition was filed, the following events have taken place:

(i) The long-awaited KPMG Phase 1 due diligence report (the KPMG report) on the company and its subsidiaries has been released (a copy of which is annexed hereto and marked as WHT-9);

(ii) The company had apparently 'committed' to 'finalising' a restructuring plan (of the Indonesian operations) by 30 September 2002 and that IBRA has agreed to take a leading role in the process;

(iii) the company has apparently agreed to opening an escrow account(s) to set aside cash for the benefit of the creditors and to make regular contributions to the account(s), but the 'details are being worked out' and the company is still haggling about the amount; and

(iv) The company has apparently agreed to augmentation of management but again the details are being worked out."

The Petitioners are gratified at these developments, but suspect that the company's newly stated willingness to accede (partially) to creditors' requests is due, the Petitioners' believe to some extent at least to their attempt to resist the appointment of judicial managers.

Whatever the level of co-operation between AP&P and its creditors may have been, when it came to the formulation of an overall strategy for the restructuring of the AP&P Group, the Group continued to need the support of its creditors as in April 2001:

AP&P asked its creditors for additional working capital of USD 200 million for its Indonesian operating subsidiaries "to stabilise our operations". The request irked creditors: "That's a bit much to ask and nobody in that room is going to give them that money" said one banker who attended the meeting, according to Reuters. There's no sense of urgency and no plan in place.

Whilst it may be that the application to appoint judicial managers encouraged the AP&P Group to pursue its restructuring proposal with more vigour, it is also the case that those associated with the Group were prepared to threaten use of their commercial influence to promote their own position. The applicants accused AP&P of using veiled threats to garner support from creditors to oppose the application. Support for that accusation was said to be found in a memorandum dated 26 June 2002 from one of AP&P's legal advisors which contained the following paragraphs:

Attached to this memorandum is a form of support letter which AP&P expects to receive from each entity or person participating in the Umbrella Steering Committee. AP&P asks that you send this memorandum and the form of support letter to those committee members whom you represent and ask that a support letter, in the suggested format, be delivered as soon as possible and, in any event, by no later than 5 July 2002. AP&P asks for your assistance in ensuring that committee members whom you represent be made aware of the contents of this memorandum, and the request that support letters be issued, as a matter of urgency.

> Please note that AP&P is of the view that the judicial management Petition is not consistent with the consensual restructuring, out-of-court restructuring concept which has been under discussion between AP&P and the Umbrella Steering Committee for more than one year. The fact that one of the Petitioners is an Umbrella Steering Committee member is also a cause of concern. In the circumstances, AP&P expects those committee members which support the consensual restructuring concept to issue the requested letter, thereby providing tangible evidence of its support for the consensual process. The refusal or other failure by an Umbrella Steering Committee member to issue a support letter will be viewed by AP&P as indicating that such member does not support the consensual, out-of-court restructuring process. Should it transpire that a material number of committee members fail to issue a support letter, AP&P is of the view that there may be material adverse consequences for the consensual debt restructuring process.

As Justice Lai noted, this was "a threat by AP&P and not a subtle one at that".

The applicants for the appointment of judicial managers alleged that creditors had appointed KPMG to conduct an independent audit of the AP&P Group. However, KPMG's progress had been hampered by AP&P's unwillingness to give the accountants access to information relating to the company's operations in China, inter-company debt analysis, inter-related company transactions and accounts receivable. Consequently, KPMG missed the deadline of July 2001 for the submission of their report, as well as the revised deadlines of January and April 2002. Without the report of KPMG, it was claimed that the creditors had not been able to assess the viability of the debt restructuring proposals put forward by the AP&P Group.

This was also denied by the AP&P Group, which said:

> The group had spent considerable time working with KPMG in reviewing the group's financial positions for its Indonesian operations. Contrary to the Petitioners' claims, the company had not been uncooperative with KPMG. In fact, it had given easy access to all documentation, made staff/accounting staff available to answer queries and, assigned in excess of 100 staff to work with the accountants. …a data room [had been created] for the benefit of KPMG and creditors…. The Petitioners' claim that the company deliberately wanted to delay the release of KPMG's report [was rejected as unfounded]. Indeed, the creditors' steering committee was at fault in not monitoring the activities of KPMG and, because KPMG had to respond to a variety of creditor demands from within the creditors' steering committee, the scope of the accountants' audit had expanded beyond that of a due diligence report, resulting in considerable delay. Further, there was a genuine dispute on the fees chargeable by KPMG (which was however resolved subsequently) which delayed the issuance of their report. I should point out that phase 1 of KPMG's report was finally released on 26 July 2002 (after the first part hearing).

Notwithstanding the allegations surrounding the audit by KPMG, at the time of the hearing of the application to appoint judicial managers, the court had before it a report from that firm. In commenting on that report, the Judge said: "It would be fair to say that some findings in the KPMG report were a cause for concern."

As described by the judge, those findings included:

(a) Questions had arisen surrounding a purchase of a huge tract of land (1 759 hectares) for USD 170 million by AP&P's subsidiary Pindo Deli from a Sinar Mas company. In actual fact, the KPMG report stated that Pindo Deli as well as PT Lontar Papyrus had paid

USD 181.6 million (of which USD 110.5 million was in cash) to the controlling shareholders to purchase additional land (between January and September 2001), at a time when both subsidiaries were facing a cash crunch. Further, Pindo Deli already owned approximately 495 hectares of land of which only about 30% had been developed. There was therefore no reason to, nor had AP&P provided any plan which necessitated, acquiring such a large piece of land. Further, AP&P did not disclose the purchase until August 2001, after the debt standstill.

(b) Yet another transaction which caused disquiet were the advances totalling USD 504 million [from AP&P's Indonesian subsidiaries] to the wood companies, made mainly in the fourth quarter of 2000.

(c) Other transactions which made no commercial sense and which were clearly disadvantageous to AP&P's subsidiaries were, fresh pulpwood purchase agreements entered into in January 2001 by Indah Kiat with Abadi and by PT Lontar Papyrus with Sakti, even though the original agreements made on 23 May 1994 and 27 January 1995 respectively between the parties, were valid for 15 years. The onerous terms in Indah Kiat's agreement included being charged for wood at agreed prices, instead of the pricing being pegged to the actual cost of production. Further, Indah Kiat could not offset the advances it had made to Abadi, against the price of wood supplied by the latter. Far worse, both agreements provided for a penalty of USD 1 billion and waiver of all outstanding balances, if either Indah Kiat or PT Lontar Papyrus obtained wood from sources other than Abadi and Sakit respectively.

(d) One other questionable transaction was the debts of USD 1 billion owed to the company's Indonesian subsidiaries by five BVI companies. Although the company told the Asian Wall Street Journal that the five BVI companies were not related to AP&P, officers and agents of those companies which the journal spoke to, turned out to be AP&P employees.

The Indonesian subsidiaries filed ten suits against the five BVI companies in the Jakarta Central Courts for claims in excess of USD 1 billion. In April 2002, Indah Kiat obtained judgments against a number of debtors for about USD 242 million. However, five of the suits were discontinued subsequently. What was even more disturbing was the company's response to these events, as can be seen from the following paragraphs in [its] affidavit [filed on its behalf]:

> **315** The Indonesian Operating Subsidiaries chose to discontinue claims against five of the BVI companies because it was decided that, given the drain on management and manpower resources of the subsidiaries, it was better to focus our efforts on the more substantial claims.
>
> **316** There is simply no basis for the Petitioners to allege that these claims are not genuine transactions.

Both explanations were highly unsatisfactory and were no answer to the creditors/petitioners concerns which were well founded; the questionable nature of the five BVI companies and their apparent connection with the Widjaja family cried out for explanations which were not at all forthcoming. I found it hard to believe that the cost of manpower and other resources to be expended by AP&P were not commensurate with the huge sums to be recovered from the five BVI companies. What is even more puzzling is why the company's subsidiaries chose to commence proceedings in the Jakarta courts instead of in the companies' place of incorporation. What is the use if the judgments obtained cannot be enforced in the British Virgin Islands and the monies thereunder recovered? Obtaining paper judgments without more is not enough.

(e) Other questionable transactions included AP&P's selective payments to creditors in Indonesia and China after the debt standstill."

In addition to the payments made to creditors in Indonesia:

> On 5 February 2001 [the month before AP&P announced the debt standstill], the Indonesian Bank Restructuring Agency (IBRA) struck a new deal with the Sinar Mas Group on loans totalling USD 1.3 billion which the Group owed to its former subsidiary, Bank International Indonesia (BII).[1]

and:

> On 2 May 2001, AP&P clarified the settlement reached between the IBRA and the shareholders of the Sinar Mas Group regarding the debt of USD 1.3 billion owed by the Sinar Mas Group to Bank International Indonesia (BII). AP&P's principal subsidiaries in Indonesia each granted liens on all of their fixed assets (land, buildings and machinery), other than those fixed assets on which liens had been previously granted, to IBRA to secure the government guarantee in respect of the BII obligations. AP&P also granted liens on the shares of its Indonesian subsidiaries. For international creditors this means it has become much more difficult now to seize shares in those Indonesian assets as part of any legal settlement.
>
> The Sinar Mas Group also has pledged stakes in Sinar Mas-controlled holding companies that hold majority stakes in PT Arara Abadi and PT Wirakarya Sakti; [being the wood companies]. These two timber firms supply wood to AP&P's major operating companies PT Indah Kiat Pulp and Paper and PT Lontar Papyrus, but are not part of the AP&P Group itself. Through the sub-holding companies, the government gets 96% of Arara and 80% of Wirakarya. But …as part of the settlement, AP&P-subsidiary Purinusa Ekapersada has agreed to acquire 51% of the shares of Bank Internsional Ningbo, a Chinese bank previously majority-owned by BII.2

In June 2002, IBRA came to an agreement with some other creditors of the AP&P Group, one stipulation of which was to the effect that:

> ...IBRA shall share the benefits of all fiduciary transfers, security rights, pledges and guarantees that IBRA may have or may have the right to have, under the Settlement Agreement (collectively called "the Security") with the other unaffiliated creditors of the AP&P Group. In sharing such benefits, IBRA may retain the Security, but may enforce such security only for the benefit of creditors generally as shall be provided under the restructuring plan.

Without traversing the allegations made in the KMPG report, the bases upon which the AP&P Group resisted the application to appoint a judicial manager were principally that:

> Creditors whose support was critical to the success of any undertaking by a judicial manager were opposed to the appointment; and

1 *Paper Tiger, Hidden Dragons,* p40.

2 *Paper Tiger, Hidden Dragons,* pp. 44-45.

Judicial managers would not be able to take effective control of the AP&P Group.

In essence, it was these two issues that determined the fate of the application as the Judge found:

> Counsel for the Petitioners had repeatedly stressed that, the judicial managers to be appointed fully intended to work in tandem with IBRA and with the Chinese creditors to rehabilitate AP&P and to better realise its assets, that the appointees would not adopt a confrontational attitude. That may well be the noble intention but the more pertinent question to ask is, would IBRA and the Chinese creditors want to work/co-operate with the judicial managers? I think not, judging from the indications given so far by both IBRA and by the Chinese creditor banks…. Without the co-operation of IBRA and the [Chinese creditor banks], the judicial managers would not be able to make any headway in the discharge of their duties outside Singapore. It bears remembering that apart from being headquartered in Singapore, AP&P has no valuable assets here; its subsidiary Nippecraft Limited cannot be considered as it is a public listed company while no information was forthcoming from either party on the company's other Singapore subsidiaries. I noted further that the Petitioners' claims (and the debt instruments of other creditors whether supporting or opposing) did not provide for Singapore as the forum *conveniens*. The transgressions complained of by the Petitioners took place outside Singapore.
>
> Counsel had indicated that the Petitioners intended to assume control of the AP&P's Indonesian and Chinese subsidiaries by exercising the company's rights as a shareholder in the subsidiaries. With respect, I am not at all optimistic that the task can be so easily achieved by such a route. That may well be the case under our system of law but may not be so under Chinese and Indonesian law, given the anticipated opposition from creditors of those subsidiaries to the judicial management order in the first place, as well as the conflict in opinions from the parties' Indonesian and Chinese legal advisers [as to whether the courts and administrative authorities in those countries would recognise the judgment of the Singaporean court and the appointment of the judicial management].

By way of post-script, *The Jakarta Post* on 30 March 2004 reported as follows:

> **AP&P Seeks Support for Restructuring Plan**, Dadan Wijaksana, The Jakarta Post, Jakarta
>
> Asia Pulp & Paper Co. (AP&P), the world's leading pulp and paper producer, said on Monday it would not be able to obtain enough support from creditors for a debt work-out scheme by the 31 March deadline.
>
> The company is now seeking creditors' consent to extend the deadline to May 30, according to G. Sulistyo, deputy chairman of the AP&P's debt restructuring team.
>
> In October last year, AP&P signed an initial restructuring agreement for its huge USD 6.7 billion debts with a number of creditors, including the largest one–the Indonesian Bank Restructuring Agency (IBRA)–with around USD 1 billion owed.
>
> The Master of Restructuring Agreement (MRA) stipulates that creditors who hold at least 90 percent of the debts have to give approval to the deal before it becomes effective. The deadline to obtain this approval is the end of this month.
>
> "By then (May 30), we're optimistic we'll be able to secure the required approvals", Sulistyo told *The Jakarta Post* on Monday.

He claimed that most creditors had in principle showed no objections to the plan. "But the problem is, it requires a lot of legal and administrative work, which is not only difficult, but also time consuming", he said, adding that the creditors who had yet to give their approval to the deal were mostly US-based.

He did not elaborate on what the consequences would be if the extended deadline was not met.

The debt workout plan was initially signed by only 40 percent of the creditors.

Three years ago, the Singapore-based AP&P defaulted on its USD 13.9 billion of debts, and restructuring talks have been underway ever since.

The MRA's signing was part of those restructuring efforts, but only covers debts owed by AP&P's four Indonesian units: PT Indah Kiat Pulp & Paper, PT Tjiwi Kimia, PT Pindodeli Pulp & Paper and PT Lontar Papyrus Pulp & Paper Industries.

Despite the signing, however, it is doubtful that AP&P can obtain enough support from creditors as many have previously objected to the deal–which they claim is in favour of the company's founder, the Widjaja family, rather than the creditors.

Critics point out, for instance, that the Widjaja family will continue to run the daily operations of the four firms, while the payment of the first tranche of the debts–amounting to USD 1.2 billion–would only be payable after 10 years.

Part II

TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK MANAGEMENT IN SOUTH EAST ASIA

TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK MANAGEMENT: A REGIONAL COMPARATIVE REVIEW

by
Lampros Vassiliou*

Introduction

This paper contains a review of trends and developments in the insolvency systems of the following selected economies: Hong Kong, China; Chinese Taipei; Indonesia; Philippines; Thailand; Vietnam and Singapore. This paper also contains a review of trends and developments in risk management systems in the selected economies with a special focus on credit information systems and credit risk transfer instruments. These reviews are based largely on country papers submitted by country representatives[1] to the Fourth Forum on Asian Insolvency Reform 2004, together with the observations of the author. This paper aims to consolidate the country reports and provide a comparative review of trends and developments in the insolvency systems and credit risk management systems in the selected economies.

Main trends and developments

As odd as it might sound, Asia is better off for the Asian economic crisis which started in 1997, at least from the perspective that there has been a dramatic improvement in the insolvency systems and in credit risk management in most economies. The evidence of this is quite simple in many cases. Countries that did not previously have an insolvency system or had systems that were outdated or rarely used, have developed well-utilised modern insolvency systems which can be regarded as on the cutting edge of global developments. The improvement in risk management practices is evident from the mere fact that loan classification criteria that were outdated and loose have been improved so that an accurate assessment of a country's level of non-performing loans (NPLs) can be made. In both cases, however, abuses endure and there is always room for criticism. But, overall, the improvement is marked.

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In many of the developing economies in Asia, there remains a lack of transparency and information that frustrates risk management efforts by financial institutions. Whilst some banks have developed ahead of others, there has often been an inadequate development of international credit risk management processes in many banks in the developing economies in Asia. Of equal concern in some developing economies is the nature of some of the present lending activity, especially where there has been a significant and rapid credit expansion. Short institutional memories are already leading to reckless lending and poor risk management practices similar in some respects (but also probably more diversified and complex) to those predating the Asian crisis.

Longstanding NPLs, which are often hidden, fictionally rescheduled NPLs and new NPLs are veiled by recent economic growth. As an almost direct affront to the proponents of dealing with NPLs efficiently, countries like China, the Philippines and Vietnam (who to date have probably made fewer realistic attempts to deal with the longstanding NPL overhang) have seen the largest level of GNP growth. Of late, growth throughout the Asian economies has been outstanding despite the baggage of NPLs. However, the hidden, veiled or simply unresolved NPLs leave economies vulnerable to higher interest rates or economic shocks.

There has often been an inability to accept the role of foreign investment in bridging the funding gap for the workout and resolution of NPLs and in the funding of the activities of asset management companies (AMCs) and asset reconstruction companies (ARCs). The secondary debt markets and disposals of NPLs replace the funding void due to the absence of effective insolvency systems. There has also often been an inability to accept the true purpose of AMCs and ARCs and the role of distressed debt investors. Furthermore there is a lack of political will to provide the necessary incentives to allow them to operate effectively.

The NPL disposal and restructuring programmes through AMCs and other vehicles have been slow in a number of developing countries and have often lacked adequate transparency. The delay in drawing new investment in NPLs and distressed businesses has lead to assets being left idle or poorly managed and economic value being lost. The focus in some countries on the structure of AMCs and ARCs seems to assume they will be around for the long term when, in reality, these vehicles should be a short-term emergency solution in which you allow the sponsors to make fantastic profits so that they are enticed to put capital into risky distressed assets.

Where AMCs have been used successfully, they have commonly been accompanied with a concession granted to the transferring banks, which allows them to amortise their losses on sales over many years, as an incentive to entice the banks to sell their debts. The result of this is that the balance sheets of the banks do not accurately state their true positions as they carry assets (sometimes called deferred assets), which are not real and do not record losses which have already been suffered. AMC, SPV and securitisation structures have also been used as ways of circumventing foreign ownership restrictions and have enabled foreign investors to control assets they would otherwise be prevented from accessing.

Aside from the rush of legal reform in the immediate post-economic crisis period, insolvency law reform has been slow in a number of developing economies like Thailand and the Philippines and even slower in some of the more developed economies like Hong Kong, China and Singapore. The design battle between pro-debtor and pro-creditor systems has been lost by all. Delay and loss of value have been the only results as long-awaited and endlessly debated proposed laws were neither finalised nor enacted.

The implementation gap between the design and implementation of laws remains in most developing economies. There is an over-complexity in the focus of legal reform. Highly developed

AMCs and ARC laws, cutting edge rehabilitation laws and specialised laws to facilitate investment in NPLs and distressed assets through asset backed securities, and special purpose vehicles and securitisation techniques have been enacted in countries where there is no effective liquidation procedure as a backbone for the insolvency system, limited and ineffective secured transactions laws and poor corporate governance. Whilst there have been some effective developments, the same underlying problems often remain; fundamental elements of the system have not been developed in many countries

Governmental interference in restructuring activity has been unpredictable and, consequently, ongoing fears for investors and bankers have been priced into the cost of credit. Countries with clear and predictable policies have benefited from maximising NPL values and refocusing their economies on growth. Countries that have not done so seem to have prospered as well.

Nationalistic concerns have lead to an excessive focus on developing individual systems without an acknowledgment of the benefit of having similar systems on a regional and global basis. The undeniable logic of that seems to be easily accepted in the context of risk management and the Basle accord, but seems to be resisted on the micro level of the resolution of debtor and creditor relationships and insolvency systems.

There is an inadequate focus on the long-term development of systems. Instead there is a focus on balancing short-term interests without understanding that, even if systems put in place in the short term do not work perfectly or causes harsh results, the long-term growth prospects of the economy will be enhanced by evolving efficient and effective systems. In the short term, even if there is not an efficient insolvency system, the government or the banking sector can set out policies and consequences which force parties into informal workouts. Notably, there is a movement to developing unified standards to provide international benchmarks and recommendations for informal workout practices and, in particular, for structured workout practices.[2] However, institutional developments, capacity, and regulation have still not received sufficient focus in the developing economies in Asia.

Credit information systems have developed with various degrees of success. In some developing countries they seem to focus on good information about loans rather than bad information about defaults. Moreover, these systems, even in countries where significant progress was made, barely touch the surface in grappling with the complex company structures used by many Asian borrowers where family ownership and complex corporate structures are commonplace. Rarely is the information held in these systems of adequate detail to be substantively useful.

There is a reluctance to pay for true experts with integrity to handle and advise on NPL resolution. Instead, practitioners with questionable ethics have prospered. Regulatory hurdles have not been successful in excluding or eliminating crooked or corrupt players. There is a failure to appreciate the degree of knowledge transfer that can occur as a result from engaging international experts with integrity to work with local practitioners to handle the very difficult challenge of resolving distressed situations. There is a failure to appreciate the value added by experts with integrity and talent.

Eventually, there will emerge countries with good systems that will benefit from cheaper credit, and countries with bad systems that will suffer, whose long-term economic development will be significantly hampered in the global economy. Against this, however, is the undeniable fact that, at present, many countries in the region with poor insolvency systems and poor credit risk management enjoy low credit costs and relatively high economic growth. This dampens the movement towards improved systems. Despite this, governments and industry have enough vision to continue the movement forward and are striving to create efficient and effective insolvency and credit risk management systems.

Insolvency systems and credit risk management

The progress of legal and institutional reform has varied greatly across the region in the last year. New insolvency laws were passed in 2004 in Indonesia and Vietnam and significant progress has been made in finalising China's long awaited Enterprise Insolvency Law. Bankruptcy law reforms in the Philippines and Thailand have stagnated, as has the long-awaited proposed streamlined corporate rescue regime in Hong Kong, China known as provisional supervision. Singapore's anticipated Omnibus legislation has also progressed slowly while in Chinese Taipei there has been reform of the Bankruptcy Law.

Hong Kong, China

Hong Kong, China's provisional supervision law has still not been enacted and many now doubt that it ever will. The proposed law has attracted opposition primarily because of its approach to the treatment of workers' claims and directors' responsibilities. The existing procedures for arrangement are rarely used in practice. Instead, of late, the courts have allowed the provisional liquidation procedure to be used to facilitate corporate rehabilitations. The leniency of the courts in this respect has acted to fill the legislative vacuum. There is also a developed industry of using the listed corporate structures of insolvent entities to achieve back door listings on the stock exchange.

Out-of-court workouts are popular and can be conducted under The Hong Kong Approach to Corporate Difficulties, which is an agreed structured informal workout process by financial institutions. Hong Kong, China has the luxury of an effective secured transactions lending regime which permits fixed and floating charges based on the English model, and allows financial institutions to enforce their charges through the appointment of receivers and managers. The liquidation regime is also effective and well used–the number of winding ups reached record levels in 2003. The court system is independent and effective, and there is well-developed use of expert insolvency professionals, although there have been recent challenges to the level of professional fees.

Hong Kong, China has had fairly low levels of NPLs to date, and most defaults are worked out through the formal insolvency system or through informal workouts co-ordinated by lenders working together. Transparency levels are high for the region, evidenced in both the banking and corporate sectors. The Hong Kong Monetary Authority operates as a combined central bank and regulatory commission in the financial sector and is effective in imposing high levels of transparency in the financial sector. Capital adequacy ratios are high, and exceed the required Basle 8% in all cases. Hong Kong, China will lead the region in the implementation of Basle II. In the corporate sector, the level of disclosure is also high with corporate results published in local newspapers. There is, however, a reluctance to bring bad information to the market and a pattern of late filings of negative information.

Loan classification criteria are detailed, with banks using their own criteria linked back to the HKMA 5-category system. Value-at-Risk (VaR) measurement of market risk is almost universally used. VaR figures are regularly disclosed in the footnotes to the accounts. More recently, some larger banks are extending VaR methodology to credit portfolios.

AMCs have not been used in Hong Kong, China. There have been some bulk sales of NPLs involving USD 1.8 billion in NPLs. A Deposit Protection Board has been established. The board will be able to start collecting contributions and provide deposit protection in 2006.

Securitisation is also used extensively, although it is not used as a tool to reduce NPLs but rather as a means of adjusting the structure of loan portfolios and generate cash. The Hong Kong Mortgage

Corporation (HKMC), a public limited company wholly-owned by the government, was set up in 1997 with a view to developing Hong Kong, China's secondary mortgage market by purchasing mortgage loans for its own portfolio. It is funded largely through the issuance of unsecured debt securities and securitising mortgages into mortgage-backed securities which are offered for sale to investors.

Thailand

Thailand was one of the most activity law reformers in the period immediately following the crisis. The Bankruptcy Law was amended in 1998 to allow for corporate reorganisation and a specialised Central Bankruptcy Court was established. The reorganisation procedure was well utilised in the 2000-2003 period when many cases were brought following pre-packaged workouts conducted under the CDRAC process, which has now ceased operation. Confidence in the procedure began to wane as abuses of gaps and other tricks began to give debtors a preference in the administration of the procedure. Even though the system was designed to enable independent planners to be appointed and permit creditor-led rehabilitations, the reality has been that most rehabilitations are debtor-led, as creditors are reluctant to appoint their own planners due to concerns about vexatious litigation being brought by a recalcitrant debtor, security issues and cost issues. In practice the system has become a quasi debtor in possession system, where debtors appoint themselves or controlled vehicles to act as planners. The class voting system has also allowed debtors (who are able to gain control of, convince or otherwise influence one class of creditors and a bare majority of 50% of the debt in value) to pass rehabilitation plans which are greeted with fierce protests from other creditors (alleging unfair treatment) or reluctant acceptance (brought on by creditor fatigue which arises from the lengthy delays which can be experienced in the plan formulation and amendment process).

One of the few exceptions has been the Thai Petrochemicals Industry case, where creditors have led the rehabilitation. Nevertheless, the debtor has continued to struggle for many years with countless lawsuits, one of which was successful in removing the creditor's planner. After some contest, the replacement planner selected was the Ministry of Finance, which successfully drove through a plan passed by creditors and approved by the court, although the debtor continues to fight through the courts.

Bankruptcy Law reform has been on the political agenda for some years now. Despite widespread debate during the recent elections which returned Thaksin Shinawatra as Prime Minister, proposals to formally convert the reorganisation procedure into a debtor in possession system and automatically release guarantors on plan approval have not, as yet, been adopted and seem to have slipped back in the political agenda. In the area of secured transactions, the public auction process has been improved significantly under the management of the Legal Execution Department with clearer bidding and auction processes as well as a movement to more realistic reserve prices and bulk sale approaches. The Thai Asset Management Corporation has continued operations focussing on restructuring rather than disposal; although a lack of detailed public reporting leaves its performance open to debate. The lapsing of the period for the establishment of mutual funds to enable investment in distressed assets has, when combined with the end of CDRAC and loss of confidence in the reorganisation procedure, led to declining activity in restructuring even though a significant level of NPLs remains and some of the reschedulings are in need of reworking. The present focus on developing the capital markets and securitisation has met with a healthy degree of initial success.

Some of the lessons learned and applied after the crisis seem to be falling away at present. It is true that there is a greater focus on cash flow analysis rather than simple collateral and relationships as the basis for lending. There has been a flood of new real estate projects although the funding does seem to be more prudent than that which occurred prior to the 1997 crisis. Whilst housing mortgage lending has also expanded significantly, many banks have centralised procedures and seem to be more

prudent, complying with a requirement that they lend no more than 70% of the appraised value of the property, although there are notable exceptions, with loan approval practices varying significantly in some banks. There is a movement toward compliance with Basle II requirements, with a movement away from rule-based requirements toward risk-based and market oriented prudential consolidated supervision by the Bank of Thailand. The Bank of Thailand's recent investigation into imprudent lending by Krung Thai Bank, the largest state bank, and the refusal to allow the reappointment of its president were high points in last year's supervision activities.

There are prudential rules as laid out in the Commercial Banking Act which limit the size of large exposures and the concentration of loans to single group or borrowers, and prohibit connected lending to directors or bank executives and families persons or legal entities in which banks have an equity share. However, nominees and indirect ownership structures have been used to circumvent these regulations. A proposed Business Financial Institutions Act is expected to deal with these loopholes.

There remain significant levels of NPLs and a lack of true operational restructuring which suggest that Thailand is by no means out of the woods yet, though present growth levels have been impressive.

Philippines

In the Philippines, non-performing assets (NPAs), which include NPLs and acquired or foreclosed assets known as ROPOAs–many of which have sat on the books of banks for years–remain at high levels and are the most significant problem facing the banking system. The success of the banks in foreclosing on assets and in debt for assets swaps (*dacion en pago*) is unquestioned although the ready availability of temporary restraining orders or TROs does create a moral hazard for some borrowers.

Similarly, the ability of many banks to adequately restructure or dispose of those acquired assets has, until recently, been lacking. The legal environment to support creditor rights and debt enforcement has been widely regarded as unsatisfactory. There have been a number of legislative changes together with the abrupt transfer of jurisdiction over insolvency cases in 2000 from the Securities and Exchange Commission to the regional trial courts which, whilst commendable, initially hampered efforts at restructuring. The regional trial courts had little experience in dealing with insolvency matters, although the Special Commercial Courts that have now been designated to handle insolvency matters have received a significant level of judicial training and seem better placed.

Jurisdictional and constitutional uncertainties continue to underlie the court's operations, even under the new Supreme Court's Interim Corporate Rehabilitation Rules. The Supreme Court's supervision of the Special Commercial Courts has restored a degree of confidence in the system, but concerns about corruption and improper influence, which also applied to the SEC, persist. There is no licensing system for receivers or structured training programmes and there is worry about the ethical conduct and limited experience of receivers in properly administering cases.

The deficiencies in the legal system have contributed to the deteriorating quality of bank loan portfolios, while efficient foreclosure laws have resulted in banks becoming inefficient holders of substantial property portfolios. The depressed real estate market following the Asian economic crisis, lengthy statutory redemption rights of borrowers (previously up to one year; but now reduced to three months) following foreclosure, the ease of obtaining temporary restraining orders, and an inadequate registration system to facilitate prompt sales with clear titles have resulted in banks holding ROPOAs for extended periods.

Uncertainties in the system, delays in legal reform, together with economic, political and social developments in the Philippines, limited the foreign and domestic investment in distressed assets and companies needed for recovery. This occurred despite legislative inducements such as the SPV legislation introduced in 2002 under which a special legislative framework was established to enable investment in distressed assets, providing special taxation benefits and fee reductions where investment is made through a registered special purpose vehicle.

Despite an extended period of inactivity, it is expected that in the latter half of 2004 and in 2005, there should be a dramatic increase in the use of the SPVs as the deadline of April 2005 for transfers to the SPVs draws close. It is anticipated that there will be a wave of transfer activity from financial institutions to SPVs similar to that experienced in Chinese Taipei in 2003. There are proposals in Congress to have the law amended by extending the deadlines for transfers past April 2005 and the Central Bank has proposed to extend the period in which transferring banks can write off their losses on sale from seven to ten years as an incentive to induce transfers. There is also some potential for the use of the Securitisation Law passed in 2004, and it is expected that 2005 will see some new securitisations. The high levels of growth in the Philippines of late have, perhaps, helped to create the environment for dealing with the overhang of the substantial NPL problem.

The principal laws in the Philippines governing corporate insolvency and rehabilitation are the Insolvency Law, enacted in 1909, and Presidential Decree No. 902-A, enacted in 1976, although following the transfer of jurisdiction from the SEC, the Supreme Court's rules on rehabilitation and intra-corporate disputes have really been the basis for most formal insolvency activity.

Recent proposals for insolvency law reform have been hotly debated, with opposing policy views delaying progression of the proposals. Despite years of work through committees of Congress, the proposed Corporate Rehabilitation and Insolvency Act has still not be passed and it is feared that the extensive work of the committees could be lost as the latest proposed drafts revert back to the original bill first put to Congress. During 2004, there were also amendments to the charter of the Philippine Deposit Insurance Corporation and the Central Bank's charter to improve the handling of the insolvency of banks. Reform of the legislation relating to the Philippines Deposit Insurance Corporation (PDIC), which increased the level of deposit insurance on certain bank accounts from PHP[3] 100 000 to 250 000 to bring the total amount of cover to 21% of total deposits, was coupled with the re-enactment of the examination power of the PDIC, which was repealed in the General Banking Law of 2000.

In the last few years, most banks are said to be flush with cash, with high capital adequacy ratios. But they are not lending, as there is a limited number of good borrowers to whom to lend. Instead, banks are investing heavily in government treasury bonds. These are a poor substitute for lending. It is difficult for distressed debtors to obtain new working capital facilities or other new money to assist them in restructuring their businesses in a workout scenario. It is noteworthy that financial advisors do not seem to have had as active a role in restructurings as has been seen in other countries in the region. Banks generally represent themselves in restructurings and the role of financial advisors is limited.

The Philippine Stock Exchange is viewed as more vigilant in the enforcement of its disclosure rules, which apply to listed companies, than the SEC in its application of its disclosure rules which apply to public companies or companies having issued registered securities, many of which are not listed. The Bankers Association of the Philippines and the Philippine Stock Exchange have made significant progress in establishing a fixed income exchange for the trading of debt instruments together with a Qualified Buyers Board.

Credit information is poor and credit decisions are often based on unaudited financial information. The Central Bank (BSP) is pushing banks to obtain externally audited financial statements from 2005 and has attempted to improve bank credit risk management practices through the issue of a number of regulations setting out guidelines for: the granting of loans; the management of large exposures and credit risk concentrations; dealings with directors and other related parties; limits on loans to a single borrower; and requirements for internal credit risk rating systems (which must be approved by the bank's board of directors, and designed and implemented by an independent credit risk control function).

Each bank must also have a Risk Management Committee (RMC) composed of at least three members of the board of directors. The RMC shall be responsible for the development and oversight of the bank's risk management programme. Specifically, the RMC shall identify and evaluate risk exposures, develop risk management strategies, implement a risk management plan, and review and revise the said plan as needed. A Financial Markets Risk Reference Manual has also been issued which is the basis for commercial bank risk management policies and practices. For credit risk, it prescribes the ideal structure of a bank's Credit Risk Management Organisation, the establishment and operation of a sound credit granting process, the establishment of credit monitoring systems which will track the composition and quality of the credit portfolio, as well as compliance with the banks' internal credit limit and concentration policies. The banks are required to adopt the core public disclosure requirements, which are risk focussed, as prescribed by the Basle Accord, although implementation is in its infancy.

Vietnam

Vietnam's growth, like the Philippines, also has hit high rates, and trails only China in the region. There has been a remarkable expansion in credit. Vietnam has been undergoing impressive and sweeping reforms at an accelerated pace over the past decade in its transitions to a socially-oriented market economy. However, there has been a longstanding NPL problem which remains unresolved and is concentrated mostly in state-owned enterprises.

There have been some notable improvements in the area of secured transactions. Land use rights (land itself is largely state-owned) are now transferable and can be mortgaged, although wide variances in registration practices limit the utility of land use rights as a major form of collateral. The system of registration at the provincial level was officially transferred to the Ministry of Natural Resources and Environment (MONRE) on 1 July 2004, when amendments to the Land Law took effect. Several decrees have been issued recently in relation to the Land Law and will be operational from 1 January 2005. Security over movables is registered with the National Registration Agency of Secured Transactions (NRAST), which became operational in March 2002, and is generally regarded as an efficient process by the banks that use it.

Not all banks use it. Enforcement of judgements is rare and there are currently approximately 17 000 cases pending. Auction procedures are inefficient, slow and unreliable, and hampered by lost paperwork, requirements for registration and approval by many parties.

There is a strong stigma associated with bankruptcy and a tendency to look to hold someone criminally liable in every bankruptcy. There is an unwillingness to acknowledge that some failure is a natural consequence of market activity where there is no criminal wrongdoing.

Proceedings under the prior 1993 Bankruptcy Law were rarely brought and although a new Bankruptcy Law, which is a vast improvement over the 1993 law, became effective on 15 October 2004, its design features fall short of best practice. It lacks a modern rehabilitation

procedure to rescue viable businesses and retains the use of unwieldy committees to administer cases. It also fails to involve secured creditors adequately. It is hoped that a number of the remaining gaps in the new Bankruptcy Law might be addressed though implementing regulations. Inefficient court procedures and the inability to handle more than a very small number of cases per year contribute to a backlog of cases.

Under a directive from the State Bank of Vietnam, the state-owned commercial banks were required to create AMCs. Each bank has adopted a different approach, with some banks having AMCs manage assets without having the assets transferred to them. There are a number of problems with the functioning of the AMCs, and it would seem there is little expertise in their management and inconsistent interpretations of their objectives. To date, the AMCs have not significantly affected restructuring activity in Vietnam.

In early 2004, the Ministry of Finance created the Debt & Assets Trading Company (DATC). The DATC was capitalised with VND[4] 2 000 billion (approximately USD 130 million) and given a mandate to resolve the long standing NPL problem of SOEs in an effort to accelerate the reform of SOEs. Unlike the AMCs established by the commercials banks that focus on the NPLs and NPAs of the commercial banks that own them, the DATC will primarily deal with NPLs and NPA of the SOEs.

Most of DATC's targeted NPLs and NPAs have been outstanding for a long time, and remain unresolved after numerous attempts to settle them by the government. Many of these NPLs are clean loans extended to loss-making SOEs without collateral. The DATC has no special powers to assist in its operation. It must comply with all laws and has no tax exemptions or other exemptions to facilitate its activities. To date, the DATC has done a number of deals with 20 enterprises. It is estimated that by the end of 2004, DATC could purchase some VND 200 billion of NPLs and distressed assets from enterprises. Its limited number of staff has not yet received detailed training in the operations of an AMC. The DATC, if provided with adequate resources and training, could offer a realistic solution to the longstanding NPL problem.

In Vietnam there are serious concerns about the quality and recoverability of loans. In the recent past, banks often preferred investing in treasury bonds with relatively high returns over lending as lending involves more risk and often lower returns. However, there has been an astounding growth in credit in recent years. Growth was 28% in 2003 alone. Despite this, there is still trepidation towards lending to private sector SMEs and other non-SOEs.

State-owned commercial banks (SOCBs) are often unable to determine with reasonable precision the cost of their own funds. The four large SOCBs hold the majority of NPLs in the banking system and have low capital adequacy ratios of around 3.5%. The ratio of bank credit to GDP is about 50%. Most of the bad loans that have accumulated are the result of soft policy loans made to inefficient SOEs before 1998-1999.

A significant portion of NPLs has been resolved by the four SOCBs, via loan loss reserve write-offs and realisation of secured assets, assisted by a fortuitous increase in real estate prices. Local banks make long-term foreign currency loans when their deposits are short-term and denominated in dong. At present, some foreign bank branches in Vietnam do not assign a risk weight to collateral, as the legal enforcement system has never been tested for foreign banks. In some cases, the local Peoples Committee guarantees a loan–but the bank cannot sue them. There is also a non-payment culture. There are many strategic debtors who are able to pay, but choose not to.

The true level of NPLs is unclear. Current NPL figures are not made public on a regular basis. The banking sector comprises four main SOCBs that have around 80% market share, 36 joint-stock

banks, and 29 foreign bank branches in Vietnam. It is estimated that SOEs owe 70% of the NPLs. Unofficial estimates of the national NPL ratio vary significantly, with figures of 0% to 75% being mentioned. The Central Bank has established NPL targets for each of the banks. As banks wish to be seen to be within their targets, they often report NPL levels of less than 1% although the credibility of the classification criteria is questionable. Banks are not required to publish their balance sheets in newspapers or otherwise. Under the present loan classification scheme, the entire principal is deemed to be an NPL if a portion of the loan is overdue.

Three primary approaches to the resolution of NPLs have been adopted: 1) debt write-offs using provisions or recapitalisation funds; 2) debt reschedulings; and 3) assets or collateral. NPLs are to classified into three categories: 1) NPLs with collateral that are to be liquidated or sold to an AMC that will resolve them; 2) NPLs without collateral where the debtor is not operational that are written off with support from the SBV; and 3) NPLs without collateral but where the debtor is still operating that are classified by assessing the viability of the debtor and resolved by rescheduling or reinvestment in the debtor to get the loan back gradually or through SBV support for a write-off, where appropriate. Banks routinely write off NPLs by using their provisions or recapitalisation funds provided by the state. The four SOCBs are unable to make adequate provisions for loan loss reserves from their own assets while still generating profits.

Debt freezes, popular in the past, have given way to the more popular approach of debt reschedulings, although there are still examples of freezing. Often, the bank will work with government authorities to try to obtain recovery of the debt. Rescheduling is subject to SBV regulations, but the common practice is to structure transactions to avoid these regulations. For long-term and medium-term loans, (medium-term loans normally run one to five years and long-term loans, over five years) the maximum period for which the debt can be rescheduled is half of the original loan period. For short-term loans (loans that run for less than 12 months) the maximum period for which the debt can be rescheduled is 12 months. There can be more than one rescheduling, but the maximum period of rescheduling in total cannot exceed the maximum periods specified by the SBV regulations. These are avoided in practice by giving a borrower new loans, which are then used to repay its NPLs (or those of its related companies). The SBV does carry out inspections to identify this and punishment can be handed out for such avoidance. However, it is understood that this avoidance technique remains a common practice. Similarly, the SBV-directed maximum lending limit of 15% to one borrower is avoided by lending to related companies.

Financial reporting standards are generally poor so that lending decisions tend to be based solely on the availability of collateral. Only 20% of registered enterprises provide financial reports and most reports are of poor quality. 90% of SOEs provide tax reports, but these are not public. Banks cannot base their lending decisions on the state of the company or the financial reports and, therefore, for most enterprises, the decision to lend is based purely on the collateral provided.

Basle II requirements are on the agenda and there is a move for all banks to develop credit manuals which are designed to adopt best international practices in risk management. However, there is long road ahead in this respect.

Chinese Taipei

Chinese Taipei is an outstanding success in dealing with NPLs, although it is not without critics. Its success has been remarkable. It has even exceeded its own goals in reducing NPLs in the banking sector through disposals to private AMCs, and the use of the Financial Restructuring Fund (which became known as the RTC based on its similarity to the Resolution Trust Corporation used in the USA during the savings and loans crisis).

A series of bulk NPL sales in 2003, mainly through auction procedures, reduced the total NPLs in the banking sector from their 2002 peak. The government's 2-5-8 programme requiring the reduction of NPL ratios to 5% and the raising of BIS ratios to 8% within two years (by 31 December 2003) was met and exceeded, though a number of banks remain above the 5% NPL ratio level.

A number of regulatory incentives (including a reduction of taxes on real estate transactions, a reduction of taxes to encourage write-offs of NPLs and a five year amortisation period for banks to write off losses arising from the sale of NPLs to an AMC) spurred the market into action. The strong legal framework was also a factor in drawing international investors into the market.

However, little has occurred by way of restructuring loans following their transfer to the AMCs. The true challenge now facing Chinese Taipei is whether the NPLs that have been transferred to AMCs can be restructured by realistic financial restructuring and true operational restructuring of borrower enterprises. In addition, the banks were given five years to amortise their losses from the transfers of NPLs to the AMCs at discount. This means that the financial accounts of banks do not, at present, state their true position, as assets are overstated and losses not fully realised. This amortisation was provided as an incentive to entice the banks to sell.

Loan classification criteria have only recently been amended to comply with international standards of requiring loans to be classified as NPLs if they are overdue by three months. The new classification criteria will be implemented in 2005 and are expected to increase the level of NPLs.

Amendments to the Bankruptcy Law were proposed by the Judicial Yuan and endorsed by the Executive Yuan in mid-2004. The amendments are substantial and include allowing: the court to order the liquidation of the debtor's assets without going through the whole bankruptcy process if the total amount of the debts claimed by the creditors is under TWD[5] 3 million; salaries a priority subject to a six month limit; and allowing foreign judgements to be enforced against the bankrupt's assets in Chinese Taipei if such foreign settlement or judgement has been recognised by the Chinese Taipei court.

The Financial Asset Securitisation Act was enacted in July 2002. The MOF promulgated eight sets of regulations to facilitate the implementation of the act. The act provides significant tax incentives for participating companies. For example, the interest payments distributed to investors are subject to a lower withholding tax rate and are taxed separately from personal or corporate income. As of 21 September 2004, a total eleven of applications were approved.

The latest securitisation product application, approved by the FSC on 16 September 2004, is Asset Backed Commercial Paper (ABCP) secured by corporate accounts receivable. The ABCP is the first securitisation product of corporate accounts receivable that has ever been issued in Chinese Taipei. The value of outstanding securitisation shares is approximately TWD 5.7 billion. A Real Estate Securitisation Act was also enacted in July 2003 which permits Commercial Mortgage Backed Security (CMBS) and Real Estate Investment Trusts (REITs). As of 21 September 2004, two applications for CMBS were approved by the authorities but no applications were filed for REITs.

Within the past three years, the government has made efforts to encourage the merger of financial institutions by providing tax incentives and more flexible merger models available under the Financial Holding Company Act (enacted in November 2001). As a result of government's efforts, 14 financial holding companies were successfully established by the end of August 2004. Notwithstanding the establishment of these holding companies, as of the end of August 2004, 50 local banks and 313 co-operatives were still in operation to provide bank services to a population of only 23 million. No bank has more than a 9.5% share of the market. Overbanking is a serious problem and the authorities hope

that: 1) by the end of 2005, there will be at least three financial institutions with market shares of at least of 10%; 2) by the end of 2006, there will only be seven financial holding companies in the market; and 3) by the end of 2006, at least one of the local financial institutions will either be operated by a foreign financial institutions or offer its capital shares overseas.

China

China remains the largest market for NPLs and the most watched. In 1998, the Chinese government injected CNY[6] 270 billion into four SOCBs. In 1999 and 2000, four AMCs were established to acquire approximately CNY 1.4 trillion of NPLs from the four SOCBs, which had arisen mainly as a result of the directed lending the SOCBs were required to undertake. The AMCs set about resolving the NPLs through either restructuring or further disposals to foreign and domestic investors. The slow progress of closing deals on NPL dispositions from the four AMCs to foreign investors has been subject to extensive criticism. Of late, activity seems to have increased with a stream of sales to domestic investors, a small amount of sales to foreign investors, an increased amount of joint venture activity between foreign and domestic investors in the provinces, some interesting bilateral deals with foreign investors (such as the Great Wall AMC bilateral deal with Citigroup), sales by AMCs of portfolios to CINDA AMC and an increased focus on securitisations.

The disposition market is extremely competitive. Stricter loan classification rules have been implemented recently and clearer NPL figures should be available in 2005. If AMC-held NPLs and government supported loans were added to the figures, NPLs are still rising in China, where the authorities are doing their best to maintain stability and cool a potentially overheated economy by limiting lending to overheated industries. When the downturn eventually comes or when an external shock causes the outstanding growth to decline, the real effect of China's baggage of NPLs will be felt. As WTO commitments to open the financial sector to foreign competition by the end of 2006 loom large and as increasing pressure is applied for there to be a revaluation of the Yuan, it may well be that 2005 sees increased activity in NPL resolution. 2006 may well be the year when China sees real progress in dealing with the huge NPL problem.

After more than ten years of debate and consideration, the National Peoples Congress also looks set to pass a new bankruptcy law known as the Enterprise Insolvency Law. The new bankruptcy law is expected to be passed in mid-2005, after final consideration by the National Peoples Congress was delayed in late 2004 to allow further consideration of a number of highly debated issues.

One of the most controversial issues concerns the priority of employee claims. A detailed consideration of various schemes used around the world was undertaken. Employees in China can be unpaid for many years and there has been a push to afford them absolute priority over secured creditor claims, though it is hoped by the financial community that the final position may involve a more tempered limited priority. Liquidation, administration and conciliation processes are permitted under the proposed law, though there are proposals to remove the conciliation procedure. Under the new law, administrators may be appointed to restructure enterprises subject to the law, a move away from the committee approached used in the 1986 Bankruptcy Law which applied to SOEs.

There is debate as to whether the court or the creditors meeting should appoint the administrator. Debtors and creditors can commence proceedings. The draft law presently provides that the insolvency of SOEs will be handled pursuant to rules and regulations issued by the State Council "prior to" the date of implementation of the draft law. The rationale behind limiting the applicable regulations is that, in the future, when the existing regulations' time limits for applicability expire in 2008-2009, SOEs will be treated the same as private enterprises. It is understandable that SOEs are in a transition period and that special regulations issued in the past should be allowed to continue until

they are fully implemented. There are some 2 000 SOEs that are scheduled for "policy bankruptcy" under these existing regulations.

In the future, however, the intention of the draft law is that the same regulations should apply to SOEs and private enterprises to ensure a level playing field. The existing regulations are, therefore, not entrenched forever, though it is acknowledged that there is a need to complete the transition and allow the existing regulations to continue to apply for an interim period. Though there are numerous other issues still to be considered, it is fair to say that the law is almost finalised. It is hoped that it will start to operate in 2006, although 2007 may be more likely.[7]

The establishment of the four AMCs was intended to pave the way for the banks to be developed into modern financial enterprises operating on a truly commercial basis and accountable for their operational decisions and related losses. Further efforts were made to strengthen bank corporate governance and risk management. At the end of 2003, a pilot programme was launched for the Bank of China and the China Construction Bank which aimed at transforming the two banks into modern and internationally competitive joint-stock commercial banks within three years.

The CBRC has set out ten requirements for good corporate governance and seven performance indicators benchmarked to the top 100 largest banks globally according to which the banks should: 1) have a sound corporate governance structure comprising the general shareholders meeting, a board of directors, a supervisory board and an executive management team; 2) invite the participation of domestic and foreign strategic investors to form synergies; 3) set out clear business strategies; 4) build sound decision-making processes, internal controls and risk management systems; 5) reduced layers of hierarchy and streamline business processes and procedures; 6) adopt a market-oriented human resource management system that highlights accountability and motivation; 7) have in place policies and procedures for prudent accounting practices and sound disclosure; 8) establish an up-to-date information technology system to ensure quality management and services; 9) provide staff training and talent recruitment; and 10) give a full roles to financial intermediaries in the process of joint-stock restructuring.

The seven performance benchmarks include the following ratios: net Return on Assets (ROA); net Return on Equity (ROE); cost/income; non-performing assets; capital adequacy; largest exposure and NPL provisioning coverage. The CBRC has also developed a number of new supervisory concepts, including: 1) conducting consolidated supervision with attention focused on the overall risks of each banking institution; 2) staying focused on risk-based supervision that stresses the identification, early warning and control of systemic risks; 3) underpinning strong internal controls at banks; and 4) enhancing the disclosure of both banking institutions and supervisors so as to underpin transparency. The right ideas are all in place. Time will tell if they can be put into practice.

Indonesia

In Indonesia, the amendment of the 1998 Bankruptcy Law was finally passed in a rush in September 2004 (shortly before the Megawati government left power) after languishing for many years. The 1998 law did not have adequate insolvency tests to prevent solvent companies from being put into insolvency, and allowed the law to be abused for strategic purposes in disputes (as the highly publicised cases involving the Canadian insurer Manulife and the British insurer Prudential Life illustrate).

The amendment limits the ability to commence proceedings against certain business so that bankruptcy petitions against financial institutions, insurance and reinsurance companies, pension funds, and other state-owned enterprises that are fully engaged in providing public services can now

only be submitted by the Ministry of Finance. The amendment does not impose any sort of solvency test as part of its entry criteria. Despite large sums of money being spent on training capacity building for Commercial Court judges, the performance of the court has been subject to extensive criticism and remains the focus of development activity.

The amendment also revoked the exclusivity of the Association of Indonesian Receivers and Administrators (AKPI) as the sole recognised professional association for receivers and administrators. It now allows others to establish professional associations. The amendment also changed the formula for the approval of receiver's fees. Before the amendment, receiver and administrator's fees were determined up front at specified rates. Now, the amendment requires the fees to be determined after the work is completed. Receivers are clearly concerned by this since they have no assurance that an appropriate fee will be approved at the end of the administration and since they will need to fund the work in the interim.

The national AMC, IBRA, ceased operations in March 2004 and was replaced with a new AMC known as PT PPA. The Jakarta Initiative Task Force, which promoted and facilitated out-of-court workouts, was also dissolved in December 2003. Despite these events, it is envisaged that 2005 may well see some significant restructuring activity in Indonesia since some of the large institutional investors in distressed assets continue to view Indonesia as a land of opportunity.

The Bank of Indonesia reports that most of the remaining NPLs reside in the largest state-owned banks. There is, at present, a lack of guidelines to assist these banks in arranging NPL disposals. Once this is overcome, there should be a stream of NPL disposals or perhaps a large packaged sale.

Indonesia has also passed a new Deposit Protection Agency law which expands the role of the deposit protection agency (LPS) from guaranteeing public deposits in national banks to handling the restructuring of failing banks. The LPS has three years to sell all of its participation in a troubled bank (two years for a failing bank with no systemic impact to the economy). It can also shut down and liquidate failing banks, if LPS predicts that shutting down such a failing bank will not have a systemic impact.

The Bank of Indonesia has set out a master plan to achieve compliance with Basle II. Risk management guidelines for banks were released in July 2003 with a transition period until December 2004. This will be a hard task to complete since risk management skills are limited.

Singapore

In Singapore the current legislative framework in relation to insolvency procedures (specifically, corporate liquidation, receivership, judicial management and schemes of arrangement) represents a mix of adaptations from the UK and Australian systems. A committee known as the CLRFC, chaired by the official assignee and official receiver, has recommended the introduction of an Omnibus Insolvency Act and subsidiary legislation that are applicable to both companies and individuals. The Omnibus legislation, modelled after the UK Insolvency Act of 1986, would set out common principles and procedures, and consolidate and update all core areas including: voluntary arrangements; judicial management; receivers and managers; voluntary and court winding up; liquidators; preferential debts; secured and unsecured debts; disclaimer; malpractices and insolvency practitioners.

The CLRFC has recommended the introduction of voluntary company arrangements, modelled after the UK Insolvency Act of 1986. It has also recommended establishing a common qualification for all insolvency practitioners *e.g.* receivers, administrative receivers, liquidators and judicial managers. The range of qualified persons should be extended to finance and other professionals. The

CLRFC further recommends establishing an Insolvency Practitioners Association, which would be responsible for accreditation of insolvency practitioners, continuing education and the setting of professional standards. The Omnibus legislation has been on the table for some time and it is hoped that it will be passed in 2005. There has been some debate of late as to whether the US Chapter 11 system of debtor in possession should be preferred to the voluntary arrangements systems in the UK act.

There is also a degree of politics surrounding the professions involved in insolvency which the new Insolvency Practitioners Association will hopefully overcome. As the recent fragmented APP restructuring case showed, where the judicial management system became a central part of the attempted restructuring of APP's operating in Indonesia and China, the insolvency system in Singapore is important for the entire region due to the cross-border nature of much of the activity of companies listed on its exchange.

The Monetary Authority of Singapore (MAS) has moved towards risk-based supervision and has issued guidelines on risk management practices which are based on adequate Board oversight, senior management accountability, sound risk management policies and operating procedures and strong risk measurement, and monitoring and control capabilities commensurate with the risk taken. The guidelines are organised by risk type (credit risk, market risk and liquidity risk) though financial institutions are encouraged to adopt a holistic approach towards risk assessment and management.

After the MAS published guidelines on the securitisation of real estate assets in January 1999, DBS launched a landmark commercial mortgaged backed security (CMBS), and other CMBSs have occurred subsequently. More CMBSs are expected to be launched in the near future since the latest MAS regulations do not allow banks to hold major stakes in non-financial businesses. All such stakes have to be divested by 17 July 2006.

There are also moves to establish a deposit insurance scheme in Singapore following a report issued by the MAS in April 2004.

Credit information systems

There is a move throughout Asia to develop credit information systems. It is a common practice for there to be different sets of books maintained by corporates in a number of Asian developing countries and credit information is generally very poor.

Singapore and Hong Kong, China lead the way. International credit bureaus and rating agencies have operated in Hong Kong, China and Singapore for many years. A Commercial Credit Reference Agency (CCRA) in Hong Kong, China has been approved and the HKMA has developed and finalised statutory guidelines governing the sharing and use of credit data. The guideline was circulated in June 2004, and the CCRA is expected to be fully operative in 2005. In Singapore, as in Hong Kong, China there are various publicly available sources where one can gather basic financial and litigation information to determine the credit-worthiness of a consumer or corporate customer. These include the court writ of summons and bankruptcy data, databases on companies and businesses maintained by the Accounting and Corporate Regulatory Authority (ACRA) and property databases maintained by the Land Dealing Office in Singapore.

There are also two private credit bureaus in Singapore where members are able to share customer information. Litigation searches on a potential customer can be conducted through the databases maintained by the courts in Singapore. These searches reveal the legal suits that the potential customer is involved in either as a plaintiff or defendant and the stages at which the legal proceedings

are. The databases are updated regularly, searches can be done on line, and the results can be generated instantaneously. The results will contain information about the sums involved in each legal suit and brief details of the nature of the claim. Searches can be conducted on an individual to identify whether he or she is facing bankruptcy proceedings. Results contain details on the amounts owed to the petitioning creditors.

Bankruptcy searches on a company will reveal whether the company has any winding-up petition filed against it. Extracts of the annual returns filed by companies and businesses can be obtained from ACRA. The amount of financial information that a company has to disclose in its annual return is dependent on its classification. A private exempt company is only required to file its financial highlights. The financial highlights do not usually provide sufficient information for one to assess the creditworthiness of a company. Private companies are required to file their audited accounts with ACRA as part of their annual returns.

Customer privacy issues have posed an obstacle to credit information systems in all countries. In Singapore, banks were restricted by the Banking Act from sharing information about their customers. In 2002, in line with the MAS's direction towards enhancing risk management capability, the Association of Banks in Singapore set up the first consumer credit bureau in Singapore. Only banks, finance companies and credit card companies recognised by the MAS are authorised to be members of the bureau. Access to the bureau's information is governed by a code of conduct, which lays down strict privacy principles by which members must abide.

The code of conduct is aligned with the Banking Act restrictions on the release of consumer information. The credit report issued by the bureau is based on inputs from members and information obtained from publicly available sources. Individuals are able to obtain a copy of their credit report and notify the credit bureau of any discrepancies. Where there are discrepancies, investigations are carried out by the bureau and changes made to the credit report, if required. In the event of disagreement between the bureau and the consumer on the outcome of the investigation, the consumer can raise a dispute with the Consumer Mediation Unit, which is an independent unit established under the Association of Banks in Singapore to resolve disputes between consumers and banks.

DP Credit Bureau was set up by DP Information Network Pte Ltd. in May 2002 as a formal information-sharing platform to improve credit transparency in Singapore. It currently has about 200 corporate members who input data on their debtors (both consumer and corporate) into a common database. The data are analysed and payment patterns of the debtors are generated. Members are able to access the database through the Internet.

Another development is the proposed establishment of Singapore's first Small and Medium Enterprise-based Credit Bureau by the first half of 2005. Membership in the SME Credit Bureau will be open to all businesses with fixed assets of less than SGD[8] 15 million or not more than 300 employees for the service industry.

In the Philippines, the legal framework for information sharing, information dissemination, credit scoring and credit rating is almost non-existent. It is expensive and time consuming to conduct a thorough legal due diligence covering all courts in the country.

PhilRatings, the Standard & Poor's affiliate in the Philippines, continues to be the prime credit rating service. Since 1985, it has assigned ratings to hundreds of debt issues and also offers ratings for banks and financial institutions, local government units, project finance transactions, and asset-backed securities as well as offering credit training, financial or credit indicators based on publicly available information, business valuations, and due diligence studies.

Notably, the Central Bank has supported the creation of a central credit bureau in order to improve the credit information systems in the domestic financial markets. This central credit bureau brings together the various small credit information bureaus, although its establishment an adequate legal framework necessary for the bureau to operate effectively. In the interim, the BSP will itself operate a credit bureau as it has the legal authority to establish and operate a credit information bureau as an internal unit while an appropriate enabling law is being settled through congressional committees. It is envisaged that once the enabling legislation is in place, the BSP will allow private sector bureaus to take over.

In Thailand, the Central Bank has a central credit file containing information on major borrowers although the information is not comprehensive and is only for internal use. The need for pooling and sharing of credit information became more urgent after the crisis and led to the emergence of two private credit bureau companies in 1999 prior to the Credit Bureau Act becoming effective in March 2003. The act overcame many legal constraints and paved the way for the development, pooling and sharing of information on the status of borrowers who borrow from financial institutions. The act empowers the Credit Information Protection Committee, which is chaired by the governor of the Bank of Thailand, to regulate and oversee the rules and operations of private organisations and memberships as well as protect the privacy rights of borrowers.

Currently, there are two credit bureaus, namely the Thai Credit Bureau Company (TCB) and the Central Credit Information Service (CCIS). TCB was initiated by the Ministry of Finance and is majority owned by the Government Housing Bank and Processing Centre, an information technology firm. CCIS was initiated by the Thai Bankers Association and is owned by 12 Thai commercial banks and two other private firms, Trans Union and Business Online. These two bureaus are in the process of being merged. Credit ratings agencies also operate in Thailand.

There are no private credit information or rating agencies in Vietnam. The Credit Information Centre (CIC), the only organisation established to share information on debtors, maintains only general and unverified information on loans and does not report negative information (*i.e.* defaults or bad debtors). The CIC is affiliated with the SBV, the central bank. It was established five years ago to provide information to banks on line. The information provided by the CIC is regarded as useful in that it shows the outstanding debt held by all banks, but the banks would like to see more detail. The CIC only provides information on loans over USD 3 000, although it would like to have the reporting threshold raised to USD 5 000. Only positive information is reported (*i.e.* that loans have been made). Details of defaults are not reported. The CIC has no enforcement powers to compel banks to report nor does it verify the information reported to it. It would seem that the CIC is an information collector, not a credit information centre. The information is out-of-date and limited, incorrect or unreliable.

In Indonesia, a credit information centre has been developed under the auspices of the the Bank of Indonesia. The information is limited to basic loan information for debtors with outstanding debts of more than IDR[9] 50 million. No information about payment history or defaults is kept. There are plans to establish a credit bureau within a few years but limited progress has been made to date. Information on borrowers is shared informally by banks and is obtained by other informal investigations. Individual company ratings and group-wide ratings are unavailable for most corporates unless they have units that are listed, for example, on an exchange in Singapore or elsewhere.

In Chinese Taipei, the Joint Credit Information Centre (JCIC) and the Financial Data Information (FDI) unit at the Ministry of Finance are actively used by banks. They collect financial and tax information for individuals and corporates and their members are allowed to access the information for the purpose of undertaking necessary credit checks. The FDI was set up in 1960 and renamed in 1987. It is a governmental organisation under the supervision of the MOF. A creditor that obtains a final

court judgement or is otherwise entitled to enforce its claims against a debtor is allowed to access FDI's databases to check the debtor's financial record after filing an application with the MOF. The FDI information base is updated annually based on tax filings.

The JCIC is a non-profit foundation established in 1975. It had 329 financial institutions, 51 local banks and 19 foreign banks as members as of May 2003. A similar company was established in Shanghai, with the support of the Chinese government in 1999, known as the Shanghai Credit Information Services Co. In Chinese Taipei, companies have been so robust in reporting payment information to a private US-based firm known as D&B, that D&B has established a service called Paydex, in which members submit their clients' payment data on a monthly basis.

In China, some private firms operate credit information databases but only have information on a small percentage of the millions of companies in China. Registered companies are required to submit financial information annually to China's Administration of Industry and Commerce, but this information may not be reliable. A culture of secrecy limits the sharing of information more than any privacy regulations. There are no commercial credit bureaus although there are moves in that direction.

The State Economic and Trade Commission has been mandated to work with nine other state agencies, including the People's Bank of China, the Taxation and Statistics Bureaus, and the Administration for Commerce and Industry to build a database of credit information. The initiative is still in the planning stage. China is expected to launch its first national private credit appraisal system in 2005. The lack of a national private credit record system has been blamed for the high risks the country's banks face when offering credit loans. The Central Bank has said that the lack of a national credit appraisal system is the major reason behind the high bad loan rate of the country's state-owned commercial banks, which dominate the country's credit loan market. This has been the basis for the central government's move to set up a task force to help establish national corporate and private credit appraisal systems. In the interim, the Shanghai Credit Information Services Co., mentioned above, is authorised to gather information. The company recently indicated that it had collected credit records on over 5 million Shanghai residents (or 80% of the city's credit consumers). It also gathered credit information on 600 000 large and medium-sized firms.

Credit risk transfer (CRT)

There was mention above of the players around the restructuring table changing. Nowhere is that more evident than in the area of credit risk transfer instruments, even if the players are normally invisible. Among various credit derivative instruments, the credit default swap (CDS) is the most widely traded, capturing nearly half (45%) of the market share according to the Bank of International Settlements (BIS). A CDS provides insurance against the risk of default by a reference entity. The protection seller is obliged to buy the reference bond at its par value when a credit event (bankruptcy, obligation acceleration, obligation default, failure to pay, repudiation, moratorium, or restructuring) occurs. In return, the protection buyer makes periodic premium payments to the protection seller over the term of the transaction.

Global and regional financial derivatives markets have seen phenomenal growth in recent years. They have been a key focus of Asian governments that are keen to develop the regional capital markets. There are extensive efforts underway in this respect at present. Data on the growth of other types of credit risk instruments are not readily available. According to the BIS, there has been an enormous growth of credit risk transfers globally, shifting risk from banks to the buyers of securities and loans. The figure grew to an estimated USD 2 trillion by 2002 from a few billion dollars worth of loans passed on through credit risk transfers in the early 1990s, and is expected to reach USD 4 trillion by the end of 2004. It is likely that a degree of credit risk transfer has occurred in Asia, but much of this is not public.

In Singapore, as from March 2004, financial institutions are required to provide information on the gross and marked to market values of all derivatives used by banks (including credit derivatives) to MAS on a monthly basis, due to the huge growth in credit risk transfers. In 2000 the MAS issued guidelines on the regulatory treatment of bank credit derivative and securitisation activities. The guidelines for credit derivatives address the capital treatment for three main credit derivatives products that are actively being used as instruments for credit risk mitigation: the credit default swap; the total rate of return swap and the credit-linked note. The guidelines retain the principle of maintaining capital against credit risk exposure, and require a credit charge for credit exposures that banks assume via the use of credit derivatives.

As discussed above, the CDS functions like a guarantee. The protection seller assumes credit risk on the reference entity without funding the position. The protection buyer obtains credit protection on the reference entity, but acquires credit exposure to the protection seller since it depends on the protection seller to make the credit event payment. A total rate of return swap (TROR) transfers the total return or the total economic performance of the reference entity from the protection buyer to the protection seller. The protection buyer pays all cash flows arising from the reference entity plus any increase in market value of the reference entity to the protection seller. In return, the protection seller pays the protection buyer a contracted rate of interest plus a premium and any decrease in the market value of the reference entity.

Upon the occurrence of the credit event, the contract will usually terminate and the credit event payment will be calculated as though the next normal payment date had been brought forward. In substance, a TROR is like an unfunded purchase of the reference entity, *i.e.* the protection seller acquires the full economic performance of the reference entity without funding the position. The payment of interest plus premium represents the fee paid to the protection buyer to fund the position. The protection seller acquires from the protection buyer the credit risk and market risk on the reference entity. The protection buyer and seller are also exposed to each other for the payments due under the swap.

A credit-linked note (CLN) is a debt instrument with an embedded CDS. In a standard contract, the protection buyer, or a special purpose vehicle (SPV) set up by the protection buyer, issues a note referenced to the reference entity. The protection seller pays cash up front for the note in exchange for a stream of fixed or floating interest payments on the note. If a credit event occurs, the note is redeemed for the credit event payment as agreed by the parties. If no credit event occurs, the note is redeemed at maturity. Unlike a CDS or TROR, a CLN is a funded credit derivative instrument since the protection buyer receives protection (the principal on the CLN) on the reference entity up front from the protection seller. The protection buyer transfers the credit risk on the reference entity to the protection seller but does not acquire an exposure to the latter. On the other hand, the protection seller acquires credit risk on the reference entity, and is also exposed to the protection buyer (or note issuer) for the amount of funding provided.

Hong Kong, China also has a broad spectrum of instruments for credit risk transfer, including credit insurance and credit risk swaps. International insurance companies and brokers have become more active in providing commercial credit insurance. The authorities have made specific regulatory provisions for adjustment of lending limits and capital provisioning for credits which are wholly or partially insured by a third party.

In the Philippines, an odd scenario has developed. Traditionally, credit derivatives offer protection buyers a means of diffusing risk, and thus achieving capital relief because the reference asset is virtually no longer in their books. For the protection sellers, credit derivatives offer an opportunity for diversifying investments since they can take positions in certain debts even if the cash market for these debts no longer exists. In the Philippines, however, offshore banks utilise credit

derivatives to reduce their exposures to the Philippine sovereign by synthetically transferring these exposures to the domestic banks. The domestic banks are willing to accept these exposures because, aside from the enhanced yield, exposures to the Philippine sovereign (even those that are dollar denominated) are considered by the BSP as risk-free. This resulted in a growing concentration of exposure of the domestic banking system to Philippine sovereign dollar debt. To provide a regulatory framework for credit derivatives transactions in the Philippines, the BSP issued Circular No. 417 specifying the capital requirements for credit-linked notes. The BSP is now in the process of drafting regulations for unfunded credit derivatives.

The Bank of Thailand has authorised commercial banks to expand the scope of their business to cover many new financial products and, especially, derivatives. It has issued regulations to cover credit-linked notes, deposit-linked notes, credit default swaps, forward bonds, bond options and equity index-linked notes. They have been authorised and are now regulated by the Bank of Thailand. These derivative instruments are subject to regulation as to their effects on capital, size of exposure, net foreign positions, etc. and account for market risk and liquidity risks. These regulations will be in force by June 2005.

In Indonesia the business of credit risk transfer is relatively new and there is no developed credit derivatives market. The Bank of Indonesia, the MoF and the Capital Market Supervisory Board (BAPEPAM) have started an initiative to develop the credit derivatives market. Vietnam's market is also undeveloped in this respect.

There is an initiative to develop the derivatives market in China at present. Chinese banks are set to increase their involvement in credit derivatives as a result of new regulations that apply to foreign currency denominated interest rate, currency and credit derivatives, and remove the restriction that use of derivatives is only allowed for hedging purposes so that protection selling is now allowed. Foreign banks are buying protection from Chinese banks with the majority of the trades involving Chinese banks selling protection on international credits. A more limited number of credit default swap trades have involved international dealers purchasing Chinese bank risk from Chinese banks. The Chinese government introduced new rules enabling overseas banks to trade derivatives directly with Chinese companies, which are now involved in significant levels of global trade and need to hedge their risks. A number of foreign banks have received licenses to trade derivatives in China. The banks plan to expand their business from foreign currency hedging, through interest rate swaps to credit derivatives such as commodity and equity derivatives. It is expected that the credit risk transfer business will also expand.

There are a number of risks to participants in credit risk transfer activities. A lack of understanding of the impact of credit risk transfer activities could affect other areas of a firm's business activities. It is natural for the seller to have more information than the buyer in these activities. There is a risk that errors in documentation may result in different legal consequences than were actually intended. Credit risk transfer activities can also be used as a means of avoiding regulatory requirements or taking advantage of differences between banking and insurance regulations. Liquidity issues could also arise when an event takes place that results in a participant having insufficient liquidity to meet their obligations. There is also the risk that the yields on instruments of varying credit quality, liquidity, and maturity do not move together, thus exposing the insurer to market value variations that are independent of liability values. Furthermore, an interest rate move may have a different impact upon the asset and the liability sides of the balance sheet as can currency risk when changes in currency values decrease the value of foreign assets or increase the value of obligations denominated in foreign currencies. These and other risks need to be carefully understood as Asia tries its hand with credit risk transfer instruments.

As has been discussed above, there is an increasing use of securitisation techniques and asset-backed securities in Asia. This has been dealt with on a country-by-country basis above. There is also one new development that may well prove very effective in Asia–synthetic securitisation. Synthetic securitisation involves the transfer of risk from a bank to investors via notes sold by an SPV except that (unlike ordinary securitisation) the instruments do not involve the transfer of a physical asset (only a risk on the asset through the use of credit default swaps).

The bank buys protection against default from investors and an SPV, which issues the notes to investors and sells default swaps to the bank. The SPV uses the funds raised from investors to buy collateral, such as government bonds, which are, in turn, used to cover any losses on the default swaps. As losses are incurred, the investor assumes this loss and their notes are written off by the amount of the loss. In other words, in a synthetic securitisation, the bank buys credit risk protection, while the investor buys credit risk exposure. This is particularly attractive in Asia where regulatory and legislative frameworks have created barriers to securitisation techniques.

Since synthetic securitisation does not involve a transfer of the originating assets, many of the taxation, withholding tax, VAT, notice requirements and other issues do not arise. These issues normally create difficulties in standard securitisations which involve what is known as a true sale. There is also a possibility to allow banks to bundle assets from different jurisdictions into one securitisation issue. The basic structure involves a transfer of risk from a bank to investors via notes sold by an SPV. The key difference between it and the flesh-and-blood model is that these instruments free up large amounts of capital that could have a dramatic effect in the Asian context.

Notes

1 Country reports and other papers submitted at the FAIR are quoted in this paper and extracts of the reports are repeated without further referencing. Text has also been used from Reports on the Observance of Standards and Codes (ROSC) prepared for the World Bank by the author as an expert consultant.

2 Lampros Vassiliou has assisted the World Bank in the development of its Unified Standard project which will produce a unified set of principles for insolvency systems which bring together the World Bank's Principles and Guidelines for Efficient and Effective Insolvency Systems issued in April 2001 and the UNCITRAL Legislative Guide. Mr. Vassiliou was appointed to draft the Unified Standards on Informal Workouts and Corporate Debt Restructuring.

3 Philippine pesos (PHP).

4 Vietnam dong (VND).

5 New Taiwan dollar (TWD).

6 Chinese Yuan renminbi (CNY).

7 Lampros Vassiliou was appointed by the sole International Expert Consultant to assist the Financial & Economic Commission (FEC) of the National Peoples Congress (NPC) of the PRC in its review of the draft PRC bankruptcy law in December 2004.

8 Singapore dollars (SGD).

9 Indonesian rupiahs (IDR).

NON-PERFORMING LOANS IN CHINA: DIMENSIONS AND FUTURE CONCERNS

by
Xian Chu Zhang*

The non-performing loans (NPLs) of state-owned banks (SOBs) in China have received both domestic and international attention for years. However, both the seriousness and the complexity of the problem have divided commentators. The views vary significantly with respect to the real size of the NPLs, the real condition of state-owned banks,[1] the effectiveness of measures taken,[2] the impact of the NPLs,[3] and the prospect for a solution to the problem.[4] Despite widespread disagreement, a consensus has been reached on at least one aspect: the gravity of the NPL problem has reached its limit, even if it has not yet gone out of control. As Premier Wen Jiabao openly admitted in early 2004, "this [banking system] reform is a fight to win or die; success is the only option. We cannot afford to lose."[5]

Apparently, the NPLs have become a menace to the historic reform in China and its dynamic economic development. Any worsening of the NPL situation may not only negate the achievements of the past quarter century, but also put the entire market reform towards WTO principles at risk. Moreover, the impact of the NPL problem is not confined to China. Given China's increasing integration into regional and international markets, a financial crisis in China would inevitably have a serious negative effect on the world economy.[6]

Against this backdrop, this paper does not intend to provide any solution to the NPL problem in China. Rather, it attempts to probe into the dimensions of the problem, and assess the current conditions and prospective developments. Part 1) of this paper highlights the current condition of NPLs in China; Part 2) reviews the rescue measures that have been taken by the government thus far; Part 3) examines some major obstacles and problems, and Part 4) draws some concluding remarks.

The current condition of NPLs in China

NPLs have existed in China for quite a long time as an inevitable result of inefficient state-owned enterprises (SOEs). They are ultimately a cost of SOE reform. In a planned economy where SOBs functioned as the government cashier to provide SOEs with unconditional finance, there was no incentive to prevent NPLs. It is the deepening of China's economic reform and the Asian financial crisis that lifted the veil on the gravity of NPLs in China.

Banking system reform took off in China in the early 1990s when efforts were devoted to removing commercial banks from government control.[7] As a result, a new regulatory framework was established with the Law on the People's Bank and the Law on Commercial Banks being adopted in 1995 for the first time in Chinese history. Under the laws, the People's Bank will function as the central bank[8] whereas commercial banks are defined as enterprise legal persons able to take public deposits, grant loans and handle financial settlements.[9] Despite this landmark effort, the legislation

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did not stop the government from continuing to control and interfere with the operations of commercial banks, particularly the four major state-owned banks, as was done during the old days under the political ideology of state supremacy.

However, the government mandate failed to improve SOE performance. On the contrary, irrational investment and poor efficiency resulted in most of the loans from SOBs to SOEs being unpaid. Worse yet, the underdeveloped social insurance system in China caused the government to worry about social and political instability if the strict enforcement of law should produce massive bankruptcy and unemployment. As a result, SOBs were required to continue their financial assistance to hopeless SOEs and provide loans known as "loans for stability and unity". Thus, in 1996 (when for the first time since the beginning of the reform at the end of 1970s, the entire state sector recorded a net loss and about half of SOEs were in the red) NPLs of SOBs reached their record high.[10] Later, the Asian financial crisis again brought Chinese NPLs under the international spotlight. In order to prevent the imminent crisis, the Central Committee of the Communist Party even established a special taskforce headed by the then-Vice Premier Wen Jiabao to deal with the danger.

To understand the seriousness of the situation, it should be noted that in 2000 the assts of the four largest SOBs (the Big Four) accounted for 68.7% of the total assets of all financial institutions.[11] Today, the Big Four still maintain a dominant position by taking 57% of all the deposits, making 55% of total lending and handling 80% of financial settlements in the country.[12]

Despite the worldwide consensus on the need to deal with NPLs as a top agenda item, there never seems to be any agreement on the precise amount of NPLs in China. According to official statistics, before the discharge of NPLs to any rescuing firm, total NPLs were 35% of total bank lending.[13] The latest report issued by the China Banking Regulatory Commission (CBRC) in 2004 shows that at the end of 2003, NPLs of all major financial institutions stood at CNY[14] 2.44 trillion (USD[15] 298 billion), representing 17.8% of outstanding loans. Among them, the NPLs of the Big Four amounted to CNY 1.92 trillion (USD 235 billion), or 20% of their total lending.[16]

With all the government bailout efforts being implemented, it is commonly agreed that the NPL level has been going down. But, the official Chinese numbers still look suspicious to foreign experts. For example, Standard & Poor's estimated NPLs in China could be as high as USD 850 billion, or 45% of total outstanding loans. Based on this, it believed that at least USD 656 billion would be needed for all rescue operations, representing 43% of China's 2004 GDP. It further pointed out that six years would be needed to lower the NPL level to 2-3% from 17.8% as the official figure claims whereas ten more years would be added if the 45% figure for NPLs were used as the working base.[17] Other independent study reports agree with this estimate, although their calculations may vary.[18] Some reports point out that before the adoption of further rescue measures in 2004, the ratio of NPLs in SOBs was much higher than in pre-crisis Indonesia, Malaysia, South Korea and Thailand[19] and that the Big Four were technically insolvent.[20]

Disregarding political concerns, one possible explanation for the sizable divergence between China's official figures and foreign estimates is that the Chinese government has been using different criteria to analyse its NPLs. Mr. Liu Mingkang, Chairman of the CBRC, admitted in 2004 that at the end of 2003 the conditions of NPLs were assessed using old tests, which counted only overdue and unrecoverable debts.[21]

In addition to the enormous size of the problem, time is not on the government's side, which makes the already daunting task even more challenging. Under China's commitment to accession to the WTO, the banking market will be opened fully to foreign players by the end of 2006.[22] In fact, competitive pressures have already built up in recent years. Today, besides the Big Four, 3 state

policy banks, 11 joint stock commercial banks, 4 asset management companies (AMCs), 112 city commercial banks, 192 foreign banking entities, 209 foreign bank representative offices, 723 urban credit unions, 3 rural commercial banks, 74 trust investment companies, 12 financial leasing companies, and 34 577 rural co-operatives all offer their services on the market.[23] In particular, the expansion of foreign banks has been very dynamic. By March 2004, the total assets of foreign banks had reached USD 53.6 billion (or 1.6% of total financial assets in China), the renminbi business of foreign banks has grown at double digit rates in recent years, and export settlements handled by foreign banks have reached over 40% of their business.[24]

In order to honour its WTO commitments, China must prepare for its further opening within less than three years. Thus, solving the NPL problem, reforming the banking system (particularly the SOBs) and opening the market to foreign banks have to be done at the same time. In this course, some other sensitive issues may also be confronted, such as the revaluation of the renminbi, freeing exchange rate controls, making the renminbi a convertible currency and even the massive dismissal of bank employees.[25] As such, the successful handling of NPLs in China will require not only firm political commitment, but also considered strategies and careful implementation.

Measures taken to rescue troubled state-owned banks

Since the establishment of the banking law framework in 1995, quite a few rescue measures have been taken to deal with the NPL problem. Generally, by their nature they can be divided into three categories: financial bailouts, improvement of the regulatory regime, and transformation of SOBs into joint-stock banks through initial public offerings (IPOs) and the introduction of foreign strategic investors.

The first financial assistance from the government under the openly adopted policy to help SOBs deal with their NPLs can be traced back to 1994 when the State Council decided to make an annual allocation from the state budget to help the Big Four write off their losses stemming from the bankruptcy of SOEs. The initial funding in 1996 was CNY 20 billion and the yearly increase made the total financial aid reach CNY 80 billion in 2002.[26]

In 1998, with the unprecedented approval of the Standing Committee of the National People's Congress, the central government issued CNY 270 billion (USD 33 billion) in special treasury bonds to recapitalise the deeply troubled SOBs. As the State Council admitted, the country faced a serious challenge in a complicated and unprecedented situation.[27]

Apparently, the 1998 recapitalisation proved to be utterly inadequate. In 1995, the state banks maintained real capital of only CNY 160 billion, whereas, since 1994, the annual loss suffered by these banks exceeded CNY 200 billion.[28] In 1994-97, NPLs in China increased by a factor of four times.[29] The imminent crisis forced the government to take some urgent measures. As a result, four asset management companies were formed as vehicles to receive bad loans from the Big Four. With total seed capital of CNY 400 billion provided by the central government and CNY 1 trillion in bonds guaranteed by the Ministry of Finance, the AMCs purchased CNY 1.4 trillion (USD 170 billion) of bad assets at par.[30]

Since 1999, AMCs have endeavoured to dispose of the bad loans by way of debt-equity swaps and further transfers, bankruptcy proceedings and settlements, and package sales. By 2004, AMCs had disposed of CNY 50.9 billion (USD 62 billion) in bad assets and still had CNY 885 billion (USD 107 billion) on their hands.[31] The AMCs again proved ineffective: in addition to all kinds of disposition difficulties, the unchanged old Big Four system soon produced another CNY 1.7 trillion in bad assets in four years.[32]

The latest campaign of recapitalisation started at the end of 2003 when the central government decided to inject USD 45 billion from its foreign exchange reserve into two of the Big Four, the Bank of China (BOC) and the China Construction Bank (CCB), in order to prepare for their worldwide listings. Later it was announced that a similar recapitalisation would be made shortly of the Industrial and Commercial Bank of China (ICBC) and the Agriculture Bank of China (ABC) in 2004-05 in order to restructure their bad debts and lower NPLs to 10% of their total assets.[33]

The new round of recapitalisation seems different from previous financial assistance in at least two aspects. First, the People's Bank of China (PBOC), as the central bank, has openly declared that after the new capital injection it would no longer provide the Big Four with any new assistance and that market discipline would be enforced.[34] Second, in a sense, the new round of recapitalisation is not free and cannot be used to write off bad assets directly. Rather, a special wholly government-owned agency, the Huijin Company, is established to hold the injected funds as an investment on behalf of the central government. As such, when BOC and CCB holding companies were formally established in September 2004 for later public issuance and listing of BOC and CCB, the holding of Huijin Company held 100% and 85.2% respectively.[35] Thus, the Huijin Company will play a crucial role in the future banking sector in China and, indeed, its status may raise some further market and legal concerns.

The next move in SOB reform will be their IPO and listing. According to Mr. Zhou Xiaochuan, the governor of the PBOC, this measure is needed because the central government lacks funds to further reduce the NPLs of the Big Four in order to meet the capital adequacy requirements stipulated by the Basel Accord. Moreover, the SOBs, like all SOEs, are not market-orientated and lack the internal impetus to reform. As such, IPO and listing would introduce the banks to public oversight and market pressure. Furthermore, the introduction of foreign strategic investors will help to separate the banks from government control and promote their efficiency.[36] According to some reports, the IPO of the CCB is estimated to have a value of USD 5-10 billion,[37] but first, it is planning to issue USD 4.8 billion in subordinated debt in 2004-05 as a measure to improve its capital adequacy. The BOC seems to be following suit. It plans to increase its capital base by issuing USD 1.2 billion in subordinated debt before its IPO and raise a total of CNY 60 billion for its listing.[38]

With respect to the regulatory framework, the most important developments are the amendments to the Law of the People's Bank and the Law of Commercial Banks, and the passage of the Law of Banking Regulative Administration at the end of 2003. This new legislation has reformed the banking regulatory structure in China in such a way that the PBOC will focus more on macro matters (such as the formulation of monetary policy and market regulations, and the deployment of the instruments of currency policy), whereas market supervision and enforcement powers are passed on to the newly established CBRC. According to the Law of Banking Regulative Administration, the CBRC is responsible for the supervision and regulation of the business operations of all financial institutions in China with the power to: enforce law and regulations; approve any new establishment and banking products; carry out inspections or investigations of capital adequacy and operational risk; and establish a bank rating and risk warning system.[39] In particular, the law sets out provisions concerning the procedure for handling emergent events,[40] measures to prevent banking risk,[41] takeover and reorganisation of troubled commercial banks,[42] suspension of business operations,[43] and revocation of banking licences.[44] Thus, the duties and responsibilities of preventing and dealing with banking risks are shared by the PBOC and the CBRC.[45] Although the effective co-operation between them still needs to be tested, the new structure does help the central bank to avoid some conflicts of interest and make the division of work more rational.

In line with the changes to the regulatory framework, the amendment to the Law on Commercial Banks also includes corresponding provisions. For example, an 8% capital adequacy benchmark, and

other tightened risk control measures and procedures become mandatory legal rules.[46] Art.71 stipulates that with the CBRC's approval, the People's Court shall declare a commercial bank bankrupt if it is unable to repay its due debts. The liquidation shall be organised by the People's Court with the participation of the CBRC and other relevant individuals.

Together with the reform of the regulatory structure, quite a number of regulations concerning internal management and risk control have been adopted by the PBOC and the CBRC in recent years. In terms of NPL definition, the People's Bank adopted the Guiding Principles of Lending Risk Classification (on trial implementation) in 1998 to replace the old Interim Measures on Determination of Bad Loans. The new principles have introduced commonly used international standards into China by classifying loans into five categories (pass, special mention, substandard, doubtful and loss) with the last three being considered NPLs. This method differs significantly from the test previously used by domestic financial institutions that only counted unrecoverable debts or debts overdue for at least 90 days as NPLs. Although the new principles will no doubt improve the risk control of Chinese banks by pushing their attention forward to the early stages of repayment performance instead of the stage of default, they have not been effectively implemented until recently.

The old rules governing the granting of loans are also being changed. The General Principles of Loan Granting of 1996 is being replaced by the New Principles of Lending, which are being finalised by the PBOC and the CBRC jointly after their publication for public comment in April 2004. On the one hand, the New Principles relax some old rules such as the approval of extension of repayment, term of the loan or discount service, and restriction on interest.[47] On the other hand, the new rules tighten the lending examination by requiring more information and more review items concerning the borrower's credit and capacity, timely notice of material events, security interest and project quality.[48] Under the new principles, the five category classification of bad loans commonly accepted worldwide will be used,[49] and the lender is provided with more power to be involved in related transactions of the borrower and to enforce its rights by way of claim preservation, publicity of its claims, and legal proceedings.[50] To deter violations and fraud, more severe penalties are imposed including higher fines, the criminal liability of responsible staff and personal liability for the compensation of losses.[51]

In the course of reforming SOBs, a new set of corporate governance rules have been introduced. On 6 April 2004, the CBRC promulgated the Guideline on Corporate Governance Reforms and Supervision of the Bank of China and the Construction Bank of China as an important part of the transformation of the two SOBs. The objective of the reform is to develop the two pilot banks into modern and international competitive joint-stock commercial banks with adequate capital, strict internal controls, safe and sound business operations, quality services and adequate profitability within three years.[52] To this end, the two pilot banks shall be encouraged to attract domestic and foreign strategic investors to diversify their equity structure and shall select investors in a fair and impartial manner.[53]

Under the guidelines, both banks are required to adopt a clear development strategy with the aim of maximising profitability, and establish sound mechanisms of decision-making, internal control, risk management and human resource management.[54] Some specific assessment criteria are provided in the guidelines. For example, the net return on assets (ROA) of the two banks shall reach 0.6% by 2005 and be further increased to an internationally competitive level by 2007. The net return on equity (ROE) shall reach 11% by 2005 and be further increased to 13% or higher by 2007.[55] In order to accomplish such a challenging goal, Art.22 of the guidelines mandates that the two banks take immediate measures to dispose of their non-performing assets.

In terms of attracting foreign strategic investors, some encouraging progress seems to have been made. After some joint-stock banks found foreign partners,[56] Huarong AMC formed at least two

assets management companies with Goldman Sachs and Morgan Stanley respectively to dispose of its NPLs. Xinda AMC has engaged Deutsche Bank to be its consultant in its NPL dispositions.[57] Recently, it was reported that a deal for Citibank to purchase 5% of CCB is about to close and the BOC is also making progress in selecting its strategic partners.[58]

Some further challenges ahead

As reflected above, the improvements to the legal framework and the faithful implementation of China's WTO commitment in recent years have been impressive. On this basis, at the end of 2003, the central government declared the goal of reforming the Big Four and transforming them into modern joint-stock commercial banks within three years. Among the four, BOC and CCB were chosen as trial cases for debt restructuring, introduction of foreign strategic investors, streamlining corporate governance, improving market competitiveness, and reaching the average efficiency level of the top 100 banks of the world by 2007.[59] The USD 45 billion recapitalisation of BOC and CCB was clearly made in preparation for their transformation and their IPO, which is tentatively planned for as early as 2005.[60]

However, compared with the complexity and the size of the NPL problem, these efforts may not be sufficient to accomplish the goal. According to the analysis of Mr. Zhou Xiaochuan, the governor of the PBOC, current NPLs have been caused by the governments' mistaken investment decisions (30%), poor SOE performance (30%), flaws in the regulatory scheme (10%), economic restructuring (10%) and the banks' own problems (20%).[61] Although merely a small fraction of blame is assigned to the SOBs, there are still many crucial questions to be answered in both practice and theory. This article will highlight some of the major challenges lying ahead.

To begin with, the exact amount NPLs is still puzzling commentators, experts and potential investors. According to all measures, the level of NPLs has indeed dropped and the determination of NPLs under the new standards has become more transparent. However, it seems undeniable that in recent years large numbers of new NPLs were again accumulating with the Big Four that may not be accurately reflected in their accounts. In this regard, at least two factors are very important. First, it has been the practice of the SOBs to use their rapidly growing loan book to make the proportion of old NPLs fall. The increased lending in 2003 alone amounted to CNY 3 trillion or 20% more than the previous year.[62] Given the low efficiency of the SOEs and their unsophisticated systems of risk control, the potential new NPLs may only be known in the years to come.

Second, the recent overheating of the economy has forced the central government to implement its so-called macro-adjustment policy, which has virtually stopped the extension of finance to projects in the steel, aluminium and construction sectors. As a result, the slowdown of the economy and the many financially troubled projects will inevitably produce more new NPLs. While Standard & Poor's has not changed its current rating, it does warn of NPL increases in the near future.[63] This worry is apparently shared by the CBRC. It has predicted that policy adjustments might see an increase of CNY 40 billion NPLs, or a 2% increase in 2005.[64] The recent report that the CBRC is reinvestigating the NPL situation may be a sign of the seriousness of the new NPL problem.[65]

Such uncertainty will certainly have some implications for the IPOs of the SOBs. For example, the US-China Economic and Security Review Commission in its report to the US Congress, expressed serious concern about Chinese SOBs' listing on global capital markets because US investors could significantly "overpay by buying into these enterprises without full knowledge of the scale of the non-performing loan problem."[66] Since the IPOs are quite large and would generate considerable fees for securities firms as underwriters, some experts even worry about these investment banks' judgment

being coloured with respect to the long-term viability of the SOBs they underwrite. In other words, these SOB IPOs may proceed even as their NPL problem goes largely unaddressed.[67]

The difficulty in avoiding new NPLs also relates to the current structure of the financial market. Despite over a decade development, the role of the Chinese securities market in project and corporate finance is still limited. Segmented securities market, the "worse than casino" speculation, government policy control and biased support for SOE listings, poor corporate governance and rampant violations, underdeveloped institutional investors and professional services, and the strict separation of the banking and securities sectors have troubled the market from the very beginning and deterred long-term investors from wholeheartedly committing themselves to the market.[68] In this circumstance, bank loans become the most important channel of business financing. Unlike many other countries where the ratio of bank lending to the national GDP is less than 10%, in China, working capital in the form of bank loans constitutes 70% of GDP. As a result, approximately CNY 8 trillion in bank loans are needed annually as a crucial financial support for China' economic development.[69] As experience has shown, an over-concentration of bank financing, if not changed, will continue to be a serious risk factor in the future.

Bankruptcy enforcement has also faced great challenges in the context of NPL disposition. In June 2004, the European Union refused to recognise China's status as a market economy, citing the lack of the existence and enforcement of effective laws to ensure the operation of a bankruptcy regime as one of the crucial grounds for the refusal.[70] Indeed, the adoption of the new Bankruptcy Law is highly anticipated.[71] Recently, Mr. Zhou Xiaochuan, the governor of the PBOC repeatedly stated that after the 2003-04 recapitalisations, all financial institutions had to be subject to market discipline and that poor performers should be eliminated from the market.[72]

However, developments in this regard might be disappointing in the near future. In fact, since the Asian financial turmoil, the failures of the Hainan Development Bank, at least three other trust investment companies, and a number of credit unions have already sent a clear warning signal to the national legislature calling for urgent enactment of rules applicable to financial institution bankruptcy and liquidation. For example, in the bankruptcy proceedings of Guangdong International Trust Investment Company (GITIC) in 1999, (where about half of CNY 38.8 billion in claims was rejected) it emerged that some issues were not governed by law. In one controversial point, the BOC became a member of the liquidation committee, although it was the also largest creditor in the same proceedings.[73] Despite this, neither the recently amended Law on Commercial Banks nor the latest draft Bankruptcy Law includes any detailed rules or procedures governing bank bankruptcy. According to the latest draft of the Bankruptcy Law, the rules and procedures governing banks and financial institutions shall be formulated by the central government at a later time.[74] Given this, the extent to which the bankruptcy regime will be enforced against failed financial institutions is still unclear.

Closely related to bankruptcy concerns are apprehensions with respect to the legal regime for security and the security industry. The Security Law was adopted in 1995 without sufficiently detailed rules and some parts have apparently become outdated. Difficulties in applying the law have forced the Supreme People's Court to issue a series of judicial interpretations in order to meet the needs of judicial practice, which has, in fact, revised many aspects the law. Two co-existing lines of rules inevitably cause confusion and conflict.[75] Moreover, some government policies may eventually trump the security interests created under the law.[76] Against this background, the unusual development of the security industry seems particularly worrying. According to the statistics of the Ministry of Finance, the number of firms in China jumped from a mere 848 at the end of 2002 to 3 000 in 2003. It seems that many of firms not only took advantage of the unclear legal rules and regulatory framework to make money (regardless of the risk), but were also created as arms of local governments to provide

banks sufficient comfort to provide financial resources for local development. As a consequence, governments are again actively involved in the market which may, in turn, lead to new NPLs.

In addition to this external environment, corporate governance in China has raised profound concerns among foreign investors.[77] In the context of SOB reform, the problem may be examined from two perspectives. The first is the internal governance of lenders, particularly with respect to clearly defined relations with the government, duties and responsibilities, and effective supervision. Despite great efforts to reform the old system, new reveal scandals may well indicate that problems will continue, at least in the near future. The investigation of the US Securities and Exchange Commission (US SEC) into China Life's accounting irregularities and into its parent company (which became the object of a class action after its New York IPO for alleged failures to disclosure adverse facts) underscores this problem.[78] More recently, four of five senior officers of BOC (Hong Kong), including its former president and two current vice presidents, were arrested under criminal investigation for misappropriation of funds and destroying bank records after its listing in Hong Kong.[79] A vice president of ABC and the Chairman of the Supervisory Board of the Great Wall AMC (who was a former vice president of the same bank) were also detained for reckless or possibly conspiratorial lending of CNY 20 million.[80] These incidents illustrate defects in the internal management SOBs, even after the significant reforms of the past decade.

Another side of the corporate governance problem concerns borrowers. Given the lack of a credit culture and high standards for professional services, many borrowers, including listed companies, care little about their creditors or try their best to defraud their banks. In this context, the recent failure of Delong Group is a telling example. Under the control of Delong International, the parent company, three listed companies channelled money collected from banks and the capital market to Delong through unlawful provisions of security. When the scheme finally collapsed in April 2004, 19 listed companies were seriously affected with CNY 20 billion worth of stock value gone. As a result, the lending of CNY 24 billion from 12 financial institutions is now in jeopardy. After a central government meeting, the PBOC authorised Huarong AMC to take over all of the assets of the Delong family and decide the next move within six months.[81] Worse yet, this is not a rare or isolated case. In the past two years at least ten senior officers of listed companies either disappeared or were arrested, causing at least CNY 10 billion in losses. Their actions ultimately resulted in the year 2003 being dubbed "the Year of the Disappearing Presidents".[82] Apparently, without a sound enterprise culture and corporate governance, (which may have to take time to establish) the root causes of NPLs persist and continue to threaten normal banking operations.

The handling of the NPLs received by AMCs has also been associated with difficulties. From the AMCs' side, (despite time pressures) political hurdles that prohibit AMCs from selling state assets to foreign buyers at a price lower than par value have also prevented package sales until recently. As a result, in 2003 some efforts to sell several packages of NPLs failed.[83] From the foreign investor's perspective, the lack of clear legal rules on securitisation and the prohibition of domestic banks from financing any foreign purchase of packaged NPLs have restricted their effective participation despite attractive market opportunities.[84] The slow handling of NPLs has triggered worries among international investors.[85]

However, some recent developments seem to indicate an important breakthrough. In June 2003, both Deutsche and Morgan Stanley won separate bids to buy NPL packages with a face value of USD 1.2 billion. The deal was entered into based on an asset recovery rate of 34.75%.[86] More recently, the Great Wall AMC announced its plan to sell all NPLs in its portfolio of CNY 150 billion in a single package. Although the price is still subject to negotiation, its current average recovery rate of 15.7% may be considered as a base line.[87] Moreover, state authorities have announced new policies to relax regulations by changing the procedure from approval in advance to registration after the

conclusion of the deal of NPL disposal and to allow the AMCs to function as wholesalers.[88] Apparently, the new strategy is being adopted as a reflection of the firm commitment to dispose the NPLs in accordance with the government's schedule. As a consequence, an acceleration of the NPL disposal can be expected. Indeed, there was some discussion on further sell-offs of NPLs by establishing "bad asset banks" or other measures in order to accelerate the disposal process. Some foreign investors also asked the Chinese government to provide guarantees for NPLs that exceed a certain ceiling. The recent speech of Zhou Xiaochuan as the governor of the PBOC in which he states that the central government would no longer provide SOBs with any further financial help after this round of recapitalisation would seem to point to a negative response to this request.[89]

Conclusions

NPLs in China have been an enormous problem with potentially serious impacts on both domestic and international markets. As a result, the Chinese government has dealt with it as one of its top agenda items and accelerated banking reform through a series of rescue measures over recent years. By the end of 2003, the government changed its strategy of providing SOBs with money to write off their bad assets. Instead, recapitalisation has been used to not only lower the NPL level, but also to prepare SOBs for IPO with enhanced state equity ownership. At the same time, the disposition of NPLs and the incorporation of the BOC and the CCB constitute significant progress in implementing China's WTO commitments.

Despite these encouraging reforms, there is a long and bumpy road ahead. Issues concerning the accurate assessment of NPL levels, the effective prevention of new NPLs, the real reform of SOBs so that their governance and operations come under market discipline, and the rational disposition of existing NPLs still call for clearer policy and more legal rules. Moreover, the solution to NPLs cannot be confined to financial circles; the success of the reform will depend more on needed political reforms, well-defined central/local government relations, firm commitment to the principles of a market economy, and the rule of law.

Notes

1 For example, in the China Financial Services Outlook 2004 released by Standard & Poor's in November 2003, eight major banks in China were all rated BB or below, which means not safe for investment. Later a Wall Street Journal article considered Chinese banks as junk. However, at the same time Moody's Investors Service rated four state-owned banks from Baaa1 to A2, thus indicating that they are fairly safe for investment. The different ratings triggered a political outcry. See Lan Xinzhen, "Bank Rating Variance Controversy", available at

http://www.bjreview.com.cn/200402/Business-200402(C).htm, visited on 1 October 2004.

2 Although the majority considers that government measures will eventually help to solve the NPL problem, some experts believe that the new round of recapitalisation is bound to fail again. See Feng Xingyuan, "The Peeling-Off Will Again Be Poorly Executed", Securities Weekly, 17 January 2004 (in Chinese); and He Qinglian, "The Only Hope for the Chinese Government to Break Away from a Financial Crisis", available at http://www.backchina.com, visited on 3 October 2004 (in Chinese).

3 Although the majority has expressed negative views on NPLs, Professor Dwight challenges the traditional approach by characterising NPLs as a necessary evil to reduce the excess burden of taxation and promote employment. Lawrence Dwight, "The Role of Non-Performing Loans in China: A Public Finance Approach," available at

http://emlab.berkeley.edu/users/webfac/auerbach/e231_f04.dwight.pdf, visited on 5 October 2004.

4 For example, some scholars with cautious optimism believe that the likelihood of bank run or a collapse of the banking system is minimal under the current situation, see He Fan, "How Far Is China Away From a Financial Crisis", Thailand Development Research Institute, 2002. But others foresee a collapse in China. Gordon G. Chang, *The Coming Collapse of China*, Random House (New York and London, 2001).

5 Statement made by the Premier at a news conference on 14 March 2004, see People's Daily, 15 March 2004 (in Chinese).

6 Bottelier P. (2004), "China's Domestic Market and Interaction with International Capital Markets", testimony before the US-China Commission Hearing on 16 April 2004, available at http://www.uscc.go/hearings/2004hearings, visited on 16 October 2004; also see Win Thye Woo, "China's Battle for Stability Amidst the Regional Crisis", available at http://141.211.136.209/cdc/papers/wingwoo.pdf., visited on 25 September 2004.

7 See Laurenceson, J. and Joseph C. H. Chai (2003), *Financial Reform and Economic Development in China, E*dward Elgar; and Yong Guo (2002), *Banking Reform and Monetary Policy in People's Republic of China,* Palgrave Macmillan.

8 Art. 2 of the People's Bank Law of 1995.

9 Art. 2 of the Commercial Bank Law of 1995.

10 See the report of Oriental Daily (Hong Kong), 7 August 1998, B14 (in Chinese).

11 Liu Haipan (ed.) (2002), *Financial Problem in China: Crisis Control and Its Solution*, the Communist Party School Press, Beijing, at 4 (in Chinese).

12 Speech made by Mr. Tang Shuangning, Vice Chairman of the CBRC on 26 April 2004 in Washington DC, available at http:// www.cbrc.gov.cn, visited on 11 June 2004.

13 Liu, note above 11.

14 Chinese Yuan renminbi (CNY).

15 United States dollars (USD).

16 The report is available at http://www.cbrc.gov.cn, visited on 11 June 2004.

17 The Standard & Poor's rating was released on 25 May 2004. The quotation here is made from the report of the Economic Times of China on the same day. Also see Editorial of Leader, 10 July 2004.

18 One report put the level of bad loans at around USD 420 billion, or nearly 40% of China's GDP, The Economist, 10 January 2004, at 13; and reports of some other leading financial institutions including the Financial Times, Moody's and Goldman Sachs believe NPLs in China to standing at USD 500-600 billion. See the report of Commercial Daily of Hong Kong, 1 April 2003 (in Chinese).

19 Drysdale P. and Yiping Huang (2003), "China's Integration into the Regional and International Financial System", paper presented at the Conference on China's Economic Development and Structural Change in East Asia at Kyoto University on 8-9 February, at 12.

20 Chi Lo (2004), "Bank Reform: How Much Time Does China Have?" The China Business Review, March-April 2004, at 33.

21 The speech by Mr. Liu Mingkong made to the Foreign Banks Conference on 12 April 2004 is available at http://www.cbrc.gov.cn, visited on 11 June 2004.

22 For the detailed WTO commitments, see the Protocol on Accession of PRC to WTO, Annex 9, Schedule of Specific Commitments on Services. For a detailed discussion, see Chen Jianxun (2004), *Banking and Insurance in the New China: Competition and the Challenge of Accession to the WTO,* Elgar Publication.

23 Tang, note above 12.

24 Speech of Mr. Shi Jiliang, Vice Chairman of the CBRC at the Forum of China Strategy of International Capital on 23 May 2004 in Beijing, available at http://www.cbrc.cn/, visited on 11 June 2004; also see Tang, note above 12.

25 In 1998-2002 the reform measures taken by the Big Four resulted in 250 000 employees being dismissed. Tang, note above 12.

26 Li Guoguang *et al.* (2002), *Correct Understanding of Supreme People's Court Interpretation on Issues Concerning Trials of Enterprise Bankruptcy Cases,* Legal System Publishing House, Beijing, at 2 (in Chinese).

27 Prime Minister Zhu Rongji proposed an act concerning the additional issue of treasury bonds and adjustment of the state financial budget to the Standing Committee of the National People's Congress on 20 August 1998.

28 Wang Ping (2002), *A Study of Legal Issues Concerning Swap of Bad Debts,* Legal System Publishing House, Beijing, at 32 (in Chinese).

29 Liu, note above 11.

30 Lo, note above 18.

31 Ernst & Young 2004 Report on International Non-Performing Loans (China), available at www.ey.com/china, visited on 5 June 2004.

32 Huang He (2004), "The Interrelated Factors of "Big Four" Reform, Southern Weekend, 14 October 2004, at 17 (in Chinese).

33 See the report of Oriental Morning, 9 October 2004 (in Chinese).

34 The statement made by Mr. Zhou Xiaochuan, the governor of the PBOC, reported by Securities Times on 23 September 2004 (in Chinese).

35 See the report of 21st Century Economic Report on 26 August 2004 and the report of China Enterprise Journal on 20 September 2004 (in Chinese).

36 See the report "Bank in China Lacking Money", Beijing Review, 5 August 2004.

37 FACTBOX-China Firms Eye USD 22.7 Billion, report of Reuters.

38 See the report: China's Bank Prepare for Public Listing, available at http://www.friedlmet.com/news/04070902/3/, visited on 6 October 2004.

39 Art. 2 and Chapter 2 of the Law of Banking Regulative Administration of 2003.

40 Arts. 28 and 29, *ibid.*

41 Art. 37, *ibid.*

42 Arts. 38 and 64, *ibid.*

43 Arts. 44 and 45, *ibid.*

44 Art. 45, *ibid.*

45 Art. 2 of the Law of the People's Bank of 2003 and Art. 1 of the Law of Banking Regulative Administration of 2003.

46 Chapter 3 of the Law of Commercial Banks of 2003.

47 For a general comment, see Wu Yusan (2004), "The Emerging New Horizon under the Revised Lending Principles", 21st Century Economic Report, 11 April 2004 (in Chinese).

48 Arts. 16, 17, 21, 27, 36 and 37 of the Draft Lending Principles of 2004.

49 Art. 47, *ibid.*

50 Arts. 41 and 48, *ibid.*

51 Arts. 69, 71, 76 and 79, *ibid.*

52 Art. 2 of the Guidelines.

53 Art. 5, *ibid.*

54 Arts 6-12, *ibid.*

55 Arts. 14-18, *ibid.*

56 Such as Newbridge Capital of the US which became the largest single shareholder of Shenzhen Development Bank with an 18%equity holding and Hong Kong Shanghai Bank which agreed to buy a19.9% stake in Bank of Communications in 2004.

57 See the report of Commercial Weekly on 2 March 2004 (in Chinese).

58 See the report of 21st Century Economic Report, 25 October 2004, at 18 (in Chinese).

59 Liu, note above 19; and Shi, note above 22.

60 Li Hao (2004), "Big Four Bad Loans Witness Big Drop", Beijing Portal, 20 February 2004.

61 Beijing Review, note above 34.

62 Holland T. and David Lague (2004), "Wasteful Transfusion", Far Eastern Economic Review, 22 January 2004, at 27; and Zhou Xiaozhi (2004), "Be Alerted of Unstable Factors in Macro-economy Coming Back", available at http://web.pzhs.gov.cn, visited on 26 October 2004 (in Chinese).

63 See the report of International Financial Times, 25 May 2004 (in Chinese).

64 Li Zhiping and Zuo Zhijian (2004), "RMB 400 Potential NPLs: Warning from the CBRC", 21 Century Economic Report, 8 September 2004 (in Chinese).

65 See the report of Xinhua News Agency on 19 October 2004, available at http://www.xinhuanet.cn, visited on 20 October 2004 (in Chinese).

66 Beijing Review, note above 34.

67 See "China: Western Appetites for Banking Assets", available at http://www.pipeline.com/~rougeforum/chinawestern.html, visited on 25 September 2004. According to the analysis, some USD 25 billion IPO of CCB to be expected in 2004-05 alone which would mean USD 875 million in underwriting fees.

68 For a detailed discussion in this regard, see China Securities Regulatory Commission, China's Securities and Futures Market (April 2004), available at http://www.csrc,gov.cn, visited on 23 May 2004; also see Xian Chu Zhang (1999), "The Old Problems, the New Law, and the Developing Market – Preliminary Examination of the First Securities Law of the People's Republic of China", 33 International Lawyer, at 983-1014; and Friedman W. I. (2002), "One Country, Two Systems: The Inherent Conflict between China's Communist Policy and Capitalist Securities Market", 27 Brooklyn Journal of International Law, at 477-517.

69 Du Yan, "Capital Games between the Central and Local Governments", 21st Century Economic Report, 12 July 2004, at 17 (in Chinese).

70 Buck T. and Mure Dickie (2004), "EU Refuses to Recognise China as Market Economy", Financial Times, 28 June 2004.

71 The new Bankruptcy Law has been drafted for several years and is expected to be adopted by the end of 2004 to replace the outdated State-Owned Bankruptcy Law of 1986.

72 Zhou Xiaochuan's speech was reported on Securities Times, 13 July 2004 (in Chinese).

73 For more detailed discussion of the concerns, see Zhou Zhongfei and Zheng Hui (ed.) (2004), *Principles of Banking Law*, CITIC Publishing House, Beijing, at 159-164 (in Chinese); and Gorden Chang (1999), "Bankruptcy Law in China: Too Much or Too Little?", China Law & Practice, June/July 1999, at 22-25.

74 Art. 163 of the draft Bankruptcy Law of 2004.

75 For instance, Art. 28 of the Security Law stipulates that if a claim is secured by both a guarantee and property, the guarantor shall be liable for the claims beyond the property security. However, Art. 38 of the Supreme People's Court Interpretation dated 8 December 2000 provides that in the same situation it shall be the creditor's choice to require either guarantor or the third party mortgagor or pledgor to repay the debt first.

76 For example, the State Council in a notice dated 2 March 1997 concerning implementation of bankruptcy, mergers and re-employment schemes ordered to first use proceeds of land use rights transfers to resettle the workers even if the land has been subject to security interest.

77 For some general comments, see Cindy A. Schipani and Liu Junhai (2002), "Corporate Governance in China: Then and Now", Columbia Business Law Review 1; and Anthony Neoh (2000), "The Chinese Domestic Capital Markets at the Dawn of the New Millennium", International Financial Market Law and Regulation, No. 4, at 119-130.

78 For more detailed information, see Li Yong Yan (2004), "A Wake-up Call for Corporate China", Financial Scandals; and Stanford Law School Securities Class Action Clearinghouse Website, available at http://securities.stanford.edu/1030/LFC04-01/, visited on 14 August 2004.

79 See Ling Huawei and Kang Weiping (2004), "BOC (HK) Case and the Story Behind", Finance and Economy, 25 August 2004 (in Chinese).

80 Yin Shichang and Ling Huawei (2004), "Two Vice Presidents of Agriculture Bank Were Detained", Finance and Economy, 6 August 2004 (in Chinese).

81 Ling Huawei (2004), "Huarong Taking over Delong and the Story Behind", Finance and Economy, 6 September 2004 (in Chinese).

82 See the report of 24 June 2004, at http://www.chinesenewsnet.com, visited on 25 June 2004 (in Chinese).

83 China: Western Appetites for Banking Assets, note above 65.

84 For some comments, see the comment of Wall Street Journal, 11 August 2004; and Commercial Weekly, note above 55; China: Western Appetites for Bank Assets, note above 65; and "Will China Remain Limited to NPL Securitisation, Even as Massive Opportunities Knock at the Door?", available at http://www.vinodkothari.com/secnews_804.htm, visited on 6 October 2004.

85 See the report of Financial Times: "China's Dad Loan Disposal Worries Moody's", 6 November 2003.

86 See the report of China Economic Review: Deutsche Bank Plans more NPL Acquisition, 1 September 2004.

87 See the report of People's Daily, 19 October 2004, at 5.

88 See Bei Hu (2004), "China Cuts Red Tape to Ease NPL Purchase by Foreigners", South China Morning Post, 19 October 2004, B1; and Bei Hu (2004), "Cinda Bad-Loan Resale Leaves Foreign Players out in Cold", South China Morning Post, 19 October 2004, B2.

89 Zhou, note above 70.

THE SIGNIFICANCE OF THE DRAFTING OF THE NEW BANKRUPTCY LAW TO CHINA'S CREDIT CULTURE AND CREDIT INSTITUTIONS FROM THE PERSPECTIVE OF BANKRUPTCY LAW

by
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Sound credit culture and institutions are in symbiosis in a viable market economy. A market economy based on a sound credit tradition and foundation is inevitably cost-effective and highly efficient. China is currently undergoing economic transformation, the goal and orientation of which is a market economy. During this stage, old fashioned credit institutions, credit culture and credit security systems are shaken by the new economic and institutional structures, while the credit institutions and credit culture required by a market economy are still in formation. In this development stage, laws and institutions are playing and will play a vital role.

The legal structure that a market economy needs is composed mainly of three parts: 1) laws on market access; 2) laws on market operation; and 3) laws on market exit. Laws on market access ensure that players involved in the market have basic credit; laws on market operation define the rules of conduct in the market; and laws on market exit refer to bankruptcy laws which are concerned with how to provide for market exit while minimising economic side-effects when players fail. This three-layered legal structure establishes the credit platform for the market economy. As far as China's current situation is concerned, the insolvency system is the weak link in the chain that leads to many credit problems.

Credit scarcity caused by the current insolvency legal system in China

The legal system and institutions constitute the basic structure needed for market operations and, at the same time, constitute the foundation for the credit institutions and the credit culture of a market economy. Insolvency, in essence, refers to the fact that debtors default on debts owed to creditors--an abnormal situation antithetical to normal market credit. Insolvency institutions should bring the impaired credit system back to normal conditions and maintain the effective operation of the economy. The improvement of the current insolvency system is a prerequisite for achieving this goal.

The fragmentation of current insolvency structures and credit scarcity

The current insolvency regime in China is characterised by five institutional structures.

The first is the Law of the People's Republic of China on Enterprise Insolvency, which was adopted on 2 February 1986 and came into force on 1 November 1988. According to Article 2 of this law, it only applies to state-owned enterprises (SOEs)[1] and is still under trial implementation. It is the only law in China under trial implementation.

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The second institution is the Procedure for Repayment of Insolvency of Enterprises as Legal Entities, Chapter 19 of the Law of Civil Procedure amended on 9 April 1991. The law extends the scope of application of insolvency repayment procedures to non-SOEs in Articles 199 to 206.

The third institution is the judicial interpretation released by the Supreme Court on 7 November 1991. By summing up its trials of insolvency cases, the Supreme Court, in accordance with the Insolvency Law, enacted the Opinions on a Number of Issues Concerning the Execution of the Law of the People's Republic of China on Enterprise Insolvency to provide for additional regulations on a number of issues concerning the current insolvency law. On 18 July 2002, the Supreme Court released the Regulations on a Number of Issues Concerning Hearing of Enterprise Insolvency Cases in which it rectifies many judicial interpretations released in 1991, and provides interpretations of substantive current issues such as protection of creditors and fraudulent insolvency. This interpretation replaced the judicial interpretation released in 1991 and came into force on 1 September 2002.[2]

The fourth institution refers to a series of policy documents for SOE insolvency released by the state council since 1994 with a view to giving impetus to SOE insolvency. The principal part of these policies is the following three documents: 1) Notice on Related Issues on a Tryout of Insolvency on State-Owned Enterprises in a Certain Number of Cities, promulgated on 25 October 1994; 2) Notice on Certain Issues on the Trial Implementation of Mergers and Insolvency of State-Owned Enterprises, jointly released by the former State Economic and Trade Commission and the People's Bank of China on 25 July 1996; and 3) Supplementary Notice on Related Issues on a Tryout of Mergers, Insolvency and Re-employment of Staff and Workers of State-Owned Enterprises in a Certain Number of Cities, promulgated on 2 March 1997. Policy documents on insolvency initially applied to only 18 pilot cities, then to 56 medium to large cities, then to 111 various cities and ultimately to all cities in China. The "bankruptcy fever" in China in the last ten years was ignited mainly by these insolvency policies.

The fifth institution is constituted by local rules, regulations and policies on insolvency enacted by provinces, prefectures and cities. For instance, the standing committee of the People's Congress of Guangdong Province drafted the Regulation of Insolvency in Companies in Guangdong Province in August 1993. The Standing Committee of Shenzhen's People's Congress adopted the Regulation on Insolvency of Enterprises in the Shenzhen Special Economic Zone on 10 November 1993.[3] Many cities have even drawn up their own policies on insolvency implementation.[4]

The five insolvency institutions have problems in three substantive aspects. First, they categorise enterprises into different types including SOEs participating in the insolvency experiment, other SOEs, non-SOEs and enterprises in special economic zones. Accordingly, different types of enterprises apply different rules. Second, despite the complex institutional structure, these institutions, regulations, rules and policies are fairly simple, and there are no institutions that apply to the insolvency of natural persons and their enterprises. Third, under the current Chinese insolvency regime, legal institutions at various levels are often in conflict with one another.

This inconsistent institutional structure renders it impossible for debtors and creditors to expect stable rules and credit in their early days of economic contact, thus fundamentally undermining the credit basis of the market economy.

The faulty insolvency regime undermines the credit basis

Regrettably, the provisions of the legal institutions mentioned above are often too theoretical to be utilised in real life. Some SOEs are unable to undergo bankruptcy due to various issues such as employee settlements. In response, the state council promulgated a large number of policy documents

to regulate insolvency among SOEs. In practice, insolvency of SOEs is declared in accordance with these policies. These "insolvencies by policy" have led to assets of SOEs being used to settle the claims of unemployed laid-off staff and workers in priority instead of paying off debts owed to banks. Insolvency by policy aims at settling extremely urgent problems in reality and is in certain conflict with the enterprise insolvency law.

As for the insolvency of non-SOEs, applicable legal provisions are seriously deficient. Provisions directly regulating the insolvency of non-SOEs are embodied in the Repayment Procedure for Insolvent Enterprises of Legal Persons, Chapter 19 of the Civil Procedure Law. However, there are only eight articles in the chapter. The judicial interpretation delivered by the Supreme Court concerning Chapter 19 contains 14 articles. The insufficiency of laws and regulations on non-SOEs makes it necessary to regulate the bankruptcy of non-SOEs in reference to bankruptcy procedures applied to SOEs. This reference is legally accepted.[5]

China's bankruptcy law and institutions have a negative effect on China's credit basis in the following four aspects:

i. *The current bankruptcy procedure prejudices secured creditor interests.* According to a World Bank report, the protection of secured rights and interests is crucial to the stability of the financial system as a whole. The significance of secured financing lies in the fact that banks may expand lending to small and medium-sized borrowers and raise funds for trade in a cost-effective way. When bankruptcy is looming, it is vitally important to confirm secured rights and interests, so that creditors are willing to reorganise bankrupt enterprises.[6] The Bankruptcy Law of Enterprises recognises the priority of secured rights and interests; it states that "secured debts rank higher than other claims in repayment order". However, secured rights and interests fail to get effective protection in practice. Firstly, policy-oriented bankruptcy denies their priority. According to document number 492 released by the State Economic and Trade Commission in 1996, and document number 10 released by the State Council in 1997, though land use rights held by SOEs have been mortgaged, they shall still be used to pay for laid-off workers' settlement fees. Secondly, even legally established secured rights fail to get proper protection in real life due to regional protectionism, the near-mandatory registration system of secured rights and deficiencies in executing secured debts. At present, many secured creditors are banks. The fact that secured rights held by banks are not protected, leads directly to the reluctance on the bank's part to lend, thus making it rather difficult for small and medium-sized enterprises to obtain loans.

ii. *Common creditors' rights and interests do not gain protection under the current bankruptcy procedure.* Strictly speaking, the current bankruptcy law is not established on the grounds that the relationship between creditors and debtors shall be properly adjusted to achieve social and economic wellbeing. The disregard of creditor protection traces back to goals crystallised in the Bankruptcy Law of Enterprises. The Bankruptcy Law of Enterprises in 1986 proposed to enhance the vitality and energy of SOEs, and prompt them to improve management. The adjustment of creditor-debtor relations

and credit was outside its scope. This guiding purpose resulted in the disregard of creditors whose rights and interests rank second to laid-off workers. The liquidation percentage of common debt inclusive of outstanding taxes payable to the state is rather low. For instance, the recovered debt owed to banks and collected from SOEs rarely exceeds 20% of their loan book value. The rate commonly varies between 3% and 10%. The relationship between creditors and debtors is the basic relational model in a market economy. The credit basis of the market economy is, therefore, on the verge of collapse when rights and interests of creditors do not get protection under law.

iii. *Regional protectionism and fraudulent bankruptcy practices run rampant.* Courts (being susceptible to influence exerted by local governments) tend to treat native and out-of-town creditors differently. It is also a common occurrence that enterprises take advantage of bankruptcy procedures to avoid repayment. The methods utilised include re-establishment of businesses under a new shell, enterprise division, asset transfers, claim abandonment, etc.

iv. *Certain institutional instruments are absent from the current bankruptcy law and regulations.* There is no reorganisation procedure embodied in current law and regulation. Although reconciliation and reorganisation are stipulated in the Bankruptcy Law of Enterprises, these two procedures are dominated by government agencies while creditors play a minor role. The lack of reorganisation procedures makes it impossible for some newly emerging mixed-ownership enterprises to be rejuvenated and leads to a gradual decline in asset values (especially intangible assets) due to inaction. The other side of the coin is that reorganisation resorts to administrative powers when reviving enterprises. Logically, disadvantaged groups are vulnerable to neglect and exploitation. That shareholders were prejudiced in the Zhengbaiwen case is illustrative. The lack of professional personnel engaged in bankruptcy is further evidence of the insufficiency of the bankruptcy law and regulations. Most members of liquidation teams come from governmental agencies and have little expertise.

To summarise, a flawed bankruptcy law and institutions deprive both investors and creditors of basic credit guarantees, and, to a certain extent, act as catalyst in the formation of a weak credit culture and seriously undermine the credit basis of China's market economy.

Cases: Issues that need resolution and policy guidelines for the new insolvency legislation

The bankruptcy of Zhongjiang Silk Company in Sichuan

Zhongjiang Silk Company was a state-owned commercial and trade enterprise located in Zhongjiang County. It was incorporated in 1982. This company engaged mainly in the selling and purchasing of silk pods, and enjoyed the exclusive right to purchase raw silk and pods. It was a very important enterprise in Zhongjiang County. From 1995 to 1999, Zhongjiang operated profitably. From 1995 to 2000, its regional and agriculture tax payments exceeded what it should have paid by CNY[7] 13 344 million. It came as no surprise that in 1998 and 1999 the Bank of China's Sichuan branch categorised it as a AA credit enterprise. At the same time, its major creditor, the Agriculture Bank of China's Sichuan branch rated it as a first class credit. The book value of its assets before the declaration of bankruptcy amounted to CNY 119 million with the amount of debt and net assets totalling CNY 87 million and CNY 39 million respectively. The ratio of debt to assets averaged 72.5%. The Zhongjjiang Company did not default on loans or interest before bankruptcy. The only debt due was CNY 100 million owed to the Jianghzong county financial bureau. In addition, cash balances totalled CNY 792 thousand in a saving account coupled with stock worth CNY 12 million mainly in the form of silk pods.

However, under the direct intervention and manipulation of the Zhongjiang county commission and government, the company, whose earnings amounted to CNY 106.7 million in 11 months in 2000, was required by its creditor (the country financial bureau) to undergo a bankruptcy procedure. The court at the county level accepted the case and made a ruling and a public announcement. A bankruptcy liquidation team was set up on the same day. Under the government's arrangement, the New Century Silk Industry Limited Liability Company, which was co-founded by the private Tianyou Company and Zhongjiang County, acquired the bankrupt Zhongjiang by auction. In this case, the rights and interests of the Zhongjiang Agriculture Bank branch, the major creditor, were seriously prejudiced; at least CNY 40 million Yuan credits were lost.

In order to bankrupt the Zhongjiang Silk Company, the Zhongjiang county commission and government arranged for ten county-owned or town and village-owned silk enterprises, which were related to Zhongjiang silk company, to be bankrupted, leading to the complete disappearance of claims held by the Zhongjiang Silk Company. Besides the above-mentioned arrangements, the Zhongjiang county commission and government drafted a plan to recover most of the debt owed to the Zhongjiang financial bureau (CNY 16 million) as quickly as possible, while repayment for the remaining debt of CNY 1 million would be suspended. At that point, the Zhongjiang financial bureau submitted the bankruptcy application against Zhongjiang Silk Company to the court. Before filing the bankruptcy application, the Zhongjiang county commission and government instigated that the company withdraw its capital and fabricate balance sheets and accounts so as to be assumed to be insolvent. Under the plan, a vice secretary of the Zhongjiang county commission headed the liquidation team. Co-operation from enterprises, court and other relevant government agencies was thus secured.

On 31 July 2001, China Central Television spotlighted the case. From 12-17 August, an in-depth investigation of the case was carried out by an investigative team composed of relevant departments of the state council, major creditor banks and the Supreme Court. Later, those persons who were responsible for the abuses in this case received administrative punishments and legal penalties.[8]

This is a typical fraudulent bankruptcy case involving direct government manipulation.

Various legal procedures embodied in the bankruptcy law fell victim to the manipulations and interventions of the Zhongjiang county commission and government. In this case, the county court failed to examine the application for bankruptcy and other relevant materials in strict accordance with the law as evidenced by its unscrupulous acts. It not only accepted the case and delivered the ruling to declare the silk company bankrupt in the same day, but failed to notify creditors regarding their claims. Suffice it to say that the county court was neither an independent nor an impartial judicial agency. Unfair practices were also applied in the asset auctioning process. The assets of the bankrupt silk company were auctioned to a buyer who had been designated in advance by the government. Artificial insolvencies, like those described above, aim at evading repayments, infringe upon the rights and interests of capital contributors and creditors, lead to a massive drain on state-owned assets and seriously undermine the credit and legal environment.

In the case of Zhongjiang Silk Company, a series of carefully designed plans aimed at evading the repayment of debts owed to state-owned commercial banks. This case indicates that local governments can pursue their own interests in the transformation from a planned to a market economy and that they can play games with the central government using administrative and legal instruments. Cases of fraudulent bankruptcy make it imperative that a new and unified bankruptcy law with specific regulations be put in place.

The ST Ningjiao bankruptcy case

ST Ningjiao was a joint-stock company, which was solely sponsored by the Ningcheng Conglomerate located in inner Mongolia. It was incorporated by means of a share offering. Its major business was the production of liquids and beverages. At the end of 2001, the Ningcheng county state asset bureau and the controlling Ningcheng Conglomerate appropriated CNY 506 million from ST Ningjiao (compared with CNY 434.8 million ST Ningjiao raised six years earlier on the date of its listing). Ningjiao was capped in 2003 due to its worsening business operations, its failure to disclose its annual report and the appropriation of cash by its controlling-shareholder. Thereafter, the efforts of Beijing Pengtai Company to reorganise ST Ningjiao were futile. On 30 June 2004, ST Ningjiao's assets totalled CNY 450 million, net assets totalled CNY 54 million, net assets per share were CNY 0.187 and total debt was CNY 388 million.

On 17 June 2004, the Chifeng intermediary court accepted the bankruptcy application filed by the Taifeng Glasswork Limited Liability Company in conformity with the law. According to the public notice made by the Chifeng intermediary court, the first creditors meeting was to have been convened on 15 October 2004. The court was to declare the company bankrupt, unless the company entered into a reconciliation agreement with the creditors meeting or due to other circumstances in accordance with the law.

On 15 October 2004, ST Ningjiao and its creditors entered into a reconciliation agreement at the first creditors meeting convened by the Chifeng intermediary court in which the majority of debts would be repaid by a mysterious third party--Haotian Green Industrial Investment Limited Liability Company. As a result, small shareholders narrowly escaped heavy losses.

The bankruptcy of listed companies is invariably a hard nut to crack, notwithstanding that the law allows listed companies to go through bankruptcy procedures. To date, there have been no cases of bankruptcy among listed companies.

The difference between a listed company and a common enterprise lies in the fact that the bankruptcy of a listed company affects not only shareholder interests but also the securities market. It is the wide range of affected stakeholders that make the bankruptcy of a listed company very thorny. Before the Ningjiao case, many listed companies failed to pay debts and ultimately escaped declaring bankruptcy. This phenomenon can now be seen as abnormal.

The insufficiency of the current bankruptcy law makes it impossible for a listed company to go bankrupt. Ailing listed companies have no alternative but to find new ways to survive in the absence of a system for reorganisation. However, during the process of trying to survive, the rights and interests of small and medium-sized shareholders are constantly impaired.

The Delong case is still pending. It is a case peculiar to the market economy of China. What makes it typical or distinct lies not only in its private attribute but also in its integration of industry with finance. This kind of integration is disposed to trigger systemic crisis. The belated reforms carried out in the financial sector and chaotic financial investments contributed to a scenario where only the bold set foot in the financial sector. When financial/industrial conglomerates lose control, systemic weakness is brought into the spotlight by crisis. Delong is a case that has been exposed.

To make matters worse, the current bankruptcy law plays no role in solving or alleviating this type of crisis with the result that the breakdown of the Delong conglomerate is likely to have a ripple effect on the market as a whole. This is, therefore, another imperative issue that the bankruptcy law must face.

The Delong case

The crisis of the Delong Group has been a very hot topic in recent years. The Delong Group is a typical privately run enterprise characterised by two notable features. The first feature is the leveraged merger and acquisition activities of Delong. In a short period of time, commencing with the acquisition of Xingjian Tunhe legal person shares, Delong merged with hundreds of manufacturing oriented enterprises ranging from ketchup, power facilities, cement, alloy materials, auto fittings, and manufacturing to the mining and agricultural industries. On the financial industry side, Delong was widely engaged in financial leasing, and the trust, securities and banking sectors. Finally, Delong became a sophisticated enterprise system involved in different industries. The second striking feature distinguishing Delong from its counterparts is its aggressive involvement in the banking industry. Delong quietly entered the banking industry by subscribing for shares issued by banks during China's financial reform process. Banks which were controlled, or whose shares were subscribed for by Delong are scattered widely geographically. They include banks located in Yunnan, Hunan, Sichuan and Jiangxi provinces, most of which are commercial banks.

On 4 April 2004, the share prices of three companies controlled by Delong, named Xianghuoju, Xinjiang Tunhe and Alloy Investment plummeted suddenly. From 2001 to 2003, the price of these three companies' shares remained relatively high against the continuously bearish secondary market background. On 21 April 2004, the drop in share prices of these three companies amounted to 40%. This meant that negotiable market value worth more than CNY 6.1 billion had vanished. Thereafter, the whole Delong chain ruptured. One after another, creditors filed bankruptcy suits sending Delong into crisis.

In August 2004, relevant supervisory departments intervened into the Delong crisis and decided that China Huarong Asset Management Company should be primarily responsible for the reorganisation of Delong in a market oriented way. At the date of writing, Delong International Strategic Investment Limited Liability Company had assigned all its property, including shares issued by listed companies and other assets at its disposable to China Huarong Asset Management Company.

The formulation of the new insolvency law and its effect on reshaping the credit culture and credit system

Internal and external incentives stimulate the drafting of the new bankruptcy law. The establishment of a socialist market economy has been the goal of China's economic and social development since the 15th Plenary Meeting of the Central Committee of the Communist Party. A unifying and perfect bankruptcy law is needed to guarantee the smooth functioning of the market economy. At the same time, the inconsistencies and problems arising from the older bankruptcy legislation and practices work as an internal factor prompting improvement. Compared with the internal requirement, China's accession to the WTO in 2001 accelerated its wide-ranging economic intercourse with the outside world, thus necessitating a new bankruptcy law in conformity with international practice.

As far as a country whose economic transformation is under way is concerned, the bankruptcy law is the basic institution for economic reform, for avoiding economic crisis and social turbulence. It bears a semblance to highly sensitive nerves in affecting social stability, economic wellbeing and culture in a multifaceted way. It has been ten years since the 8 th National People's Congress resolved to draw up a new bankruptcy law. In June 2004, the 10th National People's Congress considered the draft of the new bankruptcy law, the first time that a draft of a new bankruptcy law has been submitted to the National People's Congress for consideration. In October 2004, the Standing Committee of the National People's Congress considered the draft for a second time, which means that the drafting of the new bankruptcy law entered a crucial stage. The draft submitted by the Finance and Economy Commission to the standing committee is composed of 11 chapters and 164 articles covering general provisions, the application for and acceptance of bankruptcy cases, the administrator, debtor's property, declaration of claims, creditors meetings, reorganisation, reconciliation, liquidation, legal

obligations and liabilities and supplementary provisions. The institutional frame of the new bankruptcy law will deeply affect the credit system, credit culture and even the social and economic climate.

A consistent, market-based bankruptcy law

Compared with the current bankruptcy law, the most impressive feature of the new bankruptcy law is that it makes the chaotic old bankruptcy rules and regulations consistent. Article 2 of the draft stipulates that the scope of the bankruptcy law cover enterprises as legal persons, partnership enterprises and its partners, sole proprietorships and their capital contributors, and other profit-making organisations established in accordance with the law.[9] The new law will, therefore, end different treatments of different types of enterprises. After it comes into force, Chapter 19 of the civil litigation law will be abrogated. The bankruptcy of SOEs will be covered by the new bankruptcy law with the result that the days of policy-oriented bankruptcy are numbered. According to the new law, whether an enterprise is state-owned or not, or foreign or domestic will not be a criterion for giving different treatment; debts owed by all enterprises shall be recovered in accordance with the new market-based principles. Its implementation will be conducive to the formation and development of a mature, fair and well-functioning market. In addition, the new law is market-based and aims to alleviate and/or solve crises that occur during the operation of a market economy.

The guidelines of the draft law may be summed up as follows:

i. It is based upon country-specific situations and practices and accommodates the requirements and challenges brought by the establishment of a socialist market economy and China's access to WTO, while at the same time being committed to solving practical issues.

ii. It brings all enterprises, whether newly established, existing, SOE, domestic or foreign under a unified law.

iii. It establishes a system and reorganising institutions designed to ensure the "survival of the fittest". Concerning enterprises with no hope of recovery, greater losses shall be avoided. Medium and large-sized enterprises with prospects will be revitalised through reorganisation and reconciliation procedures.

iv. It renders fair protection to all interested parties in bankruptcy cases, prevents fraudulent bankruptcy, and regulates bankruptcy in a comprehensive way, while fully protecting the legitimate rights and interests of staff and workers. There are bankruptcy cases where the staff and workers' legitimate rights and interests are seriously prejudiced, social stability is gravely undermined. Solving these social problems and fully protecting workers' legitimate rights and interests top the drafting agenda.

v. It maintains the unity and consistency of the bankruptcy law and institutions as a whole. In addition to the new law, there are other laws, rules and regulations, including civil litigation law, company law, the law for commercial banks, insurance law, etc. that regulate the bankruptcy of specific enterprises. Special attention must be given to the coherence and consistency of these special bankruptcy provisions and the general provisions of the new bankruptcy law.[10]

Two value propositions determine the guidelines of the new bankruptcy law and its content. Specifically, the first value proposition is that the new bankruptcy law shall meet the requirements of a market economy and provide a fair and market-oriented basis on which bankruptcy cases are handled. With a transparent, clear-cut bankruptcy law, both existing and prospective debtors and creditors are

able to make sound commercial decisions, which is instrumental to avoiding risks and reducing transaction costs. Where insolvent and *bona fide* debtors go bankrupt, assets shall be liquidated and distributed to creditors in a transparent, fair, and well-ordered way. The second directing value proposition is that the new bankruptcy law shall address the special problems, without limitations, arising from the transition from the planned economy to a market economy by: properly and clearly defining the rights and obligations of debtors, creditors, government, employees and other stakeholders; dealing appropriately with the relationship between government and enterprises; adequately guaranteeing the funding of social insurance; and solving non-performing loans cost-effectively.

The institutional framework of the draft bankruptcy law

The administrator

The administrator is a new institution introduced by the draft law. The draft puts the administrator in a prominent and important position. Chapter 3 of the draft submitted to the Standing Committee of the National People's Congress stipulates the qualifications, legal status, powers and functions, supervision, remuneration, punishment and the like of the administrator. This is a breakthrough (compared to the liquidation team provided for in the current bankruptcy law) that is in line with international practices.

The administrator system is expected to enhance bankruptcy procedures in at least three aspects:

First, an administrator driven system implies making the bankruptcy procedure more authoritative and more transparent by creating an independent third party. Under the current bankruptcy law, members of the liquidation team are designated and appointed by relevant government departments. Few, if any, professionals are involved in the liquidation process, which makes it hard for the procedure to operate in a market oriented way. More unfortunately, the liquidation team is essentially absent from the liquidation process of non-SOE bankruptcies. To solve this problem, the draft bankruptcy law emphasises the professionalism of the administrator. According to the draft, the administrator shall be a liquidation team designated either by the court or established in accordance with the law, including intermediaries such as law, accounting, and bankruptcy and liquidation firms, etc. Likewise, persons who have relevant professional knowledge and obtain practice qualifications are capable of being appointed administrators.

Secondly, besides the improved neutrality of the administrator, the draft confirms the essential role creditors play in the appointment of the administrator, thus guaranteeing creditor rights and interests. Pursuant to Article 19, the court shall appoint the administrator. Per Article 56 of the draft, the creditors meeting is entitled to petition for the replacement of the administrator and to review his remuneration.

Thirdly, the draft prescribes the duties of diligence and loyalty to ensure that the administrator wields its powers and performs its functions prudently and diligently. Article 21 of the draft provides that, apart from the liquidation team, law firms, accounting firms and liquidation firms, and persons with relevant professional knowledge who have obtained practice qualification, may be appointed as administrators. Article 22 stipulates that one of the following circumstances disqualifies persons from being administrators: 1) having been criminally punished or having a criminal record; 2) revocation of the license of certified accountants and/or lawyers; 3) interest in the bankruptcy case; and 4) the consideration of the court that a person is inappropriate as administrator.

Reorganisation

Reorganisation is another freshly introduced procedure in the draft designed to revitalise distressed enterprises. The scope, basic procedures, protective measures, and reorganisation plan are stipulated in a particular chapter of the draft. Reorganisation typifies the mainstream of developments in modern international bankruptcy and has become an important component of the draft. At the outset, there was a consensus that reorganisation should be provided for in a separate chapter. The directing consensus aims at revitalising enterprises without initiating liquidation procedures.

To increase the likelihood of successful reorganisation, the draft widens the reasons for reorganisation to include enterprises that are likely to continue servicing their debts. These enterprises may apply directly for reorganisation. The reasoning is that management knows the real condition of the enterprise better than anyone else. The draft encourages the debtor to resolve its internal problems through legal procedures as soon as possible by specifying that the debtor may, when applying for reorganisation, apply for the management of the property and business itself.

The reorganisation system is the real game of the market economy. That is to say, the normal business environment has enterprises constantly confronting complicated financial and business difficulties. This is especially true with respect to large enterprises. For them, the creditor-debtor relationship and their financial structure is so sophisticated, and factors affecting their business operations are so numerous that using the value of enterprises to appraise whether they are insolvent or not is unjustifiable. However, the reorganisation of enterprises not only maintains and enlarges their operating value by creating a revival opportunity but also avoids social turbulence by retaining the human resources of enterprises.

Preferential protection to secured claim

Based on the theory that the protection of secured rights and interests is crucial to the stability of the financial system as a whole, the draft bankruptcy law clearly stipulates that if a claim is secured by mortgaged property, pledged property or lien property, relevant debts shall be realised to the extent that they are covered by the secured property. This means that the secured asset will not form part of the bankruptcy assets of a debtor. However, a secured debt is not inevitably safe.

This point deserves further comment since it tends to give people the wrong impression that secured claims are secured against any legal risk. In practice, there may be more than one mortgage on the same secured asset. In this instance, the priority of the secured rights will be ranked according to the date they came into effect. This should be either the date of registration of the secured right or the date of execution. Therefore, if the secured asset can be registered but all the mortgages over it have not been registered yet, the priority of payment will be determined in order of the execution dates. If some of the mortgages have been registered while others not, the registered mortgages shall have priority over non-registered ones. It is therefore not always the case that a mortgage will have the first priority. Furthermore, if the debt is secured by a guarantee, creditors should be careful with respect to the termination dates of guarantees under securities law. Even if they take actions to demand payment, they will have to do so again every two years to ensure that their secured claims will not lapse.

Combating the fraudulent bankruptcy

Fraudulent bankruptcy is a persistent problem. The occurrence of fraudulent bankruptcies has made the drafting of the bankruptcy law run counter to its original intention. The draft now has the primary goal of combating fraud by invalidating certain practices. Article 33 of the draft provides that

the administrator is entitled to request the People's Court to rescind certain activities concerning a debtor's property and property rights taken within one year before the court accepts a case. These include: 1) transferring property or property rights free of charge; 2) transferring property or property rights at abnormally depressed values; 3) providing security for debts that originally had no security; 4) paying off debts in advance; and 5) giving up creditors' rights. In addition, the draft states that the administrator is entitled to ask the People's Court to rescind repayments made by a debtor to specific creditors during the six months before the court accepts a bankruptcy case if the debtor knew of its general inability to meet its obligations (unless such repayments benefit the bankrupt property). Compared with the current bankruptcy law, the draft metes out more severe punishment for fraudulent bankruptcy and annuls certain acts resulting in a stronger defence against disloyal credit and bankruptcy acts.

In addition to annulling certain acts, the draft law prescribes civil, administrative, and criminal liabilities. Criminal liabilities apply to:

i. Directors, managers and other personnel of the bankrupt enterprise who bear major responsibility for the bankruptcy of the enterprise owing to gross negligence or intentional offence;

ii. Debtors or debtor representatives who are absent from mandatory creditors meetings without justifiable reason in spite of a summons from the People's Court;

iii. Debtors who refuse to submit information on their financial status, a detailed list of debts and credits, and related financial reports to the People's Court, or who submit false documents;

iv. Debtors who refuse to transfer property, accounts, documents, material, data and seals related to the bankrupt property to the administrator or the liquidator, or who counterfeit or destroy evidence resulting in ambiguity with respect to the property's status;

v. Debtors who knew or should have known of their inability to repay debts, but still make irrational or extravagant expenditures;

vi. Administrators and/or members of the creditors committee who take advantage of their duties or position to demand or accept bribes for personal interest;

vii. Administrators and/or members of the creditors committee who cause economic loss to the creditors, the debtor or a third parties due to negligence or other unlawful activity.

Implications for risk management

The draft bankruptcy law awakens both enterprises and individuals (either as capital contributors to sole proprietorships or as partners in partnerships) to the insolvency crisis and to the fact that insolvencies can have a negative effect on business operations through the increased difficulty of obtaining loans etc. Another newly introduced risk management instrument stipulated in this draft deserves special attention: the financial and/or operational reorganisation of large enterprises in such a manner as to avoid wide-ranging social turbulence.

Financial institutions, including banks and insurance companies, are omitted intentionally from the draft. Article 163 stipulates that the bankruptcy of commercial banks and insurance companies shall be dealt with pursuant to the implementation measures that will be formulated by the State Council in conformity with this law and other relevant laws and regulations. This exclusion is because of the peculiar aspects of financial institutions that distinguish them from non-financial enterprises. Besides reserve fund and capital adequacy requirements, financial institutions are expected to face

challenges raised by the implementation of the new law's requirements. What the specific requirements are likely to be remains to be seen.

Generally speaking, the draft of the new bankruptcy law not only draws on advanced and mature bankruptcy practices in developed countries, but also responds to China's specific situation. Considering the wide-ranging participation from enterprises, legal sections, and the public in the drafting process, one would expect that the new law might finally be passed at the end of 2004 by the Standing Committee of the National People's Congress. It will, by then, definitely propel China's economic reforms, and market economy development and reshape the credit culture constructively.

Notes

1 Article 2 of the Law of the People's Republic of China on Enterprise Insolvency stipulates, "this law applies to enterprises owned by all people".

2 Li Guoguang, *Comprehension and Application of Judicial Interpretations of the Insolvency Law Made by the Supreme Court*, People's Court Publication.

3 Xu Dongliang, *Trying Procedure of the Bankruptcy Case*, People's Court Publication.

4 World Bank, *Report on Bankruptcy Research of China's State-Owned Enterprises--The Necessity and Avenues to Reform the Bankruptcy Law and Institutions*, China Finance and Economy Press.

5 The Supreme Court Article 253 on Opinions on Several Issues Concerning the Application of the Civil Litigation Law states that: "the people's court shall apply Chapter 19 of the Civil Litigation Law, and refer to relevant provisions stipulated in the Bankruptcy Law of Enterprises (trial implementation) when trying the bankruptcy case".

6 World Bank, *Report on Bankruptcy Research of China's State-Owned Enterprises--The Necessity and Avenues to Reform the Bankruptcy Law and Institutions*, China Finance and Economy Press.

7 CNY: Yuan remnimbi.

8 Case origins: *Why Profitable Enterprises Went Bankrupt all of a Sudden--The Investigation into and In-Depth Reflection on the Bankruptcy of Zhongjiang County Silk Company in Sichuan Province, People Daily*, 31 October, 2001

9 During the drafting process, some advocated that the bankruptcy of 23 million individual industrial and commercial households, and personal consumptive acts be under the scope of the bankruptcy law. The drafting group held that the time was not ripe to bring the above-mentioned objects under the law's regulation or that of a new law on personal bankruptcy.

10 Finance and Economic Commission Under the National People's Congress, *Explanation of the Draft of the New Bankruptcy Law*, 21 July 2004.

THE ROLE OF THE ADMINISTRATOR IN CHINA'S NEW BANKRUPTCY LAW

by
Wang Weiguo*

Introduction

The new Bankruptcy Law of China is coming out. Something catching people's eyes in this law is the chapter on the administrator.

In the existing Enterprise Bankruptcy Law (For Trial Implementation) of 1986, the function of administration in the bankruptcy proceeding is assumed by the "liquidation team". The design of this institution has three features. First, the team is established after bankruptcy adjudication. Therefore, during the period from acceptance of a case to adjudication (which usually amounts to quite a long time) the assets and affairs of an insolvent firm continue to be controlled by the management without any outside supervision. There is, therefore, an obvious risk of pilfering of assets. Second, team members are mainly from local government agencies and lack neutrality, professional skills and transparency. Third, mechanisms for the supervision, dismissal and investigation of a team's conducts are absent.

In 1994 when the new bankruptcy law started to be drafted, the drafters realised the above-mentioned shortcomings. In the first draft we introduced a "temporary receiver" in order to fill the vacuum of administration before bankruptcy adjudication. Then, the draft established rules for takeover by the administrator as early as acceptance of a case and defined the administrator as intermediary agencies, *e.g.* lawyers and accountants that are supposed to be independent from the government. Afterwards the draft combined administrator, liquidator and reorganiser into a single concept named the "administrator".

Appointment of the administrator

As for the nature of the administrator, there are various doctrines that consider the administrator as a "representative of creditors", "representative of debtor", "representative of the estate of assets", "trustee" or "legal organ". The first two doctrines (representative of creditors and representative of debtor) are deemed to be inconsistent with the principle of neutrality. The second two, (representative of the estate of assets and trustee) are separately based on the concept of the estate of assets as a legal entity and the concept of trust which are not present in Chinese bankruptcy law. Therefore, in the process of drafting the new law, the leading doctrine is that of "legal organ" which takes the administrator to be an organ that is established by law and performs the functions provided by law in order to realise the objectives of bankruptcy proceedings. During the discussions, some scholars

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supported the doctrine of representative of creditors, suggesting that the administrator be appointed by the creditors' meeting. However, the majority agreed that even though protection of creditors' interests should be one of the major objectives of bankruptcy proceedings, the administrator must remain independent and neutral. The administrator could conceivably be required to litigate against some creditors to protect the larger group, as well as the debtor, workers or other parties with an interest.

Consequently, the draft provides that the administrator be appointed by the people's court and responsible to the court. Further, for the sake of monitoring by creditors' collectives over the administrator, the draft entitles the creditors' meeting to petition the court to dismiss an unqualified administrator and have him replaced.

Qualifications of the administrator

According to the draft, the administrator can be an intermediary agency such as a law, accounting or liquidating firm, or personnel who have relevant professional knowledge, special qualifications and experience. However, anyone who has ever been punished criminally or has had their professional license revoked, or who has an interest in the case, or who is unsuitable to take the position as deemed by the court shall not assume the office of administrator.

In reality, the function of the administrator is carried out by real persons. These persons should therefore be qualified practitioners. Based on the term "special qualification of practice" used in the draft, it seems a logical conclusion that a special license for insolvency administrators be put into practice and that only those who have passed the unified examination and received their license should be appointed as administrators in a bankruptcy case.

Taking into account the complexities of real practice, the draft grants judges discretion in determining the qualifications of the administrator. For instance, they may dismiss, or refuse to appoint a person who is proven incompetent to deal with a large company bankruptcy, has no commercial experience in business reorganisation, or has a grave moral blemish, even outside the scope of the unqualified situations as provided in the law, for the sake of maintaining justness and effectiveness in a bankruptcy case.

Functions of the administrator

There are eleven general functions of the administrator provided in the draft law:

i. Taking over the control of all the property, books, documents, files, seals and stamps, and so forth of the debtor;

ii. Investigating the situation of assets and making a report thereon;

iii. Determining the affairs of internal management of the debtor;

iv. Determining the day-to-day expenditures and other necessary spending of the debtor;

v. Employing management, professionals and other personnel as needed;

vi. Determining whether the debtor continues to operate before the first creditors' meeting;

vii. Managing and disposing of the assets of the debtor;

viii. Accepting payment or delivery of property to the debtor by a third party;

ix. Taking part on behalf of the debtor in litigation or arbitration;

x. Requesting the summoning of creditors' meetings; and

xi. Conducting other functions which the people's court deems necessary for the administrator to carry out.

In addition, there are a number of special functions provided in other chapters of the draft law. These include: the right to void transactions occurring prior to insolvency proceedings and recover the property transferred thereby when managing the assets; the duty to register and record filed claims and keep documents; the right to raise objection during investigations of claims; the duty to give notice for summoning creditors' meeting; the duty to report important dealings to the creditors' committee; the right to monitor the self-management of the debtor or appoint management during a takeover; the right to determine the performance of executory contracts; the right to submit reorganisation plans and to apply for an extension of time to formulate the plan; the right to negotiate and apply for confirmation when voting the plan; the duty to hand over affairs and the right to monitor for execution of the plan during the reorganisation proceeding; the right to call back secured property; the right to determine the performance of executory contracts; and the right to carry out the asset disposal scheme and the scheme of distribution during the liquidation proceeding.

The draft stipulates that the administrator may employ necessary staff. It is also stipulates that the expenditures and remuneration of the administrator and the cost of staff take priority as administrative expenses that can be paid out of the debtor's assets at any time.

The responsibilities of the administrator

The draft stipulates that the administrator shall carry out its functions with diligence, due care and loyalty. Further, whenever an administrator asks for or accepts a bribe, or is guilty of misconduct in office, and if the act constitutes a crime, criminal responsibility shall be investigated in accordance with the law. If the illegal act causes significant losses to the creditors, the debtor or a third party, liability for damages shall be imposed.

The draft establishes the creditors' committee as a standing agent of the creditors' meeting, with the main function of monitoring the administrator's management. Therefore, the draft lists major asset disposals and other significant transactions for which the administrator must report to the creditors' committee on a timely basis. This widens the administrator's responsibilities.

During the drafting process people expressed their concern with the moral hazard of the administrator. Obviously, it is crucial to establish the good reputation of the bankruptcy administrator in society from the very beginning. It is safe to say that the trust of society in the administrator is very important to the future implementation of the new bankruptcy law. On the other hand, we should understand the riskiness of bankruptcy administration, and should not ignore the particularities of such a business when imposing the standards of duty and care on the administrator. If the responsibilities imposed on the administrator are so hard so that people shy away from this profession, it would work against the purposes of the system of legal responsibility in the bankruptcy law.

The remuneration of the administrator

According to the draft, the administrator's remuneration shall be determined by the people's court and the standard of remuneration will be prescribed by the Supreme People's Court. In addition, the draft stipulates that any creditor who objects to the remuneration of the administrator may make a claim before the court.

Since the administrator's remuneration is paid in priority by the debtor's assets, the amount of remuneration is important to the creditors' interests. To a large extent, the maximisation of creditors' interests relies on the maximisation of the value of the debtor's assets. It is easy to see that fair and favourable remuneration is conducive to attracting excellent practitioners to take part in bankruptcy administration and provide excellent services.

Professionalising bankruptcy administration

It can be expected that with the implementation of the new bankruptcy law, bankruptcy administration will emerge as a new profession in China. In many modern countries bankruptcy practitioners have their guilds. In the global community there is a well-known international association of insolvency practitioners named "INSOL". After promulgation of the new bankruptcy law, we will have the difficult chore of rapidly training a large number of practitioners in bankruptcy administration and ensuring ongoing training. As a result, we should lose no time in organising local and national bankruptcy practitioner associations so as to strengthen the self-discipline of the industry, and develop business co-operation and international exchange. In this regard, the government may play an active role.

It is understood that the new law sets the foundation for a system of bankruptcy administration. At the same time, the life of the system comes not only from its logos, but also from its practice and the support of other relevant systems. The loyalty, diligence and wisdom of thousands of judges and practitioners for the cause of bankruptcy administration will be the real source of power that will allow the system to flourish in the long-term.

CORPORATE GOVERNANCE CONSIDERATIONS IN THE DRAFT BANKRUPTCY LAW OF CHINA

by
Wang Weiguo*

Introduction

Modern insolvency law and corporation law are close brothers. The rules of insolvency law that operate as a set of incentives and constraints to influence company directors' behaviour should be taken into account by both insolvency and corporation lawyers:

> Directorial accountability can operate through a variety of devices . . . but the purposes to be served by such devices may also vary. Insolvency law, for instance, might set out to punish an errant director; to protect creditors at risk from directorial actions; to compensate parties who have suffered losses at the hands of directors; and insolvency law and company law may also seek to achieve a number of other ends such as raising standards of business conduct and entrepreneurship.[1]
>
> Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles*

A search for the purposes underlying current corporate insolvency law controls over directors can begin with the Cork Report.[2] Cork indicated that the function of insolvency law was not only to distribute the insolvency estate to creditors, but also to encourage debt recovery and, through investigations and disciplinary actions, to meet "the demands of commercial morality".[3] Central here, then, was the notion that insolvency law and investigative processes would uncover assets concealed from creditors, ascertain the validity of creditors' claims, and expose the circumstances surrounding the debtor's failure. Cork, thus, emphasised the need for insolvency law to promote the "highest standards of business probity and competence".[4]

In China, the relevant provision on this account first appeared in the 1986 Enterprise Bankruptcy Law which reads as follows:

- **Article 42:** After an enterprise is declared bankrupt, the government supervisory departments and audit departments are responsible for pinpointing the responsibility for the bankruptcy of the enterprise.

  Where the legal representative of the bankrupt enterprise bears the major responsibility for the bankruptcy of the enterprise, administrative sanctions shall be applied.

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> Where the superior departments in charge of the bankrupt enterprise bear the major responsibility for the bankruptcy of the enterprise, administrative sanctions shall be applied to the leaders of such superior departments in charge.

During the past years, this rule was not well enforced. The main reasons are that most state-owned enterprises (SOEs) had long been insolvent before bankruptcy proceedings were filed and the elements contributing to the financial distress of SOEs were very complicated. On the other hand, the bankruptcy procedure lacked sufficient means to deal with the pre-petition conduct of management.

In 1994-95, when the new bankruptcy legislation was being drafted, the stipulation was ignored. At that time the focus of the drafting work in this regard was on fraudulent transactions and other illegal conduct during or prior to the proceeding, aiming at the order of collective satisfaction.

In 2000, when the drafting work started again, more attention was paid to corporate governance and the protection of financial stability.[5] In many occasions when the new law was under discussion, corporate governance was taken into account seriously. In the 2000 draft, the rule on investigating the responsibility of management for failure of the insolvent firm was restored.[6] Some rules related to corporate governance were stressed in subsequent drafts.

Since 2000, the draft has undergone several revisions. The current draft was completed in June 2004 by the drafting committee under the leadership of the Fiscal and Economic Commission of the 10th National People's Congress (NPC). In this draft, that has been submitted to the Standing Committee of the NPC and distributed nationwide to collect comments, the articles relevant to corporate governance could be categorised in two parts: first, restrictions on managerial behaviour during the procedure; and second, investigation of conduct prior to the procedure.

Restrictions on managerial behaviour during the procedure

Takeover

The draft set up the office of the administrator who is designated when the court accepts the insolvency case. One of the major functions of the administrator is to take over the assets and business of the debtor.[7] In order to fulfil this function, some duties are imposed on management:

- **Article 18:** The debtor and relevant persons shall bear the following obligations from the date when the people's court accepts the insolvency case:
  - i. Appropriately keeping all the property, accounting books, documents, data, seals and other articles that are occupied, used and managed by them;
  - ii. Working according to the requirements of the people's court, the administrator and the reorganisation executor and answering the inquiries with honesty;
  - iii. Attending the creditors' meeting as nonvoting delegates and answering the creditors' inquiries with honesty;
  - iv. Not leaving the place of domicile without the authorisation of the people's court; and
  - v. Not assuming the office of director, manager or the like at any other enterprise. The relevant persons referred to in the preceding paragraph include legal representatives of enterprise legal persons, partners and chief officers of partnership enterprises, investors and chief officers of sole-proprietorship enterprises or principals of other profit-making entities; if necessary and the people's court so decides, financial officers and key business executors of an enterprise may be included.

Business operation

In case the reorganisation proceeding is applied, the managerial personnel could be authorised to carry out business operation in two ways: first, self-management under the supervision of the administrator; and second, dealing with business as directed by the administrator. The draft provides:

- **Article 70:** During the period of reorganisation, if so applied by the debtor and approved by the people's court, the debtor may manage its assets and business affairs under supervision of the administrator.
- **Article 71:** If there is no such case as prescribed in Article 70 of this law, the administrator exercises the functions as prescribed in Article 23 of this law.

  The administrator may appoint the managerial personnel of the debtor enterprise to preside over its business operation.

In the first occasion, the former management would be more active in running the business, comparable to the concept of "debtor in possession" in American bankruptcy law. Bearing in mind that the problem of "moral hazard" of management cannot be excluded, the difference is that the Chinese draft sets the supervision of the administrator over the debtor, even if under the provisions of Article 71 this problem does exist. Obviously, the administrator is authorised here to supervise business operations with greater initiative.

One of the restrictive measures over managerial persons in the draft is the exit of reorganisation that leads to bankruptcy liquidation, as stipulated in the following:

- **Article 77:** During the period of reorganisation, upon the request of interested parties, the people's court may decide to terminate the reorganisation procedure after examination and confirmation:

  1. If the management and financial situation of the debtor continue to deteriorate and there is no possibility of saving it;
  2. If the debtor acts fraudulently, decreasing the enterprise's property value, delaying without reason or engages in other behaviour that is apparently disadvantageous to the creditors; and
  3. If the behaviour of the debtor institution or other employees makes the administrator unable to perform his duty.

  Where the reorganisation plan has not been submitted for approval upon the expiration of the period specified in Article 78, the people's court may decide to terminate the reorganisation procedure.

  Under the circumstances prescribed in the preceding two paragraphs, the people's court shall meanwhile make a ruling to declare the debtor bankrupt.

Sanctions

Some sanctions are provided in Chapter 10 on Legal Responsibilities against those who violate the above-mentioned restrictions. There are two illustrations below:

- **Article 152:** Debtors or debtor's representatives, who are obliged to be present at the creditors' meeting who are absent from the meeting without justifiable reason in spite of the summons from the people's court, shall be arrested and taken into custody by the people's court and shall be subject to an administrative fine of no more than CNY[8] 50 000 and no less

than CNY 5 000. Debtors and other personnel responsible for the accounts and other explanations shall be subject to an administrative fine of no more than CNY 50 000 and no less than CNY 5 000 by the people's court for providing false accounts or explanations.

Where such misconduct constitutes a crime, criminal responsibility shall be investigated in accordance with the law.

- **Article 153:** Where the debtor, in violation of the provisions of this law, refuses to submit the specifics of its financial status, the detailed list of debts, the detailed list of credits and related financial reports to the people's court, or submits false documents, the people's court may impose a fine ranging from CNY 5 000 to CNY 50 000 on the person directly responsible for the violation.

  Where the debtor, in violation of the provisions of this law, refuses to transfer the property or the accounting books, documents, material, data and/or seals related to the property to the administrator or the bankruptcy liquidator, or where the debtor counterfeits or destroys evidence related to the property resulting in ambiguity regarding the property's status, the people's court may impose a fine ranging from CNY 10 000 to CNY 50 000 on the person directly responsible for the violation.

  Where anyone acts as described in the preceding two paragraphs and commits crimes, criminal responsibilities shall be investigated in accordance with the law.

Investigation of conduct prior to the procedure

Exposing debtor's business failure

There was a strong voice in the drafting process calling for the investigation of the role of management in the business failure that led to the bankruptcy. In the current text, Article 151 differs from Article 156 of the 2000 draft[9] in three ways. First, the duties of loyalty and care are introduced as general standards of behaviour. Second, intentional offences and gross negligence are taken as aggravating circumstances. Third, disqualifications and some other personal restrictions are imposed. It is also obviously different from Article 42 of the 1986 Enterprise Bankruptcy Law in which civil liability and the sanction of disqualification are not adopted. Remarkably, in Chapter 1, General Principles, Article 9 of the June 2004 draft, a new provision states, "the people's court shall … investigate the legal responsibilities of managerial personnel of bankrupt enterprises in accordance with the law". This means that the legislature will strengthen the discipline over managements who are responsible for bankruptcy.

- **Article 151:** Where the directors, managers and other personnel of the bankrupt enterprise breached their duties of loyalty and diligence so as to lead to the bankruptcy of the enterprise, they shall assume the relevant civil liabilities; those who led to the bankruptcy by intentional offence or gross negligence shall carry liability jointly and severally for the enterprise's debts; where their misconduct constitutes crimes, office criminal responsibility shall be investigated in accordance with the law.

  Personnel as above described shall not engage in any elevated consumption spending or any investment before the civil liabilities are fulfilled and shall be restricted from being directors, managers or assuming other managerial offices for five years following the conclusion of the bankruptcy case.

This could be deemed a positive response to the principle suggested by the World Bank that "[l]aws governing director and officer liability for decisions detrimental to creditors made when an

enterprise is in financial distress or insolvent should promote responsible corporate behaviour while fostering reasonable risk taking. At a minimum, standards should hold management accountable for harm to creditors resulting from wilful, reckless or grossly negligent conduct."[10]

Avoidance of pre-commencement transactions and transfers

UNCITRAL suggests, "Many laws regard some transactions executed prior to the initiation of an insolvency proceeding as unfair or financially harmful to the interests of all of the debtor's stakeholders, especially if they are executed in contemplation of a likely insolvency. A transaction may fall into this category retrospectively—that is, it may be a transaction that would not ordinarily be regarded as legally wrongful, but is seen as harmful in light of a subsequent insolvency. "[11] In most of the insolvency cases in China, debtors had long been insolvent before commencement of the proceedings, and the managements thereof had plenty of time to conceal or transfer the property to themselves or related persons with the effect of prejudicing the general body of creditors. This is a common phenomenon worldwide as IMF indicates: "[a] debtor may enter or be placed into insolvency proceedings days, weeks, months, or sometimes years after recognising that this outcome is inevitable. In anticipation of the formal commencement of insolvency proceedings, therefore, debtors may deviate from their ordinary business practices by attempting to hide assets from their creditors, incurring artificial liabilities, favouring certain creditors over others, or making donations to relatives or friends."[12] China's existing Enterprise Bankruptcy Law sets forth a mechanism that recaptures assets whose transfer prior to the commencement of the proceedings has a detrimental effect as follows:

- **Article 35:** During the period from six months before the people's court accepts the insolvency case until the date that bankruptcy is declared, the following actions of a bankrupt enterprise are null and void:
  - i. Concealment, secret distribution or transfer of property without compensation;
  - ii. Sale of property at abnormally depressed prices;
  - iii. Securing with property claims that originally were not secured with property;
  - iv. Early repayment of claims that are not yet due; and

Abandonment of the enterprise's own claims.

With respect to bankrupt enterprises that have committed acts listed in the previous paragraphs, the liquidation team has the right to apply to the people's court to recover the property, which shall be added to the bankruptcy property.

In practice, this provision has two shortcomings. First, the period from six months before acceptance of the case is too short. Second, the unfair favourite payment prior to the proceeding is ignored. UNCITRAL advises:

> Four common types of avoidable transactions are found in most legal systems. They are: transfers intended to defraud creditors, transfers at an undervalue, preferential payments to certain creditors, and invalid security interests. Some insolvency laws explicitly specify the suspect period (for example, so many days or months before commencement of insolvency) during which each of these types of transactions would be subject to avoidance. . . . Some systems may have one suspect period for all types of avoidable transactions, while others have different periods depending upon factors such as whether the injury to creditors was intentional, or whether the transferee was an insider (i.e. a person who has a close corporate or family relation to the debtor or its creditors). Because fraudulent transactions involve intentionally wrongful conduct, substantial suspect periods, which might be anything from one to six years, are often fixed.[13]

The draft law includes three articles to address these transactions:

- **Article 33:** Within one year before the people's court accepts the insolvency case, the administrator is entitled to request the people's court to rescind the following actions taken by the debtor concerning the debtor's property and property rights:
    i. Transferring property or property rights free of charge;
    ii. Transferring property with obviously unreasonable low prices;
    iii. Providing property security for debts that originally have no property security;
    iv. Paying off in advance an undue debt;
    v. Giving up credits; and
    vi. Other activities that impair the interests of the creditors.

- **Article 34:** Within six months before the people's court accepts the insolvency case and with full knowledge of his inability to pay off due debts, where the debtor still pays off debts to specific creditors, which impairs the interests of other creditors, the administrator is entitled to request the people's court to rescind the repayment unless the specific repayment benefits the bankrupt property.

- **Article 35** The following activities taken by the debtor concerning the property and property rights of the debtor shall be invalid:
    i. Hiding or illegally distributing property; and
    ii. Fabricating debts or recognising unreal debts.

The most severe frauds contained in Article 35 shall be void whenever they occur. The other fraudulent transactions in Article 33 are treated invalid within the suspect period of one year before acceptance.[14] Article 34 dealing with unfair favouritism seems quite gentle with only six months of suspect period and some exceptional cases added. Corresponding punishments for these violations are as follows:

- **Article 154:** Where the debtor acts as described under the provisions of Article 35 of this law, the people's court may impose a fine ranging from CNY 20 000 to CNY 100 000 on the person directly responsible for the misconduct. Where such misconduct constitutes a crime, criminal responsibilities shall be investigated in accordance with the law.

- **Article 155:** Where the debtor acts as described under the provisions of Article 33 and Article 34 of this law, the people's court may impose a fine ranging from CNY 10 000 to CNY 50 000 upon the person directly responsible for the misconduct. Where such misconduct constitutes a crime, criminal responsibilities shall be investigated in accordance with the law.

In comparison with the provisions of Article 41 of the existing 1986 Enterprise Bankruptcy Law,[15] the punishments in the draft are much clearer and workable. By way of illustration, "administrative sanctions" in Article 41 are decided by the government. In the past years, their occurrence has been rare. It is not expected that government agencies will be involved in bankruptcy proceedings in the age of the market economy. Moreover it does not appear justified to impose administrative sanctions on managers of non-state investments. The proper solution should be to shift the sanctioning power from the government to the courts.

In addition to the right to rescind or void the transactions described in Articles 33, 34 and 35, the right to recover the property so transferred is granted to the administrator who is appointed at the time of the court's acceptance of the case and who is responsible for taking over and managing the debtor's assets.[16]

Further recovery of property abnormally obtained by the management

During the drafting process some people urged the establishment of a rule dealing with situations where the management enriched itself or otherwise dissipated company assets when the enterprise had long been distressed. In response to this appeal some particular stipulations are given in the draft.

- **Article 38:** The administrator shall recover the abnormal income that the directors, managers and other principals of the bankrupt enterprise have obtained by taking advantages of their official authority and enterprise property that they acquire in the same manner.
- **Article 156:** Where the debtor has known or should have known of his inability to pay off his due debts, but still makes irrational or extravagant expenditures, the people's court may impose a fine ranging from over CNY 10 000 to CNY 50 000 on the person directly responsible for the action. Where such misconduct constitutes a crime, criminal responsibilities shall be investigated in accordance with the law.

Conclusions

Generally speaking, there are two basic problems related to corporate governance. The first one is the so-called "soft budget constraint". Where there is opportunity to shift risk and losses to outsiders, *e.g.* creditors or consumers, the insiders of a company are willing to act wildly against legal and moral norms. The second one is the information asymmetry between insiders and outsiders. Since the outsiders have insufficient information concerning the risk/loss shift, the insiders have a much higher probability of "winning the game". This may further encourage insiders to seek rents. In ordinary situations outsiders are not entitled to look into the inside of a company; they have no means of getting sufficient information. When the bankruptcy procedure is applied, however, the situation is different–almost all the information will be available to the creditors or the administrator who has the function of protecting creditors' interests. As long as there is a mechanism to investigate and punish misconduct, anticipation of reprisals will encourage a "hard budget constraint" and restrict the "moral hazard" of insiders.

In fact, bankruptcy law is a potential mechanism of outside supervision. Since the key issue of corporate governance is transparency or information disclosure, bankruptcy procedure provides creditors the power of supervision under the circumstance of corporate insolvency. Significantly, this power is exercised in a collective way, and supported by the judicial authority and some professional agencies. This should be a strong force in spurring management to work with great loyalty and diligence.

It is to be expected that when the new Bankruptcy Law is promulgated and enforced, it will play a positive role in improving corporate governance in China. First, management (when anticipating the legal effect of their conduct under the bankruptcy procedure) shall have incentives to operate businesses with greater care, whether combating financial difficulties or avoiding fraudulent transactions. Second, recognising the risk of possible investigation and legal punishment provided in the new law, they shall have less courage to take advantage of bankruptcy to evade liabilities, and will improve the manner in which they carry out their managerial functions.

Notes

1 Finch V. (2002), *Corporate Insolvency Law: Perspectives and Principles*, Cambridge University Press, p. 495.

2 *Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558, 1982) "the Cork Report".

3 Cork Report, para. 235.

4 See, also, Finch V., *Ibid*, p.496.

5 See, Wang Weiguo, "On Several Aims in Drafting the New Bankruptcy Law", *Tribune of Political Science and Law*, No.3, Vol.20 (June 2003). This paper is based on the author's speech at the International Conference on Corporate Insolvency and Reorganisation in July 2000. The author indicates:

> "It is an important task of enacting new bankruptcy law to advance and safeguard the SOE reform. . . . The fundamental objective of SOE reformation is establishment of modern company system, and one of the major issues in this system is corporate governance. The new bankruptcy law shall play a role in bestirring and spurring on the corporate managements and shall not leave chance for the scrimshankers and badger hats to betake themselves to their heels via bankruptcy."

6 Article 156 of the 2000 draft reads:

> If the directors, managers and other administrative personnel of an enterprise render the enterprise bankrupt due to their negligence or deliberation, they shall be imposed a fine of more than [CNY] 50 000. If the acts constitute crimes, criminal responsibilities shall be investigated in accordance with the laws.
>
> The personnel punished under the preceding paragraph shall be prohibited from engaging in operation and management affairs of an enterprise within 10 years after the close of insolvency case.

7 Article 25 reads: "The administrator shall take over the debtor's all property from the date appointed by the people's court."

8 Chinese yuan (CNY).

9 For Article 156 of the 2000 draft, see, note 7 above.

10 The World Bank (2003), *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*, No.6.

11 United Nations Commission on International Trade Law (2001), *Draft Legislative Guide on Insolvency Law: Report of the Secretary-General*, para.119.

12 IMF Legal Department (1999), *Orderly & Effective Insolvency Procedures: Key Issues*.

13 United Nations Commission on International Trade Law (UNCITRAL) (2001), *Draft Legislative Guide on Insolvency Law: Report of the Secretary-General paras.*122, 124.

14 The suspect period for such circumstances as specified in this Article was originally six month in the 1995 draft and then became one year in the 2000 draft.

15 Article 41 of the Enterprise Bankruptcy Law reads:

> With respect to bankrupt enterprises that have committed any of the acts listed in Article 35 of this law, the legal representative and the directly responsible personnel of the bankrupt enterprise shall be subject to administrative sanctions; where the acts of the legal representative and the directly responsible personnel of the bankrupt enterprise constitute crimes, criminal responsibility shall be investigated in accordance with the law.

16 Article 36 reads:

> The administrator is entitled to recover the debtor's property or property rights that are obtained through activities stipulated in Article 33, Article 34 or Article 35 of this law.

TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK MANAGEMENT: THE EXPERIENCE OF HONG KONG, CHINA

by
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Introduction and summary

On 1 July 1997, Hong Kong became a Special Administrative Region of the People's Republic of China under the "one country, two systems" approach embedded in the Basic Law (Hong Kong's constitution). Although part of China, Hong Kong retains a common law commercial structure with English origins. Hong Kong's insolvency laws are in the midst of reform–dramatic changes to bankruptcy law came into operation in 1998. Several (albeit unsuccessful) attempts have been made to enact a corporate rescue procedure called provisional supervision, and substantial amendments to corporate liquidation law are likely to be enacted within the next few years.

In Hong Kong, different laws apply to the insolvency of individuals and companies. Personal insolvency law is contained in the Bankruptcy Ordinance, as amended by the Bankruptcy (Amendment) Ordinance 1996, which came into operation on 1 April 1998. Corporate insolvency law is contained in the Companies Ordinance. A liquidation is also called a "winding up". There are two types of liquidation procedures: voluntary winding up (a winding up without a court order) and winding up by the court (compulsory winding up). The discussion of corporate insolvency below will focus on compulsory liquidations and the proposed provisional supervision procedure.

The most significant ongoing debate in Hong Kong regarding insolvency, centres on the proposed enactment of the controversial provisional supervision procedure. Unlike almost every other jurisdiction in the region, Hong Kong still lacks an effective formal insolvency procedure for restructuring or rehabilitating companies. It is unclear at this stage whether the legislation will ever be enacted. The pendulum has swung back and forth many times on this issue and, at present, it again appears that provisional supervision will not be enacted.

In the absence of an effective corporate rescue law, there have been two developments in Hong Kong that have filled the void. First, in April 1998, the Hong Kong Association of Banks (HKAB) issued guidelines for corporate restructuring in multi-bank situations based on the well-known London Approach. In 1999, these guidelines were revised and extended in the form of joint guidelines issued by the HKAB and the Hong Kong Monetary Authority (HKMA), and are known as the Hong Kong Approach to Corporate Difficulties. (See HKMA Quarterly Bulletin 13, 11/1999). These guidelines have proved useful in practice.

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The second development, and one of the most significant recent judicial developments in Hong Kong insolvency law, has been the adoption by the courts of the provisional liquidation procedure for use in corporate reorganisations. Traditionally, provisional liquidation is an interim period during which the assets of a company are protected while the court considers the merits of making a winding up order. However, concerning Keyview Technology (BVI) Ltd. [2002] 2 HKLRD 290 (Keyview), the court extended the provisional liquidators' powers and enabled the provisional liquidators to participate in a restructuring. (In Keyview, the provisional liquidators first secured the agreement of all the company's creditors to a restructuring proposal before applying to the court for an extension of their powers and permission to participate in the restructuring.) Over the last two years, the use of provisional liquidation to facilitate corporate rescue has become generally accepted in Hong Kong, and the holding of Keyview has been extended by the courts in several cases, including Luen Cheong Tai International Holdings Ltd. [2002] 3 HKLRD 610, Re I-China Holdings Ltd. [2002] HKCFI 1357, and Re Fujian Group Ltd. [2003] HKCFI 36. These cases make it clear that provisional liquidators can be appointed at the outset to facilitate a corporate rescue. The irony is that the courts' creativity in fashioning provisional liquidation as a corporate rescue procedure is now raised by many as a factor against the need for the enactment of provisional supervision.

Another important recent case is the decision in August 2004 in Re Zhu Kuan Group Co. Ltd. (HCCW 874/2003) in which the Hong Kong High Court wound up the Zhu Kuan Group Co Ltd. (ZK Group), which was incorporated in Macau and had served as a "window company" for the Zhuhai Municipal Government. The decision offers the most in-depth discussion to date of the factors for a Hong Kong court to apply when deciding whether to wind up a foreign company as an "unregistered company" under Part X of the Companies Ordinance. The court wound up the ZK Group even though winding up proceedings were also underway in Macau; counsel for the petitioner stressed that the making of the winding up order would enable the liquidators to use the private examination power under Section 221 of the Companies Ordinance and thereby, perhaps, locate undisclosed assets.

Trends and developments in insolvency and creditor rights frameworks and practices

Current legal and institutional developments[1]

As noted above, the most contentious area of insolvency law reform in Hong Kong involves corporate rescue. Provisional supervision recommendations were first made by the Law Reform Commission's Sub-Committee on Insolvency in its 1995 Consultation Paper and by the Law Reform Commission (LRC) in its 1996 Report. Serious opposition arose to many aspects of the government's proposal in its first bill in January 2000, which differed in several important respects from the earlier recommendations of the LRC and its Insolvency Sub-Committee. The government's second bill proposing provisional supervision, gazetted in 2001 (The Companies (Corporate Rescue) Bill, Legal Supplement No. 3 to the HKSAR Gazette No. 20 (Vol. 5), 18 May 2001) continues to attract opposition, primarily because of its approach to resolving the issue of workers' rights (discussed below). The current consensus is that the bill will not be enacted.

At present, the only statutory mechanism available in Hong Kong to enable a company in financial distress to restructure is a scheme of arrangement pursuant to Section 166 of the Companies Ordinance (a replica of the UK scheme of arrangement procedure), which was not specifically designed for insolvency reorganisations. This procedure is expensive, requires many court hearings, does not include a moratorium (unless commenced during provisional liquidation), and is rarely used in practice.

The LRC's proposals for a new provisional supervision regime were intended to streamline the corporate rescue process, with the use of a moratorium and minimal court involvement. A company,

without going to court, would be able to appoint a suitably qualified professional–normally an accountant with extensive insolvency experience–to take over the management of the company and to ascertain whether a rescue plan is feasible. If so, a rescue proposal would be put to the creditors for their approval (two-thirds in value of the creditors present and voting in one single class). To increase the odds of the rescue succeeding, super-priority funding would be available and give the post-commencement lender priority over all other debts except a fixed charge.

The January 2000 bill almost immediately came under attack, primarily for its handling of wage and other claims owed to a company's workers. The bill–in variance from the LRC's proposals–proposed that a company would either have to pay in full all wages and other entitlements owing to the workers or set up a trust account with sufficient funds at a bank, before the company could go into provisional supervision. The main objection to this proposal was how a company in financial distress was going to raise sufficient amounts to pay in full, and in advance, all outstanding workers' claims. (For an alternative proposal for how to handle workers' claims in provisional supervision, see Philip Smart & Charles D. Booth, Provisional Supervision and Workers' Wages: An Alternative Proposal, 31 Hong Kong Law Journal 188-199 (2001)). Unfortunately, however, the most recent bill, gazetted in 2001, retains this position. In late 2001, it appeared that a possible compromise was in the offing pursuant to which (instead of a company having to pay off its workers in full in advance or set up a trust account), a limit or cap would be put on the amount that would have to be set aside by the company before it could go into provisional supervision. This limit would be calculated by reference to the amounts currently payable by the Protection of Wages on Insolvency Fund where a company goes into compulsory liquidation. However, it seems that this compromise might prove to be too little, too late and, at this stage, most pundits are predicting that the bill will not be enacted.

Institutional developments

The judiciary

Hong Kong has a well-developed institutional framework for administering insolvency cases based on an English model. There is not a separate insolvency court system. Rather, the Court of First Instance, Hong Kong's highest trial court and part of the Hong Kong High Court, has jurisdiction over corporate liquidations and reorganisations. Twenty-four judges sit in the Court of First Instance and one judge hears company law cases and deals with contested winding up petitions and other corporate insolvency matters. This judge will also deal with matters relating to provisional supervision if the new procedures are enacted. Unopposed winding up petitions are dealt with by the Registrar of the High Court in open court.

Article 85 of the Basic Law provides for the independence of the judiciary. Unlike in some other Asian jurisdictions, in Hong Kong the government does not interfere in the handling and administration of insolvency cases. There is confidence among insolvency practitioners in the independence and integrity of the judicial system and in the standards of performance of the judiciary. Article 92 of the Basic Law provides that judges shall be chosen based on their judicial and administrative qualities and may be recruited from outside Hong Kong. Article 88 provides that judges are to be appointed by the Chief Executive on the recommendation of an independent commission. In practice, most judges come from the Hong Kong Bar.

The professionals

There is a large group of insolvency practitioners (lawyers, accountants, and others) in Hong Kong. As Hong Kong's system is based on the English model, accountants play the central role in the process. There is no formal registration or certification procedure for insolvency practitioners.

However, the Official Receiver's Office sets requirements for insolvency practitioners who wish to be appointed as liquidator. For example, to be able to serve as a Panel A liquidator in a compulsory liquidation case in which the assets exceed HKD[2] 200 000, an insolvency practitioner must show that they have undertaken at least 600 hours of insolvency work on non-related insolvent liquidations during the previous three years.

The Hong Kong Institute of Certified Public Accountants (HKICPA) (formerly the Hong Kong Society of Accountants or HKSA) has established an Insolvency Interest Group that is open to accountants, lawyers, and other insolvency practitioners. The HKICPA also runs three insolvency training courses, including a Diploma Course in Insolvency (soon entering its fourth year), which is recognised by the Official Receiver's Office. Successful completion of the Diploma Course counts as the equivalent of 50 hours toward the 600-hour requirement under the Panel A scheme.

The Official Receiver's Office monitors the conduct of private sector insolvency practitioners in compulsory liquidations and, where necessary, takes action against those practitioners who are negligent or fraudulent in their casework, including the commencement of disqualification proceedings. The statutory framework for the remuneration of insolvency professionals is set out in the Companies Ordinance and the Companies (Winding Up) Rules (CWUR). Section 196 of the Companies Ordinance provides that where a person, other than the Official Receiver, has been appointed liquidator, his remuneration shall be by way of percentage or otherwise as determined (a) where there is a committee of inspection, by agreement between the liquidator and the committee of inspection or (b) where there is no committee or where the liquidator and committee are unable to agree, by the court. CWUR Rule 146(2) provides that where there is no committee, the liquidator's remuneration shall be fixed by the scale of fees and percentages for the time being payable on realisations and distributions by the Official Receiver as liquidator. Where the Official Receiver is of the opinion that the remuneration of a liquidator should be reviewed, he may apply to the court and the court may make an order confirming, increasing or reducing the remuneration of the liquidator. (CO, Section 196(2A). The Official Receiver has approved standard hourly rates for Panel A liquidators in consultation with the Hong Kong Society of Accountants.

The issue of the compensation of insolvency professionals in Hong Kong was sparked by a judgment in the liquidation proceedings arising from the collapse of Peregrine–Re Peregrine Investments Holdings Ltd. & Ors. [1998] 3 HKC 1. The case involved a request by the provisional liquidators for payment of their fees and recovery or reimbursement for professional fees incurred by them out of the assets of the companies in liquidation. The sums sought were substantial–HKD 76 million for the 63 days between the commencement of the provisional supervision and the making of the winding up orders. In the court's view, the critical issue was whether the provisional liquidators had discharged the burden of showing that the fees they sought were justified. Among the factors noted by the court were the following (ibid, p. 15):

- Whether the provisional liquidators had sufficiently explained the nature of each task undertaken;
- Whether these explanations were properly linked to the time spent on the task;
- Whether a reasonably prudent man would have spent his own money on what the provisional liquidators did;
- Whether the provisional liquidators had produced contemporaneous time records of what they did and why they did it, as well as of all items of expenditure and of services rendered, how they were calculated, and how they were justified;

- Whether the fees for any item of work should be disallowed as being unnecessarily incurred; and
- Whether the fees for any item of work should be disallowed as being incurred in the breach of duties.

This case led Hong Kong accountants and solicitors to review their internal billing and record keeping practices.

The regulators

The Hong Kong Monetary Authority (HKMA) is effectively a combined Central Bank and Regulatory Commission, reporting to Hong Kong's Financial Secretary. Several boards (*i.e.* the Exchange Fund Advisory Committee, the Banking Advisory Committee, and the Deposit Taking Company Advisory Committee) oversee the major functions of the HKMA. While the HKMA is superficially analogous to a Ministry of Finance unit, the operational autonomy of the HKMA is statutorily guaranteed by the Exchange Fund and Banking Ordinances. Operational autonomy was further clarified in June 2003 by a public exchange of letters that details the delegation of statutory powers from the Financial Secretary to the HKMA.

The total staff of the HKMA is approximately 600. Even post-handover, Hong Kong continues to open senior regulatory positions to non-local candidates, thereby tapping a global talent pool. The Hong Kong civil service is among the world's highest paid, and the remuneration of regulators has been adjusted further to be competitive with the local highly-compensated financial sector. Pay for HKMA staff is reviewed annually by the Financial Secretary, taking into account the findings of independent consultants on pay trends and pay levels in the financial sector. Staff members are entitled to an annual bonus based on individual performance.

In bank regulation, the HKMA operates with a high degree of transparency, exemplified by the detailed and bilingual guidelines on risk management published online. Hong Kong's role as a regional centre of financial journalism may have positive effects as well.

Since 2002, the HKMA has implemented a training programme of vertical and horizontal training, encompassing topics including risk-based supervision, the New Capital Accord, stress testing, money laundering, deposit protection, credit reference agency and securities activities. In 2003, an average of 6.4 training days per staff was provided.

Status of other institutions such as AMCs

AMCs and other government-sponsored financial or corporate workout institutions have not been necessary in Hong Kong. (Some may assert that the support provided to the Hong Kong stock market by investment into the Tracker Fund by the Exchange Fund several years ago might have served some of the same purpose).

Current practices in various areas

Efficiency of secured lending procedures and unsecured credit

Hong Kong has an effective secured-lending regime with fixed and floating charges based on the English model, although floating charges are less frequently used in Hong Kong than in England. Banks enforce their charges through the appointment of a receiver (fixed charge) or a receiver and manager (floating chare).

Recourse to liquidation

A record 1 451 compulsory winding up petitions were filed in 2003. The rate has slowed down a little with 1 048 petitions having been filed in the first ten months of 2004. Winding up orders were made in 1 248 cases in 2003 and in 927 cases in the first ten months of 2004.[3] However, these numbers would have been much higher if creditors had resorted to corporate insolvency at the rates seen in many counties overseas. In Hong Kong, creditors, generally, and banks, in particular, are slow to petition for liquidation. It is common for banks that have security in the form of real property that is underwater to wait for market recovery rather than to resort to winding up proceedings.

The threat of commencing liquidation proceedings is a disciplining mechanism in Hong Kong. Until recently, the filing of a winding up petition was the death knell for a company.

Recourse to reorganisation procedures/out-of-court workouts

The formal corporate rescue mechanism under Section 166 of the Companies Ordinance is rarely used. As noted above, there have been some recent cases in which provisional liquidation has been used to facilitate reorganisation. The majority of companies in Hong Kong that resort to reorganisation are restructured out of court. The government does not keep any statistics on the utilisation of The Hong Kong Approach to Corporate Difficulties or on out-of-court workouts generally. Furthermore, data from the private sector is hard to come by, as most companies prefer to keep their "reorganisation" confidential. Anecdotal evidence, however, suggests that the annual number of successful out-of-court corporate restructurings of Hong Kong companies is in the low 100s, while the number of cases involving formal or informal rescheduling or refinancing of debt is in the low 1 000s.

Current risk assessment and management systems and policies

Risk assessment and management systems

Sources of major credit problems

For decades, the chronic credit concern in Hong Kong has been exposure to the real estate sector–aggregating exposures via residential and commercial mortgages, loans to property developers and projects, and less direct exposure via loans to companies heavily engaged in property development and/or investment. Historically, credit problems arose cyclically from over-lending to developers, with owner-occupied residential properties enjoying very low default rates. However, in recent years, Hong Kong has not experienced a banking crisis due to this concentration of credit, though bank credit is highly concentrated in residential mortgages and real estate development as the table below displays.

Prudential norms, role of financial sector authorities, and supervisory information needs

The HKMA has taken an aggressive posture on compliance with the Bank for International Settlements. For example, the internationally accepted capital adequacy framework proposed by the Basle Committee on Banking Supervision in 1988 has been applied in Hong Kong since the end of 1989. Locally incorporated institutions report their capital adequacy ratios in accordance with the Basle I definition. The consolidated capital adequacy ratio for locally incorporated institutions has remained in the high teens over the past five years–well in excess of the minimum international standard of 8% set by the Basle Committee.

In a presentation given in September 2004 to the Global Association of Risk Professionals–Asia Pacific Convention, the HKMA's Executive Director, Banking Policy, demonstrated Hong Kong's commitment to apply Basle II, pointing out, *inter alia*, that "Hong Kong is one of the first jurisdictions to publish detailed implementation plans for Basle II" and that "we will allow institutions to choose between standardised approach, foundation IRB and advanced IRB for credit risk, and between basic indicator approach and standardised approach (not AMA) for operational risk; we will also allow smaller institutions to choose a 'basic' approach".

With encouragement from the HKMA, banks are moving to greater granularity in internal risk rating systems; internally used loan classification systems are generally increasing to 8-12, though still mapped to a standard central bank 5-category system in use since 1994.

Value-at-Risk (VaR) measurement of market risk is almost universally used by banks active in Hong Kong, and VaR figures are regularly disclosed in footnotes to accounts. More recently, some larger banks are extending VaR methodology to credit portfolios.

As Hong Kong has been relatively early in articulating its posture on Basle II compliance for its banks, the consideration of software system upgrades (and aggressive marketing by their providers) has also received an early start.

Existence and effectiveness of specific structures

Banks adhere to HKMA credit principles guidelines regarding separation of risk management and marketing, separation of credit risk and branch management, independent internal audit function, and convergence of credit origination, credit risk management and credit inspection at or close to Board level. Weaknesses have been revealed in banks' credit card risk management procedures.

Disclosure requirements and practices

The standard of financial disclosure in Hong Kong has been brought substantially in line with that of other leading financial centres following adoption in 1994 by Authorised Institutions (AI) (see text box below) of the Best Practice Guide on Financial Disclosure issued by the HKMA. In addition to annual disclosure standards for locally incorporated authorised institutions, the HKMA has also issued guidance in respect of interim financial disclosure by locally incorporated institutions and half-yearly financial disclosure by institutions incorporated overseas. In 2001, the three sets of financial disclosure standards were recast into modules of the HKMA's consolidated Supervisory Policy Manual.

Annual reports are not generally released. Instead, companies publish their results on one or two pages in local newspapers. In contrast to their counterparts in many western countries, Hong Kong companies are usually slower to voluntarily release negative information during the middle of reporting periods and less likely to comply with filing deadlines as set out in the companies legislation.

Extent to which the practices take into consideration new financial instruments: their relevance in addressing NPAs in the country; and adequacy of risk management schemes to evaluate the risks stemming from new financial instruments

In June 2001, the HKMA issued a statutory guideline under the Banking Ordinance, section 16(10), superseding its circular Supervisory Approach to Credit Derivatives of November 1999. The guideline sets out the HKMA's supervisory approach to credit derivative instruments, particularly in relation to capital requirements and treatment for large exposures, and covers, *inter alia*, Use of Credit Derivatives, Types of Credit Derivatives, Credit Derivatives Policy, Risk Management, and

Information Requirements. In the guideline, the HKMA provides for review and approval on a case-by-case basis of AI's internal models for calculating capital charges related to credit derivatives or, alternatively, for compliance with the Basle standardised approach.

Analyse measures under consideration by government, regulator, banks and financial institutions to assess and manage risk

After deliberations spanning several years, Hong Kong's legislature approved the Deposit Protection Scheme Ordinance, of which section 3 establishes the Deposit Protection Board. As per the HKMA press release of 30 June 2004: "It is envisaged that the Board will be able to start collecting contributions and providing deposit protection in 2006."

Credit information systems

Quality of the legal framework for information sharing and dissemination, credit scoring and rating

Although the major international credit bureaus and rating agencies have operated in Hong Kong for many years, and banks have co-operated according to the traditional manner in sharing credit information, the government has long recognised a need for more comprehensive and widely available credit information.

Credit information collecting, collating and sharing systems

In 2001, the Legislative Council passed a motion to establish a Commercial Credit Reference Agency (CCRA) in Hong Kong to gather and collate information about the indebtedness of commercial enterprises and make the information available to lending institutions. Since then, the Industry Working Group and its advisors have finalised the operational details, and the HKMA has developed and finalised the statutory guideline governing the sharing and use of credit data. The guideline was circulated to all AIs in June 2004, and the CCRA is expected to be fully operation by the end of this year.

Credit risk transfer (CRT) and new financial instruments

CRT is assumed herein to refer to: (i) asset management companies and "bad bank" structures in weak systems; (ii) securitisation of loans in both healthy and weak systems; and (iii) risk management tools such as credit insurance and credit derivatives.

Definitions and analysis of existing credit risk instruments (single name, portfolio, funded–e.g. sales of loans, etc. or unfunded–e.g. insurance contracts, direct risk transfer or through special purpose vehicles)

In Hong Kong, a spectrum of instruments for credit risk transfer on a commercial basis is available, including credit insurance, credit risk swaps and a debt-securitisation market. Not applicable are government-sponsored solutions for transferring risk from banks.

CRT markets: drivers of development (supply-banks and demand-managed funds) and the role of policy

The primary drivers of development likely are intermediaries such as international investment banks, of which Hong Kong has a concentrated pool given its role as a financial centre. Local government policy has been oriented both towards regulation of the local market, and protection and development of Hong Kong's regional and global role.

The market for loan securitisation in Hong Kong has developed extensively since the early 1990s, mainly as a means for banks to adjust their mortgage portfolios rather than to effect NPA reduction. The government has encouraged development of the loan securitisation market through the uncharacteristic creation of a government financial institution, the Hong Kong Mortgage Corporation (HKMC), a public limited company incorporated under the Companies Ordinance and wholly owned by the government. The HKMC was incorporated in March 1997 with a view to developing Hong Kong's secondary mortgage market. Its business is being developed in two phases: (1) purchasing mortgage loans for its own portfolio, funded largely through the issuance of unsecured debt securities; and (2) securitising mortgages into mortgage-backed securities which are offered for sale to investors.

Market institutions and concentration of markets in a few institutions

The regional economic situation of the late 1990s did not affect Hong Kong to the extent that a government-sponsored institution for CRT, or emergency involvement by state-owned or state-related banks, was required. Therefore, there is no particular concentration of CRT in specific institutions. The volume of institutional CRT via debt trading and securitisation has grown and its market encompasses a broad spectrum of lending institutions, international investment banks and specialised investment funds.

Role of credit monitoring, credit insurance and rating agencies

The Hong Kong government has not backed the creation of a credit insurance institution. In recent years, international insurance companies and brokers have become more active in providing commercial credit insurance. In certain instances, such as in proposed guidelines for compliance with Basle II, regulators have made specific provision for adjustment of lending limits and capital provisioning for credits which are wholly or partially insured by a third party. The major international rating agencies are active in Hong Kong, with the territory's high debt rating leading to the enjoyment of investment grade or near investment grade rating by many local corporate debt instruments.

Conclusions and recommendations

Although risk assessment and management systems in Hong Kong could, of course, be improved, they appear to be adequate at present. Hong Kong's credit information systems are in the process of being expanded to enable more information to be made available to lending institutions. CRT in the form of government sponsored AMCs is not necessary in Hong Kong. CRT in the form of loan securitisation is expanding as the market for loan securitisation continues to grow.

Hong Kong does not have a systemic insolvency problem at present and did not have such a problem even at the height of the Asian financial crisis. The current insolvency system is sound. Credit risk improvements would be beneficial for improving the performance and efficiency of Hong Kong banking institutions. Such improvements might well bring down the rate of insolvency in Hong Kong, but this would be an additional benefit, not the main reason for the reforms. As noted above, the main legislative need in Hong Kong–which is independent of credit risk management–is for the enactment of a formal corporate rescue procedure.

Additional Information

Non-Performing Assets status, definition and classification

The HKMA uses a 5-category system:

Table on Non-Performing Assets (NPAs)

	31 Dec 1999	31 Dec 2000	31 Dec 2001	31 Dec 2002	31 Dec 2003	30 June 2004
Pass	82.0%	86.1%	88.0%	88.9%	89.5%	91.4%
Special Mention	7.9%	6.7%	5.5%	6.1%	6.5%	5.6%
Substandard	4.0%	2.3%	2.2%	1.9%	1.4%	1.2%
Doubtful	5.2%	4.1%	3.2%	2.0%	1.7%	1.3%
Loss	0.9%	0.9%	1.2%	1.2%	0.8%	0.6%

As can be seen from the above chart, NPAs are not a major problem in Hong Kong. Moreover, data for the last five years shows an increase rather than a decrease in asset quality as Hong Kong has recovered and emerged from the Asian financial crisis. As noted above, Hong Kong never experienced the systemic NPA problems, as did other Asian jurisdictions. Although the number of insolvencies did increase during the Asian financial crisis, the magnitude never reached a critical level. The current liquidation, reorganisation, and write-off procedures seem adequate to handle the level of NPAs. What Hong Kong lacks is an effective, efficient formal workout procedure, which would supplement the HKMA Guidelines and offer a weapon against holdout creditors in out-of-court workouts.

Factors that contribute to NPAs

One of the problems in Hong Kong affecting the NPAs for banks has been the negative equity in residential mortgages. However, the residential market conditions have been improving–in some sectors returning to and even exceeding 1997 levels.

Types and number of banks and financial institution

Hong Kong has a three-tier system of deposit-taking institutions, namely, Licensed Banks, Restricted License Banks (RLBs) and Deposit-Taking Companies (DTCs), collectively known as Authorised Institutions (AIs). Hong Kong's 214 AIs operate a total of 1 299 local branches. A total of 187 AIs are beneficially owned by interests from 31 countries.

Prudential supervision and regulatory capacity

The HKMA conducts on-site, off-site and third party examinations of AIs to supplement its policy of "continuous supervision". HKMA uses a "CAMEL" scoring system (Capital adequacy, Asset quality, Management, Earnings and Liquidity) for AIs and considers applications to become controllers, directors, chief executives and alternate chief executive officers of AIs. In 2003, the HKMA conducted 247 on-site examinations of AI operations, including 76 risk-focused, 9 treasury, and 18 securities examinations. The on-site examinations also included 21 focused examinations of specific components of credit portfolios and 10 special examinations of AI lending policies and practices. On-site examinations were higher in 2002 as precautionary measures to reduce physical interaction were taken by AIs and by HKMA during the second quarter of 2003 due to the SARS outbreak. The HKMA's specialised examination teams for electronic banking conducted 28 e-banking and IT related examinations in 2003.

Financial health of major lenders and potential sources of systemic risk

Financial health of Major Lenders

1. Loan quality breakdown (30 June 2004 as reported by the HKMA):
   - Pass loans: 91.4%
   - Special mention loans: 5.6%
   - Classified loans (Substandard + Doubtful + Loss) 3.0%
2. Loan quality improved steadily since a recent historical low in 1Q 1999 (see table above):
   - 1Q 1999 = Pass: 80.2%; Special mention: 9.7%; Classified: 10.1%
3. Capital position of AI's (31 August 2004 as reported by the HKMA):
   - Capital + Reserves + Other Liabilities/Total Assets = 12.3%
4. Capital position improved steadily since 4Q 1997:
   - Capital + Reserves + Other Liabilities/Total Assets = 8.2%
5. Risks related to local activities:
   - Segmental concentrations in residential property, property development and financial services.
6. Risks related to international activities:
   - Activities of foreign bank branches and offices;
   - Derivatives portfolios and trading activities of AIs;
   - Lending to enterprises whose ultimate parents are domiciled in China; and
   - Risk of sudden change in fixed exchange rates of HKD and CNY*

* China Yuan remnimbi (CNY)

Ownership structures of banks–if majority privately owned or not

Publicly listed banks with diverse share ownership hold the large majority of bank assets. An important local exception is BOC Hong Kong (Holdings) Ltd., majority-owned by its ultimate parent, the Bank of China. There is no state development bank sector.

Size, types and volume of credit

Tables on Aggregate Balance Sheet of AIs:

Total Loans and Advances (Licensed Banks, in HKD millions)		
	Amount	**% of total AIs**
For use in Hong Kong	1 626 512	94.9%
For use outside Hong Kong	183 229	94.8%
Unknown	19 920	93.4%
TOTAL	2 062 534	97.9%

Loans and Advances by Business Sector (Licensed Banks, in HKD millions)		
	Amount	**% of total AIs**
Professional and Private Individuals	746 544	43.2%
(For purchase of residential property)	(612 478)	(35.4%)
Building and Construction, Property Development and Investment	360 824	20.9%
Financial Concerns	156 184	9.0%
Transport and Equipment	112 919	6.5%
Wholesale and Retail Trade	98 450	5.7%
Manufacturing	91 953	5.3%
Electricity, Gas and Telecommunications	43 038	2.5%
Other	117 578	6.8%
TOTAL	1 727 490	100.0%

Types of collateral, directed lending and their percentage

As the above table displays, real estate assets and residential mortgages, in particular, are the dominant type of collateral. Directed lending to priority sectors has not been a feature of Hong Kong's administration either during the colonial or post-colonial periods.

Risk management capacity

Risk management capacity can be defined in different ways, but by most measurements, Hong Kong would rank high. For example, in addition to the issues of capital adequacy, legal framework and regulatory effectiveness discussed earlier, Hong Kong can include among its strengths the availability of financial instruments used for risk management. The Bank for International Settlements triennial survey on turnover of foreign exchange and derivatives, released in September 2004, showed Hong Kong advancing one place from 2001 to rank sixth in the global foreign exchange market, and seventh in the foreign exchange and over-the-counter derivatives market. Average daily net turnover of over-the-counter derivatives (both foreign exchange and interest rate derivatives) increased by 2.6 times to USD[4] 14.9 billion.

Financial market characteristics and role in risk management

The major characteristics of Hong Kong's financial markets that affect the territory's risk management capability are:

- Hong Kong's position as a major international financial centre;
- Transparency of the financial markets, both as regards financial institutions and
- Regulatory policies;
- Consciousness of best international practices in risk management; and
- Concentration of banking (and legal and audit) talent locally.

Notes

1 Parts of this section are drawn from Philip Smart & Charles D. Booth, *Corporate Rescue: Hong Kong Developments*, 10 AMERICAN BANKRUPTCY INSTITUTE LAW REVIEW 41 (2002). For a more detailed discussion of provisional supervision, see Philip Smart and Charles D. Booth, *Reforming Corporate Rescue Procedures in Hong Kong*, 1(2) JOURNAL OF CORPORATE LAW STUDIES 485 (Dec. 2001).

2 Hong Kong dollar (HKD).

3 The statistics are from the Official Receiver's website at http://www.info.gov.hk/oro/statistics/statistics.htm.

4 United States dollar (USD).

TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK MANAGEMENT: THE EXPERIENCE OF CHINESE TAIPEI

by
Dr. Christina Y. Liu*

Introduction

This report has two parts: the first provides an update on recent developments in Chinese Taipei RTC and the speedy resolution of the NPL problem; the second part of this report describes the Procomp fraud case and the government's answer to it in the form of partial amendments to the Securities Transaction Law and the Commercial Accounting Law. Some controversies surrounding these amendments will also be discussed briefly.

Dealing with the non-performing loan problem: Chinese Taipei's experience

How did Chinese Taipei bring down the NPL ratio by one-half (from over 8% to less than 4%) in less than three years? Chinese Taipei did it through a three-pronged approach, namely, infusion of RTC funds into the most troubled institutions, active and aggressive participation of AMCs in bad loan auctions, and the bold apportionment of large non-performing loan losses taken by troubled financial institutions.

This does not mean that Chinese Taipei is completely free from the threat of financial crisis, though it did manage to escape financial meltdown. Some of the measures used to tame the NPL beast were quick fixes or makeshift patches that pose potential problems and raise concerns regarding the health and long-term sustainability of Chinese Taipei's financial system. This section pinpoints and elaborates on some of the problems that we think should be brought to the attention of policy makers.

RTC

First, regarding the usage of public funds to help lower the NPL ratio, the most contentious issues in Chinese Taipei are the efficiency, adequacy and fairness stemming from past operations of the RTC. For instance, the bulk of RTC approval and dispensing decisions were made in less than two months as part of the political mandate to salvage some 40 failing local credit unions. In a short two- month period, and without a well-designed operating mechanism and procedure in place, it is virtually impossible to conduct a comprehensive evaluation of the assets and collaterals associated with non-performing loans, thus rendering the pricing of the packaged loans (and dispensing of RTC) grossly inaccurate and at best questionable. Furthermore, the decision makers (the appointed RTC supervisory committee members) are part-timers. It is impossible to expect them to devote full attention to the information and appraisals given to them to ensure the most efficient and fair outcome of their decisions. As a result, controversies, suspicions and disputes were bound to arise from their decisions.

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AMC

Besides RTC, another option of non-performing loan management is to sell bad loans to asset management corporations (AMCs). In practice, this approach has met with a fair amount of success in Chinese Taipei: TWD[1] 400 billion, amounting to 40% of the one trillion of bad assets disposed of up to now, were resolved through this channel.

However, this approach is not free from problems and potential distortions. For one thing, the Ministry of Finance allowed financial institutions to amortise the loss incurred from selling their bad assets to AMCs over a five-year period. As a result, the aforementioned TWD 400 billion bad assets were disposed of by AMCs paying, for example, 160 billion to acquire those assets. Assuming the recovery rate to be 40%, the banks were able to digest the remaining 240 billion transaction loss by amortising it over five years and showing it on their balance sheets under the guise of 48 billion of "deferred assets" each year.

This "clever" accounting manoeuvre, that was allowed, perhaps, with the good intention of facilitating the disposal of non-performing loans, distorts bank balance sheets and can conceivably lead to a serious understatement (and hence misjudgement) of the extent of problems plaguing a troubled financial institution. Moreover, each financial institution may take advantage of this accounting treatment to varying degrees, (some banks use the entire annually allowed amount, listing the loss as deferred assets, while others use the allowance partially), rendering comparisons of financial conditions across banks difficult and unreliable. The problems associated with this accounting treatment, which is in violation of international accounting protocols, will linger for years to come even after the termination of this provision, effective 1 July 2005.

Another concern related to the AMC approach to NPL reduction is the leverage implicit in AMC purchases of bad assets. To be sure, leverage is to be expected in this type of business and does not pose a concern by itself. The concern arises from the extremely high leverage in many AMC purchases. More seriously, except TAMCO and a few foreign AMCs, many of these AMCs are joint ventures between domestic financial institutions and foreign entities, with some suspected of having been set up exclusively by domestic institutions (who have NPL problems themselves), and functioning effectively as affiliates or subsidiaries. While the latter cannot be ascertained, given that the current legal framework on AMC regulation does not provide adequate disclosure of the funding source of an AMC, there is no telling if bad assets purchased by an AMC are truly disposed of or are simply shifted from one hand to another in the same sector. If the last scenario were the case, it would make improvement in the situation illusory by making the numbers look good.

Banks acknowledging and absorbing losses

Third, we turn to the direct approach, where banks take the initiative of writing off unrecoverable portions of bad loans themselves. This approach typically entails banks tapping into past surplus reserves to absorb the loss.

Again, despite appealing reasons for promoting this approach, it is not without limitations and reservations either. The first and foremost concern is about the depletion of surplus reserves and the long-term viability of this approach. This approach has forced banks to draw from pooled reserves built up over the last 20 or 30 years, and now with the expensing of several billion, and more to be expected, reserves stand to be exhausted in the not too distant future. This raises the inevitable

[1] New Taiwan dollars (NTD).

question: what to do if similar explosions of bad loans recur? How can the banking system in Chinese Taipei fight the unthinkable without any more self-owned ammunition?

To conclude, even though Chinese Taipei avoided the banking crisis that normally would have occurred (as predicted by outsiders) and succeeded in lowering NPL ratios with the three-pronged approach of RTC infusion, AMC purchase and recovery, and bank self-restructuring, it is not completely out of the woods yet. This section of the report enumerates several hidden problems and concerns that challenge policy makers to take heed and act in order to ensure a sustainable and healthier financial system in Chinese Taipei.

The Procomp fraud case

On June 14, Procomp Informatics Ltd., Chinese Taipei's first gallium arsenide epitaxial (GaAs) wafer foundry, once touted the "King of Stocks", filed a restructuring proposal in a local district court, saying it was unable to maintain solvency. GaAs chips are used in communications devices including mobile phones, satellite communications systems and car navigation systems due to their speedier transmission compared to other chips. On June 16, the company failed to pay a bond worth TWD 2.98 while financial reports showed it had TWD 6.3 billion in cash. The default led to a suspension of trading of Procomp shares on June 23 and the detention of its chairwoman Sophie Yeh on June 27.

On October 25, the district prosecutors, after four months' investigation, indicted Yeh and suggested a 20-year sentence and a TWD 500 million fine on charges of breach of trust and violating the Securities Transaction Law and the Commercial Accounting Law. In addition to Yeh, prosecutors also indicted another 30 employees of the company who were allegedly Yeh's accomplices. The initial investigation showed that Yeh had stolen approximately TWD 6.3 billion (USD[2] 187 million) from the company, but the prosecutors think she may have actually stolen more than TWD 7 billion. The Securities Investor Protection Centre, a pseudo-government agency, has already received more than 8 000 claims amounting to TWD 4 billion against Yeh and Procomp within just a month, setting records for Chinese Taipei.

Summarising from the indictment and financial press reports, Yeh used four primary schemes to steal from the company or to profit from the stock market:

i. *Fabricating export/import transactions to window dress financials:* Yeh started fabricating transactions as early as 1994, five years before the IPO. It is estimated that as much as TWD 11 billion worth of revenues and associated accounts receivables per year were created through as many as 40 domestic and foreign shell upstream/downstream companies. As a result, Procomp was first listed in December 1999 at TWD 98 and within four months, reached TWD 368, and claimed the "King of Stocks" title.

ii. *Arranged ECB issues:* During 2002 and 2003, Yeh issued USD 50 million worth of ECBs and had her shell companies buy them using Procomp funds. After converting all the bonds into Procomp stocks, the shell companies simply sold them and presumably funnelled the proceeds to Yeh's phoney agent accounts. The funds that the shell companies used to buy ECBs were borrowed from two foreign banks. The banks approved the loans based on Procomp's deposits. At the end of the day, it was the investors who bought Procomp stocks who were badly taken in.

[2] United States dollars (USD).

iii. *Arranged CLN issues:* Also during 2002 and 2003, Yeh asked several foreign shell companies to buy another foreign shell's corporate bonds using borrowed funds with either Procomp funds or shell associates' fictitious accounts receivable as collateral. The bond issuer then took out loans totalling USD 85 million by issuing CLNs (credit linked notes) through a foreign bank. The proceeds again disappeared, presumably into Yeh hands.

iv. *Manipulating the Procomp stock price and insider trading:* At various points, particularly immediately before IPO, recapitalisation, and the pricing of ECB, she intentionally released favourable company information to boost the stock price. She also used company funds to buy company stock at the same time, and kept profits as personal gains. The transactions were all done on false domestic and foreign accounts.

The government's answer to the confidence crisis prompted by Procomp scandal

The case of Procomp and several "landmine" cases following it, happened at a highly opportune time. The brand new integrated financial sector regulatory body FSC (Financial Supervisory Commission) just opened its doors for operation on July 1. Before that, many proposals and initiatives were sitting on various agencies' desks waiting for the new agency to review and finalise. Most of them had corporate governance or risk management improvements in mind. The FSC selected two from these as a quick answers to the Procomp crisis: the Securities Transaction Law Amendments (STLA) and the Commercial Accounting Law Amendments (CALA).

The STLA initiative came from the Financial Reform Taskforce of the Executive Yuan, started in May 2002. It includes four major areas:

- *Corporate governance:* To require that at least one-fourth of company board members be independent directors; to set up audit committees comprised of independent directors and replace "board supervisors" for large corporations; and to improve board supervisor independence for those corporations who do not elect to set up audit committees.

- *Securities companies businesses:* To relax restrictions on securities houses on holding shares of other houses; to allow securities companies to engage in related business lines such as investment trusts and investment advisory services; to allow securities companies to transact in more financial products, such as exotic synthetic derivatives; and to streamline securities underwriting procedures.

- *Foreign co-operation in regulatory actions:* With prior consent from the Executive Yuan, to allow various functional regulatory bodies to sign co-operative memoranda with foreign counterparts, mainly to enhance the sharing of information and technology, to join forces in fighting economic crimes, etc.

- *Fine tune market manipulation and insider trading-related clauses*

Similar to the STLA initiative, the CALA initiative has been around for a number of years since Enron. The US Sarbanes-Oxley Act of 2002 also had its influence. It was not until the Procomp scandal that the government finally decided to quickly pass it through the Executive Yuan and deliver it to the Legislative Yuan for formal legislation. The amendments include the following major areas:

- *Towards a better environment for CPAs:* To clarify the status of the so-called "united CPA firm" as a partnership; to introduce US-style limited liability partnerships (LLPs) to be the

standard organisational form for the large CPA firms, where the felon partner has unlimited liability while the other partners are liable only up to their stake in the firm.

- *To strengthen the CPA associations' role:* To promote an individual member-based national association to handle US AICPA and PCAOB-like functions such as CPA registration, quality assurance/monitoring, continuing education, sanctions, etc.

- *Tougher punishments for wrongdoing:* For minor violations such as soliciting business without a CPA license, the fine is to be increased from under TWD 3 000 to between TWD 300 000 and TWD 1.5 million; for LLP-type CPA firms, fines for violations that cause serious financial losses can go as high as TWD 30 million.

- *To improve the quality of CPA work:* To bar CPAs, engaged in consulting or other non-audit work that may compromise their independence, from also doing the client's audit; to toughen the requirements for CPA registration and post-registration continuing education requirements; and to authorise FSC regulators to examine a CPA firm's business and financial operations and documentation, if circumstances warrant such examination.

- *Other rationalisation measures for CPAs:* Such as easier registration procedures, allowing firms to open more than one branch office in each metropolitan area, and more lenient rules on advertising.

Some controversies surrounding the FSC's actions and the proposed amendments

- Observers from many different sectors believe that the FSC's actions were heavy on punishing CPAs and light, too light, on regulators themselves. Within weeks after the FSC was set up, and only a little more than a month since the Procomp case broke, the FSC decided to sanction both Procomp's former and then current CPAs by suspending their licenses for two years. FSC faulted the four CPAs for not being able to uncover the fact that Procomp's huge cash balances during the past three years were nonexistent or at best restricted by the banks supposedly holding its deposits. Both firms are Big 4. Both have indicated strong objections to the allegations and are preparing to appeal for the four CPAs. In the meantime, neither the Chinese Taipei Stock Exchange (TSE) nor the FSC's Securities and Futures Bureau have issued any apology or expressed any intent to review their own personnel or procedures.

- Unlike in the US, where the Sarbanes-Oxley Act was passed swiftly after the Enron and WorldCom fiascos, and where the US SEC started implementing its statutes within a mere 100 days after it was signed into law by President Bush, many implementation deadlines in the original proposed amendments were relaxed and significantly postponed in Chinese Taipei. Most notable were the implementation deadlines set for independent board directors, audit committees and board supervisor independence enhancement measures that were postponed from their original effective date at the beginning of 2006. The official explanation is to allow corporations a reasonably long period to adjust to the new requirements. Many observers, however, believe the real reason was pressure from a few business tycoons visiting the new FSC commissioner shortly after it announced the proposals. Similarly, the monetary fines included in the STLA initiative were originally set at much higher levels than the original STLs, but were then adjusted back to the original amounts, far too low relative to Sarbanes-Oxley or the financial losses caused by Procomp to its investors.

- Although independent directors were covered in the STLA, the way they are nominated was left to the company to lay down in detail in its charter. Unlike Sarbanes-Oxley and the ensuing SEC and NYSE regulations which clearly spell out the director nomination process and minority shareholder protection arrangements, this lack of specifics will no doubt give the many family and conglomerate business owners leeway to engage related parties and fully controlled individuals as independent board directors and supervisors.

TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK MANAGEMENT: THE EXPERIENCE OF CHINESE TAIPEI

by
Dr. George C. H. Lin*

Trends and developments in the insolvency and creditor rights framework and practices

Legal framework

There are currently three sets of laws in Chinese Taipei that govern corporate insolvency and reorganisation proceedings. Those laws are the Company Law, the Bankruptcy Law, and the Banking Law.

In Chinese Taipei, corporate reorganisation proceedings are part of the Company Law rather than an independent body of law such as the Bankruptcy Law in the United States and Japan. Our corporate reorganisation proceedings only apply to public companies or companies issuing corporate bonds. Commercial companies sometimes use reorganisation proceedings as a bargaining chip to negotiate with their creditors for the purpose of lowering the current interest rate or reducing the amount of their outstanding debts. This tactic works most of time because reorganisation proceedings under Chinese Taipei law are very time-consuming and most creditors do not wish to see their claims suspended for such a long time.

The courts in Chinese Taipei, of course, do not wish to see reorganisation proceedings being misused by companies to threaten their creditors. Our courts, therefore, review company reorganisation applications with particular care before granting approval in order to prevent the company from abusing or misusing the bankruptcy proceeding. In the past three years, from 2001 to 2003, more than 100 companies in Chinese Taipei filed applications for reorganisation with the courts. Some of the applications are still pending, 46 were dismissed and only 16 applications were approved.

According to our laws, both individuals and companies are eligible to apply for settlement and bankruptcy protection under the Bankruptcy Law. The bankruptcy protections our laws provide are similar to those provided by Chapter 11 of the US Federal Bankruptcy Code. Nevertheless, individuals rarely apply for bankruptcy, even if it may discharge them of their liabilities, because, in Chinese society, people see bankruptcy as a profound disgrace.

The insolvency of banks and insurance companies is subject to the regulations provided under the Banking Law and the Insurance Law. In recent years, the Financial Supervisory Commission (FSC) has adopted a policy of having sound financial institutions take over or merge with failed financial institutions. In July 2001, the government established the Financial Restructuring Fund (RTC) and enacted the Statute for the Establishment and Administration of the Financial Restructuring Fund

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(RTC Act) in order to facilitate the orderly exit of insolvent financial institutions from the market. The function of the RTC is similar to that of the Resolution Trust Corporation established by the US Congress in 1989 in accordance with the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA).

Current legal developments

The Company Law and the Banking Law were amended by our government on November 2001 and November 2000, respectively. A brief summary of the amendments to these laws and the proposed amendments to the Bankruptcy Law follows:

The amendment of the Company Law

The 2001 Company Law amendment was the most significant amendment to the Company Law since 1966. It includes the addition of 24 new articles, the deletion of 56 articles, and modifications to 156 articles. One of the main goals of the amended Company Law is to improve reorganisation proceedings. Important amendments to the Company Law concerning corporate reorganisation include:

i. The court is mandated to dismiss a reorganisation application if the insolvent company fails to meet statutory requirements. (Article 283-1);

ii. The company is not eligible to apply for reorganisation if there is no possibility for the applying company to rehabilitate. (Article 282); and

iii. The creditors may demand that the court issue a provisional restraining order to secure corporate assets before the commencement of reorganisation proceedings, however, the period of the provisional restraining order cannot exceed 90 days. (Article 287).

Although the Company Law has been substantially amended, the protections it provides for creditors of reorganising companies are still insufficient. In situations where a reorganising company transfers company assets to third parties with the purpose of defrauding the creditors, nothing in the Company Law provides the creditors or the administrator/trustee with the right to cancel the transaction and demand the return of the assets as the creditors and administrator can do in a bankruptcy proceeding. (Article 78 and 79 of the Chinese Taipei Bankruptcy Law).

The Ministry of Finance (MOF) has tried to add a provision to its proposed Company Law amendment which provides that the court may, upon the request of a company, creditor or the administrator, dismiss the company's reorganisation application if the company entrusts or transfers all of its assets or substantial assets to third parties within six months before applying for the reorganisation proceeding.

The amendment of the Banking Law

Merger and winding-up, together with receivership constitute the entire safety net of the banking system in the event of financial institution failure. Due to its significant influence on the public interest, the latest amendment emphasises governmental involvement, in the event a bank fails, by providing more supervisory power to the competent authorities and requiring more co-operation from the failed bank.

Furthermore, in order to avoid systemic risk, the Chinese Taipei government enacted the RTC Act in July 2001 to provide assistance to failed financial institutions. The RTC Act supersedes all banking related laws and regulations if any conflicts exist between those laws and regulations, and the RTC Act. A summary of the important provisions of the RTC Act appears in the following section.

The amendment of the Bankruptcy Law

The Bankruptcy Law has not been amended since 1993. The Judicial Yuan proposed its version of a Banking Law amendment, endorsed by the Executive Yuan, on 6 May 2004 for public comment. The Judicial Yuan's version of the Bankruptcy Law contains 132 articles whereas the current Bankruptcy Law has 160 articles. The Judicial Yuan's version adds 106 newly enacted articles and deletes 10 articles from the current Bankruptcy Law, which makes the Judicial Yuan's version the most substantial amendment of the past five decades. The major points addressed in the Judicial Yuan's version of the Bankruptcy Law are:

i. The court may order the liquidation of the debtor's assets to repay debts without going through the whole bankruptcy process if the total amount of the debt claimed by creditors is under TWD[1] 3 million, which is approximately USD[2] 90,000 (Article 59 to 61);

ii. The court, upon application of the administrator, may limit the bankrupt individual's spending if their living standard is substantially higher than that of ordinary people (Article 82);

iii. The law holds certified public accountants jointly and severally liable with their clients, if the accountants do not faithfully fulfil their duties while auditing or certifying their clients' financial statements (Article 100);

iv. The bankrupt estate does not include the assets obtained by the bankrupt after the declaration of bankruptcy, unless those assets were obtained by succession, gift or by other gratuitous methods (Article 101);

v. The claims of employees with respect to salaries payable within six months shall have priority rights (Article 118); and

vi. Settlements and judgements made by foreign courts may be enforced against assets in Chinese Taipei if such foreign settlement or judgement has been recognised by a Chinese Taipei court (Article 208).

Institutional developments

Asset Management Companies (AMC)

The first AMC in Chinese Taipei was founded in accordance with the Law Governing the Merger of Financial Institutions with the support of our government and enacted in December 2000. The founding members include 30 banks and 3 bill finance companies. The official name for the first AMC in Chinese Taipei is Taiwan Asset Management Corporation (TAMCO). When TAMCO was established on 22 May 2001, it had registered capital of TWD 2.5 billion and paid-in capital of TWD 1.76 billion.

The main purpose for establishing TAMCO is to provide assistance to Chinese Taipei banks and financial institutions to reduce their NPL ratios. To encourage the establishment of such asset management companies, the government provides many tax incentives, including amortising the loss generated from the disposal of the NPL over five years, and a lower value added tax rate (2%) applicable to financial institutions. Following the establishment of TAMCO, some domestic banks joined with foreign financial institutions, such as Lone Star, Cerberus, GE Capital, Lehman Brothers and Morgan Stanley, to establish asset management companies to handle their own NPLs.

AMCs have functioned well in Chinese Taipei. By the end of May 2003, the amount of NPLs sold by local financial institutions to AMCs reached TWD 230 billion.[3]

Financial Restructuring Fund (RTC)

As stated above, our government enacted the RTC Act in July 2001. RTC was set up on June 2001 with initial capital of approximately TWD 13.8 billion. According to the RTC Act, the term of the RTC would be three years from its establishment; in other words, the RTC will cease operating in July 2005. The term may be extended for another year upon approval by the Legislative Yuan. According to Article 10 of the RTC Act, the CDIC may utilise the RTC fund to assist failed financial institutions by: (1) paying off their outstanding debts; (2) liquidating their assets in order to satisfy the company's unpaid debts; or (3) investing in the failed institution by purchasing its preferred shares. By the end of August 2004[4] the CDIC successfully held public bids for 46 financial institutions via the RTC.

Ratio of non-performing loans

Through the operation of AMCs and the RTC, the NPL ratio has been substantially reduced from its highest point of 8.04% in March 2002 to 4.33% by the end of 2003. The MOF's goal to lower the NPL ratio under 5% within only two years has been achieved[5]. Based on the latest data published on the official website of the FSC, the NPL ratio was 4.03% in August 2004. Further, according to the latest public release of the FSC on 5 October 2004, the NPL ratio declined to 3.54 % in August 2004.

Professional liability

i. The liability of Certified Public Accountants and/or external auditors

In a changing financial environment, the question of accountant and/or external auditor liability arises. After the enactment of the Sarbanes-Oxley Act of 2002, many countries have followed in the footsteps of the United States by adopting the principles set forth in the Sarbanes-Oxley Act by imposing stringent new rules to regulate accountants and external auditors. In Chinese Taipei, several major laws have been or are about to be amended to achieve the same objectives as the Sarbanes-Oxley Act, that is, "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws". The important amendments of those laws are as follows:

(a) *The Securities and Exchange Amendment of April 2004:* The licensed public accountant would be subject to imprisonment, criminal fine of up to TWD 15 million, and/or suspension of license to practice if he: (1) intentionally issues audit reports or opinions that contain false or untruthful material information; (2) issues audit reports/opinions containing false or untruthful material because of his failure to perform audit work with due care; or (3) fails to perform audit work in

accordance with applicable laws, regulations and publicly recognised auditing guidelines. (Article 174);

(b) *The proposed amendment of the Certified Public Accountant Law:* According to the proposed amendment, the official authority may suspend the accountant's license to practice and/or cancel or revoke the business registration of the accounting firm if the accountant or the accounting firm practices business in violation of this law (Article 38). The accounting firm will also be held jointly and severally liable with the offending accountant to the client or other interested party for damages caused by their breach of legal duty (Article 42).

(c) *The proposed amendment of the Bankruptcy Law:* The amendment holds the public accountant jointly and severally liable with a debtor if the accountant includes false information or fails to include material information in the debtor's financial statement.

Lawyers' liability

The latest amendment of the Securities and Exchange Act also allows sanctions, imprisonment, or criminal fines of up to TWD 15 million against lawyers who issues false or untruthful opinions on any contract, report, or document concerning the trading, offering or sale of company securities (Article 174).

Current risk assessment and management systems and policies

Credit information systems

The Joint Credit Information Centre (JCIC) and Financial Data Information, Ministry of Finance (FDI) play a very important role in our risk assessment and management system. These two institutions are responsible for the collection of financial and tax-related information on individuals and companies. The members of JCIC and FDI are allowed to access the information retained by these two institutions for necessary credit checks and reference.

Joint Credit Information Centre (JCIC)

The JCIC is a non-profit foundation established on 20 March 1975. As of 14 May 2003, JCIC has been composed exclusively of institutional members: 329 financial institutions, including 51 local banks and 19 foreign banks. JCIC's data basis contains a large volume of information concerning checking, loan and credit card transactions within and between financial institutions. The operating model of JCIC is very successful. Encouraged by this experience, an institution with similar functions was established in 1999 in Shanghai with the support of the Chinese government. The official name of the institution is Credit Information Services Co., Ltd.

Financial Data Information (FDI)

FDI was established in 1960 and was renamed in 1987. It is a governmental organisation under the supervision of the MOF. Creditors who obtain a final court judgement or entitlement to enforcement are allowed to access FDI's data basis to check the debtor's financial records after filing an application with the MOF. Generally, the FDC will update the information kept in its data base annually based on the tax records it collects from individuals or companies.

New financial instruments

With the aim to meet the needs of rapid economic transformation and development, create a more favourable banking investment environment, and establish a more inviting capital market, MOF has newly recognised the legality of a number of new financial products, including the securitisation of financial assets and the securitisation of real estate.

Securitisation of financial assets

The Financial Asset Securitisation Act was enacted in July 2002 in order to increase the liquidity of financial assets. It aims to provide flexible capital allocation, more effective reduction of funding costs and better risk management. The MOF promulgated eight sets of regulations to facilitate the implementation of the act. Two types of securitisation have been provided for: Special Purpose Corporations (SPC) and Special Purpose Trusts (SPT). The act is silent as to whether the originators can also act as service agents that manage the trust property. The act provides significant tax incentives for participating companies. For example, interest payments distributed to investors are subject to a lower withholding tax rate and will be taxed separately from personal or corporate income. As of 21 September 2004, the authority approved a total of 11 applications. Those approved securitisation products include: corporate loans, residential mortgage loans, cash advance card receivables, receivables on vehicle loans, and corporate accounts receivable. Among those approved applications, five were issued via public offering while the rests were sold through private placements. Two out of 11 approved products have been issued abroad. The latest securitisation product application, approved by the FSC on 16 September 2004, is Asset Backed Commercial Paper (ABCP) secured by corporate accounts receivable. The ABCP is the first securitisation product of corporate accounts receivables issued in Chinese Taipei. The value of outstanding securitised shares is approximately TWD 5.7 billion[6].

Securitisation of real estate

The Real Estate Securitisation Act was enacted in July 2003. The act provides for only one securitisation structure, that is, SPT. The framework of real estate securitisation is substantially similar to that of the SPT under financial asset securitisation. Seven regulations were promulgated to facilitate implementation of the act. The two types of securitisation incorporated in the act are: Commercial Mortgage Backed Securities (CMBS) and Real Estate Investment Trusts (REIT). As of 21 September 2004, two applications for CMBSs have been approved but no application had been filed for REITs. The value of one of the approved CMBS applications was approximately TWD 4.4 billion, shares of which were sold via public offering. The value of the other CMBS project was approximately TWD 0.6 billion, the shares of which were sold in forfeiting form by private placement.

Conclusions and perspectives

Within the past three years, the Chinese Taipei government has made many efforts to encourage the merger of financial institutions by providing tax incentives and the use of flexible merger models available under the Financial Holding Company Act (enacted in November 2001). As a result, 14 financial holding companies were successfully established by the end of August 2004. Notwithstanding, 50 local banks and 313 bank co-operatives are still in operation to provide services to a population of only 23 million. According to records, none of the banks acquired more than 9.5% of market share.

Over-banking is a serious problem that needs to be resolved in the near future by our government. In this regard, our government expressly states that the targets of our second financial reform would

be: (1) at least three financial institutions with a minimum of 10% market share by the end of 2005; (2) no more than seven financial holding companies in the market by the end of 2006; and (3) at least one of the local financial institutions shall be operated either by foreign financial institutions or offer its capital shares overseas by the end of 2006.

Furthermore, our government plans to put the New Basel Capital Accord (Basel II) in force in 2006. Basel II mandates that banks achieve the international settlement ratio (BIS Ratio) of 8% set forth in the Basel Capital Accord of 1988. To satisfy this requirement, the Chinese Taipei government amended the Statutes of the Capital Adequacy Ratio of Banks to require banks to maintain at least 8% in their BIS Ratio. Additionally, the "2-5-8 Financial Reform Plan" mentioned above was executed in September 2002 by the MOF with the aim of reaching the 8% BIS Ratio by the end of 2003. Finally, to cope with the additional requirements set forth in Basel II, the FSC is preparing a proposal to amend the Statutes of the Capital Adequacy Ratio of Banks, which should be approved by the legislative branch in 2005.

Regardless of these efforts, there are still six local banks that failed to reach the BIS Ratio mandated by the MOF by the end of 2003. In this respect, we believe more efforts are required to implement this policy.

Notes

1 New Taiwan dollar (TWD).

2 United States dollar (USD).

3 The total NPLs of local banks and credit co-operatives by the end of June 2003 is approximately TWD 9 551 billion according to the FSC.

4 The total number of local financial institutions, including banks and credit co-operatives, was 363 by the end of July 2004.

5 The so-called "2-5-8 Financial Reform Plan" seeks to strengthen financial institutions under the MOF. This means that in 2 years, the NPL ratios of these institutions would be reduced to below 5% and their capital adequacy ratio maintained at a minimum of 8% as required by the Bank for International Settlements.

6 By the end of August 2004, the total value of all financial assets was TWD 34 233.5 billion.

TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK MANAGEMENT: THE EXPERIENCE OF INDONESIA

by
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Introduction

Following the financial crisis of 1997-98, Indonesia learned many lessons dealing with insolvency resolution in the financial industry and in other commercial companies. How to treat failing companies without creating distortions in the financial system became the art of crisis management in Indonesia. Does one need to close a financial institution or a large corporate? In theory, the answer is determined by the minimisation of costs to the economy, but these costs are hard to determine.

Moral hazard is also a primary concern for the public when legal and corporate governance are weak. Rule based insolvency resolution helps the authorities ensure that moral hazard is minimised. However, there is no guarantee that rule based resolution will work. In some cases, judgement is still necessary to minimise economic costs.

The Indonesian government has improved insolvency prevention and resolution for the purpose of maintaining financial system stability as stipulated in the amendment of the Central Bank Act (Act No.3, 2004) and the deposits protection law. Two failing banks in mid-2004 are good examples of insolvencies that worked well without creating financial system instability. Will the approach work in the future, and how to deal with a systemic bank failure? It is difficult to answer without having experienced similar cases. Additionally, one can conclude from the bank failures that poor governance and weak risk management are the sources of insolvency in Indonesia.

This paper will outline the development of insolvency prevention and resolution in Indonesia by focusing on three areas, namely: trends and developments in the insolvency and creditor rights framework and practices; current risk assessment and management systems and policies; and the future agenda in credit risk management and the financial safety net.

Trends and developments in the insolvency and creditor rights framework and practices

Current legal and institutional developments

There are two important legislative initiatives that need to be considered in the recent insolvency reform in Indonesia: first, the reform of the banking sector, which touches upon aspects of insolvency; and second, the amendment of the bankruptcy law.

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Many criticisms were aimed at the government for bailing out failed banks during the crisis. The main issue was whether the decision to recapitalise banks was the best public interest solution. It would not be an issue if legislation provided a clear mandate to the authorities. To address similar issues in the future, government has set an agenda to: improve the legal framework for bank insolvency through the amendment of the Central Bank Act; establish a deposit protection scheme; amend the Banking Act; and establish the Financial Safety Net Act.

Among the legislative initiatives in the banking sector, only the bills on the Central Bank and the Deposit Protection Agency were approved by the parliament.[1] The remaining bills, including the Financial Service Authority Law, failed passage during the 1999-2004 parliamentary term due to insufficient time for discussion.[2] This means that the next parliament will start the discussion of the bills from the beginning, since state conventions do not bind the succeeding parliament to the interim results of the previous parliament. If the succeeding parliament wishes to continue the discussion of outstanding bills from the previous term, it must commence from the beginning.[3] Nevertheless, there no guarantee that the succeeding parliament will even discuss the subject, since they might have their own agendas and priorities.

The finalisation of the bill on the Financial Service Authority might be further delayed since Article 34 of Law No.3/2004 on the amendment of the Central Bank Law already stipulates that the Financial Service Authority will be established at the latest in 2010. While the bill on the Financial Service Authority is still under discussion, supervisory authority shall remain with each supervising institution.

Deposit Protection Agency Law

Even though Article 37 b of Law No. 10/1998 of the Banking Law only stipulates the establishment of a deposit protection agency (LPS) as an agency to guarantee public deposits in national banks, the Deposit Protection Agency Law expands the functions and authorities of the LPS to include the restructuring of failing banks by way of formulating, deciding and implementing policies to settle failing banks that have no systemic impact on society as well as the authority to restructure failing banks having a systemic impact on society.

This has made LPS an institution with functions more or less similar to those of the previous Indonesian Bank Restructuring Agency (IBRA) when it comes to bank restructuring.[4] Compared to IBRA this law provides a clearer definition of how LPS should handle failing banks. For example, in handling failing banks with a systemic impact on the economy, the LPS shall only have three years before it must sell its participation in that bank (two years for a failing bank with no systemic impact).

The time frame can only be extended two times (one year for each extension) to obtain an optimal level of return. The optimal level of return required by law is at least the same amount of the LPS's participation in that particular bank. Nevertheless, the law still allows LPS to waive its obligation to achieve the optimal level of return if the restructuring process has been extended two times. The institution can also shut down and liquidate failing banks if it projects no systemic impact and when certain other criteria are fulfilled.[5]

The debate surrounding the bill itself is more focused on the guarantee function of LPS than its restructuring function. Regardless of the public consensus on the need for a proper protection scheme for public funds in the banking sector, whether the guaranteeing institution should be government or privately-managed remains an important question of deliberation. Some experts say that a government-run deposit protection agency would not provide sufficient incentives for the private sector to take more care in doing business since the government will, ultimately, bear all the costs of

failure. However, considering the authorities of the LPS, which include the authority to restructure and liquidate failing banks, the involvement of government should become imperative.

Amendment of the Bankruptcy Law

After being suspended for more than three years, the parliament finally passed the amendment of the 1998 Bankruptcy Law in September 2004 a few days before its term expired. Many alleged that the amendment of the Bankruptcy Law was premature since the parliament did not contribute sufficient time to the discussion of the bill; it had suspended its deliberation for years before suddenly accelerating the discussion significantly.

One of the chief concerns that drove the amendment was that the 1998 bankruptcy law was regarded by many as being too creditor friendly. It enabled creditors to easily send debtors into bankruptcy, regardless of the amount of debt relative to the debtor's asset. Many believe that it is necessary to limit the ability of creditors to petition bankruptcy in order to protect solvent companies, provide legal certainty and recover investor trust, which has deteriorated as a result of several infamous bankruptcy cases.[6]

Therefore, it is not surprising that one of the main goals of the amendment is to limit the capacity of creditors to file for bankruptcy for certain types of business. According to the amended law, bankruptcy petitions for financial institutions (such as insurance and reinsurance companies, pension funds, and other state-owned enterprises that are fully engaged in providing public services) can now only be submitted by the Ministry of Finance.[7] This measure is less than expected from some analysts who feel that the law should impose a mechanism to measure the solvency of a company before the court can even entertain a bankruptcy petition.

There is some indication that problems in implementing bankruptcy law in Indonesia are caused by a lack of understanding of core bankruptcy concepts. This lack of understanding often leads to misperceptions of the role of bankruptcy in society. The amendment apparently realises this problem. It argues that it is necessary to draft a new law on bankruptcy and suspension of payments with more domestic-oriented value, and in accordance with the needs of and legal development within society. In so doing, the law introduces a set of principles to which one must refer when interpreting the law, namely:

- *The principle of balance:* The law aims to avoid excessive and abusive use of bankruptcy law by both debtors and creditors;

- *The principle of going concern:* The law contains provisions that enable prospective debtors to continue their business;

- *The principle of justice:* The law's objective is to provide justice to every stakeholder in the bankruptcy by preventing abusive behaviour by creditors who demand fulfilment of their debt without considering other creditors;

- *The principle of integration:* The law contains an understanding that the formal legal system and the material legal system are a complete integration of the private law system and the nation's private procedural law.

The spirit of the current amendment is to limit interpretation of the bankruptcy law. The 1998 law was criticised for being too summary, and for leaving discretion to judges and practitioners to interpret its provisions. This often led to uncertainties in practice. The 1998 Bankruptcy Law

approach, which only regulates the main principles and allows practice to relate those provisions to other private law provisions (for example, in the Civil Code, Commercial Code, Company Law and others), has not proven successful in building a solid bankruptcy practice. Discretion has generated contradictory interpretations on some important provisions of the law, for example, the definition of debt and the definition of maturity of debt.

In addition, the summary nature of the bankruptcy law means that some important measures cannot be implemented effectively because judges have difficulty implementing provisions that have no direct explanation in the law. Examples are problems in implementing conservatory attachment, the detention of uncooperative debtors (*gijzeling*) and claw back provisions (*action pauliana*).

Nevertheless, some analysts assert that the amendment only scratches the surface and fails to address the main problems. These people argue that the underlying problems of the commercial court are the insufficient education and supervision of judges rather than solely the provisions of the law. Amendments may, thus, not be the ultimate answer for implementation problems.

The establishment of legal limits does not guarantee a more effective or efficient implementation of the bankruptcy law since much of the content of the amendment has already been settled in practice. Issues such as the definition of debt, maturity date and arbitration clauses are just a sample of the amended provisions that have been settled. It is believed that the knowledge of judges can be improved by imposing a proper training scheme. Proper supervision could help in building consistency and discipline, which, in turn, could increase the level of certainty in the commercial courts.

An important provision that aims to promote the use of court-supervised restructuring should also be noted. Before the amendment, dissenting creditors were excluded from the decision-making process during the suspension of payment. Dissenting creditors who disagreed with the composition plan could, therefore, interfere with the composition process by simply exercising their right. However, under the new law, dissenting creditors are now eligible to vote in the suspension of payment. Furthermore, those who disagree with the composition plan can now be bought out by compensating them for the lowest value between the secured and the actual debt value that is directly secured by the security right.[8]

There are, however, some drawbacks to the amended law. The law extends the time available for the courts to hear bankruptcy petitions from 30 days to 60 days for all levels of the court. Many consider this provision unnecessary because almost all bankruptcy decisions (especially in the commercial courts) are delivered on time and because the summary nature of the examination process should allow for a proper hearing to be conducted in 30 days. There was, therefore, no real demand for more time to hear bankruptcy cases. Furthermore, there are drawbacks with respect to professional services that will be discussed later.

Institutional developments

Qualifications and the performance of judges

There are currently 14 active judges in the Commercial Court in the Court of Central Jakarta from out of almost 30 commercial judges throughout Indonesia.[9] Commercial Court judges were recruited by the Supreme Court from among the judges of courts of general jurisdiction, who were considered sufficiently experienced and educated on commercial matters. The closed career system of the Indonesian court makes it impossible for a non-career judge to be appointed as a commercial court

judge. However, the law opens the possibility for a legal expert to be appointed as an *ad hoc* judge at all levels of the court.[10]

The requirement to be appointed as a commercial court judge is currently more associated with seniority and ranks, rather than a competitive scheme. Article 302 (2) prescribes several requirements for recruiting commercial judges (chiefly experience and participation in special training). However, in practice, the selection of judges who participate in training is quite problematic, as it is known that during the "two roof system", the court's database on human resources was not very well managed.

Traditionally, the judicial corps has been reported to be independent relative to the executive branch.[11] The recent amendment of the Law on Judiciary Power, which consolidates the authority to manage both organisational and administrative aspect of the court in the hands of the Supreme Court (also known as the "one roof system"), has made this perception even stronger.[12] The one roof system has made the government lose its influence over judges. Before the one roof system, the government, through the Ministry of Justice and Human Rights, ran the management of human resources of the lower courts.[13] Under the one roof system, all authority to manage the lower courts was transferred to the Supreme Court.

However, an examination of the decision-making of the commercial court judges before the one roof system was implemented, does not give the impression that the court was easily affected by government intervention. In fact, the only intervention made by the government against the commercial courts (the temporary dismissal of judges suspected of violating their professional oath in the infamous Manulife case) was overturned by the judicial corps in the Court of Appeal by establishing its own internal Committee for Professional Honour, which, contrary to the government's findings, concluded that these judges were innocent.

The commercial court is currently going through various institutional changes. Starting in 2002, the court will also hear intellectual property rights cases, and several new laws refer their dispute settlement to the commercial courts.[14] Several constructive programmes (such as a needs assessment for the commercial court, the development of a career path for commercial court judges, the development of a court report, the court's blueprint, and the publication of a manual on commercial court administration) were conducted under the auspices of a steering committee to ensure capacity building and establish the commercial court as a model court for Indonesia.

The role of professionals

The amended law has also brought some changes into the constellation of professionals involved in the bankruptcy process. For advocates, there is no special regulation that limits their eligibility to appear before the commercial court. As long as the advocate has complied with Law No. 18/2003 on Advocates, he/she is eligible to represent his/her clients before the commercial court. There is also an Association of Bankruptcy Lawyers. However, its membership status does not affect the eligibility to appear before the court.

With regard to the receiver and the administrator, some changes have taken place. Before the amendment, the registration of receivers and administrators with the Ministry of Justice was subject to membership in the Association of Indonesian Receivers and Administrators (AKPI) as the sole recognised professional association for receivers and administrators. However, the amended law will apparently revoke the exclusivity the AKPI. Under the amended law, anyone can freely establish their own professional association. Registration with the Ministry of Justice and Human Rights is subject to the receiver's membership in one of the associations.

This, of course, raised concerns with legal practitioners. It is feared that more than one professional association will make it difficult to control the professional behaviour of the receiver/administrator. Each association might have their own standards and their own code of ethics. It is also unclear how to implement the admissions test. Before the amendment, the admissions test was conducted by AKPI and successful candidates were recommended by AKPI for registration with the Ministry. However, if a competing organisation is established, would they conduct admissions tests as well? This problem is still unsolved. The government plans to draft a Ministerial decree to regulate it.

The amended law also changes the mechanism to determine receiver's fees. Before the amendment, receiver and administrator's fees were determined up front, with the rate in accordance with the Ministry of Law decree number M.09-HT.05.10 of 1998, Guidance on Receiver and Administrator Fees. However, current law stipulates that fees be determined after the receiver/administrator completes their task.[15] This provision is viewed negatively by many receivers, who see it as limiting their flexibility to advance some costs associated with bankruptcy, as there is no guarantee that a proper fee payment will be received afterwards.

Indonesian Banking Restructuring Agency (IBRA)

Under the Presidential Decree No. 27 of 1998 on The Establishment of the Indonesian Banking Restructuring Agency (IBRA), the government took strategic steps to establish an *ad hoc* institution, which had the main task of restructuring banks, recovering bank assets (both physical assets and loans) and recovering state funds formerly disbursed to the banking sector.

In fact, IBRA faced manifold difficulties in meeting its objectives due to:

- Structural weaknesses in the integrity of assets held by IBRA as it did not have direct ownership of the assets of the previous owners of the banks,
- Incomplete and inaccurate documentation of the problem loans moved to IBRA;
- Weaknesses in the legal documentation supporting IBRA's claims to assets which impeded the ability to enforce IBRA's rights;
- Book versus market value of assets held by IBRA;
- Public distrust of IBRA and its operations;
- Decision-making processes hindered by an unwieldy and inefficient structure; and
- The economic situation in Indonesia.

IBRA management had identified several initiatives, with the support of its stakeholders, to resolve several of the difficulties facing it, while expediting the restructuring and disposal process of assets held by Asset Management Credit (AMC) and Asset Management Investment (AMI) as well as improving IBRA's efficiency, transparency, and legal and litigation capacity. In the implementation of the initiatives, IBRA required approval of the Ministry of Finance and/or the Financial Sector Policy Committee (FSPC) as necessary. However, the recovery rate of IBRA was very low. Ultimately, IBRA was closed in February 2004. The remaining tasks were transferred to a new working group called the Asset Management Company (PPA).

Current practices in various areas

Efficiency of secured lending procedures

The implementation of secured lending in Indonesia has slowly begun to improve, especially after the enactment of several new laws on security rights, namely Law No. 4/1996 on Mortgage and Law No. 42 /1999 on Fiduciary Transfer, both of which give business actors more certainty in securing their transactions and in the enforcement process.

One of the most important contributions of these laws is that they eliminate many doubts and inconsistencies regarding enforcement. The new Mortgage Law allows the first level mortgage holder to exercise the right of instant execution without the obligation to obtain a prior court order. This was regulated under the old Civil Code, but never implemented properly. Prior to this law, the first level mortgage holder had difficulties in enforcing this privilege, as auction houses usually require a court order prior to enforcing this right. This often resulted in lengthy and costly litigation proceedings, especially if third parties intervened.

In addition, the Fiduciary Transfer Law establishes the first fiduciary transfer registry in the land, which provides for the registration of movable assets that are encumbered by secured rights. With this registry, business actors are more confident of their ability to encumber movable property with secured rights. A central fiduciary transfer registry has been set up in the capital, while others will soon be established in the regions.

Unfortunately, these developments are tempered by the fact that the land registry system--an important infrastructure element in mortgage law--is not sufficiently reliable. The national land registry system is managed manually and the integrity of the data is often questionable. Low integrity makes enforcement of secured lending inefficient, since the mortgage holder often faces legal suits concerning the ownership status of the land before they can enforce security rights.

Unsecured lending

Financial institutions only offer unsecured loans in a select environment and under very prudent policy. Financial institutions provide unsecured lending to borrowers in distressed areas and to micro and retail enterprises, based on the reasoning that distressed areas need to be developed and small creditors have less morale hazard compared to larger ones.

Litigation to recover small loans becomes unfeasible, particularly since Indonesia does not have small claims courts. Bankruptcy law actually tries to accommodate all debt values, however, it is still considered too expensive and inefficient for retail debtors to use bankruptcy, as the commercial court registration fee is ten times more expensive than the registration fee of an ordinary court. Therefore, financial institutions rely primarily on out-of-court mechanisms to recover unsecured lending. Self-help is reported as the primary tool for recovering unsecured debt. A financial institution was reported to recover at least 30% of total defaults from unsecured debtors through the self-help mechanism.

Out-of-court workouts

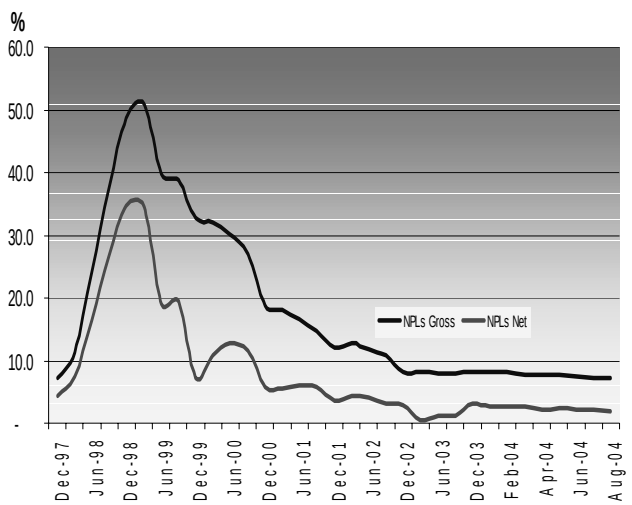
With the dissolution of the Jakarta Initiative Task Force in December 2003, there is currently no general scheme to facilitate creditor workouts. The existing court supervised workouts--the suspension of payment scheme--could not be described as an effective scheme among business actors. Nevertheless, for most banks, out of court settlement is still the primary choice for their restructuring

scheme. The main argument in support of this is that court settlement is costly and time consuming. Ultimately, net recovery from out-of-court settlements is higher.

Most banks' current restructuring portfolios were acquired from IBRA before it was dissolved in March 2004.[16] These portfolios consist mostly of loans that were not restructured or were difficult to restructure. Banks generally consider that the co-operation of the debtor is the key to the restructuring process. Therefore, given the potential difficulties in collecting claims, most banks buy them at a deep discount. The problem occurs when banks try to restructure their portfolios, as most debtors are naturally uncooperative, and because debtors are informed about the rate that banks paid IBRA. This has proven to be to the disadvantage of banks as they seek to improve the recovery rate of their portfolios.

Current risk assessment and management systems and policies

Risk assessment and management systems



According to the experiences of 1997/98, proper prudential regulation and crisis resolution were not in place in Indonesia. This made it difficult for government to restore public confidence in the banking system. This section will outline the main sources of insolvency in the banking system, the role of risk management in crisis prevention and the reformulation of the financial safety net in the banking system. These three items are the main focus of efforts to restructure the banking industry in Indonesia.

Sources of crisis

Risk is associated with the estimation of the future losses of a financial institution. Failures in risk management are the main cause of insolvency in the financial and corporate sectors. Therefore, adoption of risk management processes is the most important strategy to manage risk properly and, furthermore, to prevent insolvency and crisis.

Risks in financial institutions may cover credit risk, market risk, operational risk, legal risk, strategic risk and reputational risk. Each financial institution has its own risk characteristics. In general, credit risk was the main source of risk in insolvent banks in Indonesia as traditional loans dominate asset portfolios in banking. That is the main reason why the discussion in this section will

focus on credit risk management. The main indicator of credit risk is the level of non-performing loans (NPLs). The graph shows the level of NPLs before and after the crisis.

Loan loss classifications reached IDR[17] 280 trillion during the crisis; these loans were transferred to IBRA for further workout.

The macro-economic shock (*i.e.* extreme volatility) during the crisis was believed to be the main cause of increased NPLs. Corporate borrowers suffered the most in the distressed economy as the demand for goods dropped and the cost of production increased. Companies were struggling to pay their obligations to banks and became non-performing. It would be fair to say that proper credit risk management alone is not enough to prevent a bank from insolvency without a stable macro-economy.

Potential Reversal of NPLs

The NPL ratio has gradually decreased over the last five years as a large number (approximately 60% of loan portfolios) were removed from banks and transferred to IBRA. The NPL transfer was a requirement for an insolvent bank to enter the government's recapitalisation scheme. A bank was required to make 100% provisions before these loans were transferred to ensure that the losses were absorbed by the capital. Ultimately, the remaining capital would be the true economic capital available for the bank to continue its business. If the capital adequacy requirement (CAR) of the bank was below the minimum requirement (4%), the owners were required to inject more capital.

Government did allow a bank to enter the recapitalisation scheme if the owners failed to increase CAR to a minimum level. The scheme allowed owners to increase their shares 20% out of the total minimum capital injection for the banks; the remaining 80% would be in the form of government money raised by a government debt issue. The total level of government debt is approximately IDR 431 trillion (approximately USD 47.9 billion). This money is considered as the cost of the crisis to taxpayers. Government debt dominates asset portfolios in the banking sector. NPL reduction is low after recapitalisation; hence, NPL resolution in the banking sector is considered unsuccessful.

It is possible that the trend of NPL reduction could reverse in the future. One can conclude that: (1) The reduction of NPLs is still low (the main reduction of NPLs resulted from the transfer of NPLs from banks to IBRA); and (2) The restructuring process in Indonesia has some problems relating to legal issues, bad governance and information asymmetries.

Lack of good governance was also a source of credit risk in the banking sector. The majority of credits were associated with groups of companies that speculated in real estate. State bank management was not independent from government, hence, the majority of credits were granted to borrowers who were affiliated with government officials.

Financial safety net and crisis resolution

Insolvency and crisis prevention is not always successful in the financial system. The previous section mentions that the macro-economy has a significant impact on the stability and soundness of financial institutions and the financial system. Once crisis strikes, the main prerequisite for restoring stability is clear roles and responsibilities for each agency.

The Indonesian experience shows that there was no clear role for either the Bank of Indoneisa (BI) or the government in solving the crisis. The bail-out of failing banks by the BI resulted in a debate between the BI and other related agencies that believed that the bail-out was illegitimate. The presence of a financial safety net and a crisis resolution mechanism should provide clear authorities,

responsibilities and actions for agencies in the event of crisis. For that purpose, the government has initiated the establishment of a financial safety net scheme and a crisis resolution mechanism.

The first action by government was to amend the 1968 central bank act in 1999. The focus of this amendment was to provide more independence for the BI, which was to focus more on monetary policy. There were three main features of this amendment. First, the governor and deputy governors are proposed by the president and appointed by parliament to ensure that the central bank is independent from government. Second, the central bank is not allowed to have credit exposure to the public. Third, the banking supervision function would be transferred to an independent supervisory agency by the end of 2002. The act was amended in January 2004 to improve the governance of the BI by establishing a supervisory board and explicitly specifying BI's role in financial stability and as a lender of last resort. This role is one of the elements of the financial safety net designed to maintain financial system stability in Indonesia. In addition, the government also extended the time limit for the establishment of a supervisory agency to 2010 because this item has a lower priority for the government at that moment.

The deposit protection scheme law was approved by parliament in mid-2004. This scheme limits protection to small depositors with a maximum of IDR 100 million (equivalent to roughly USD[18] 11 000 at the current exchange rate). Protection covers public funds, namely, demand, time and savings deposits. Government will implement this scheme gradually to ensure that public confidence not deteriorate in the banking industry. The agency also has the role of bailing out insolvent banks based on the recommendations of the financial stability committee (a joint committee of the governors of the BI and the Minister of Finance). In case the agency has insufficient funds to bail out a bank, the government will be responsible for bailing out the deposit protection agency.

With the completion of the legal basis, the Indonesian financial system has a financial safety net that provides authorisation for each related agency to take action in preventing and solving insolvency and crisis. The central bank law and the deposit protection law cover the following arrangements:

i. The first net is the implementation of risk management in banks to prevent liquidity or solvency problems.

ii. The second net is the short-term liquidity facility from the central bank in the event a bank suffers from a liquidity mismatch with liquid collateral and a maximum of 90 days.

iii. The third net is an emergency liquidity facility from the central bank for solvent banks in emergency conditions. This facility will be granted if a bank does not fulfil requirements for receiving the second net. This facility is under full government guarantee.

iv. The fourth net is insolvency resolution by the deposit protection agency for both systemic and non-systemic banks. A joint committee is authorised to provide recommendations to bail out a systemic bank to prevent systemic crisis. The deposit protection agency will assist the non-systemic insolvent bank using the least cost method.

v. The fifth net is the government's injection of funds into the deposit protection agency in the event of a liquidity shortfall.

Institutional insolvency prevention: adoption of risk management

Insolvency is the event when the capital of a bank is insufficient to absorb losses and repay its debts. Merton (1973) believed that insolvency occurs when the market value of capital is less than the amount of debts it should repay. This approach has been used widely to estimate the probability of firm failure. How to measure the market value of capital is very complicated especially for unlisted shares or shares traded in thin capital markets such as those in emerging economies. Risk management tools provide information on potential losses in assets and liabilities for the purpose of establishing the economic value of assets and liabilities and, ultimately, for calculating the economic value of capital or the market value of capital.

Illiquidity and insolvency prevention policies in the banking industry are stipulated by regulatory authorities in risk management and capital adequacy regulations. A series of international standards have been released by the Basel Committee on Banking Supervision to improve the effectiveness of risk management and the accuracy of capital adequacy regulation (CAR) in banking, including the 25 Principles for Effective Banking Supervision (BCP), the Basel Accord of 1988, the Market Risk Amendment of 1996, Basel II of June 2004 and the Risk Management Guidelines.

The BI has set up a master plan to improve compliance with the BCP and the CAR. Risk management guidelines for banks were released in July 2003 with a transition period until December 2004 to provide time for banks to prepare their infrastructure and skills. The CAR regulation was improved in July 2003 by adopting component market risk in the capital regulation. The transition period is approximately two years. Implementation of the new Basel Accord (Basel II) is expected in a few years. A working group of BI staff and practitioners was set up with the task of developing an implementation schedule in Indonesia. Implementation of risk management is a prerequisite for the implementation of Basel II.

With the implementation of risk management, information on potential losses will be available and banks will be more effective in preventing and managing such losses so as to limit them. Ultimately, the likelihood of bank insolvency can be minimised.

Current status of risk management in banking

A risk management system is a comprehensive process for policy formulation, senior management oversight, risk identification, measurement, mitigation, monitoring of implementation and independent internal control. The following list describes typical risk management practices in Indonesian banks.

- Risk management policy covers only the area of business and target without specifically mentioning risk management policy.
- Implementation is based on a traditional approach, which covers mainly credit and liquidity risk. Other risks such us operational, legal, market, reputation and strategic risk are not stated clearly in the policy. Furthermore, these risks are not the main concern of Indonesian banks.
- A subjective risk assessment methodology is the main weaknesses of the traditional approach, hence, an accurate assessment of the fair value of assets and liabilities is difficult to achieve.
- Limited data and information systems for risk management analysis and decision support.
- Risk management skill is very limited.

Improper risk management processes and assessments may result in misleading information for stakeholders and mislead public opinion with respect to bank performance. Financial ratios will fail to reflect the true condition of banks; hence, public transparency will be lacking.

The general economic downturn was the main source of credit problems. High interest and exchange rate volatility during the crisis provide good evidence to show that the macro-economy significantly affects credit quality. NPLs increased sharply during the crisis, reaching more than 50%. Credit risk management, public disclosure and effective supervision are important to improve good governance, however, a stable macro-economic environment is the most important factor to minimise NPLs.

Credit risk assessment is mainly based on traditional loan classifications. Five grades are applied, namely: good, special mention, sub-standard, doubtful and loss according to delinquency and business prospects. This classification acts as a proxy for the potential loss associated with each grade and imposes provisions for that loss. Potential losses for each grade are a specified percentage, which has been agreed between regulatory authorities and the banking industry. The provisions for unexpected losses is 1% and for expected losses are 5%, 15%, 50% and 100% for special mention, substandard, doubtful and loss, respectively.

The current credit risk assessment approach is still relevant for the industry since a credit information system is not available. However, this approach is irrelevant for credit derivatives. The role of credit rating agencies will be important in anticipation of the development of credit risk assessments for credit derivative instruments in the future.

The credit information system

Good risk management systems in banks will provide accurate information since the external infrastructure (such as credit information centres [credit bureaus], ratings agencies, the legal basis, credit insurance, and regulations and supervision) exists.

Information is key to accurately assessing credit risk. A comprehensive individual and aggregate debtors' database is required to assess the probability of firm default, and its credit rating and scoring, which are proxies for potential losses. The database will only be available if information sharing among banks and other financial institutions is permitted by the different jurisdictions in the country. How they share information and whether there is any legal constraint to sharing individual information are the main issues that will affect the quality of information.

A comprehensive credit information centre has been developed in Indonesia under the BI where the information is still limited to raw financial information for debtors with more than IDR 50 million in outstanding debt. It contains no information on credit scoring, variables to assess credit scoring or negative information on debtors. The credit bureau will be established in Indonesia in a few years.

Decision-making in credit risk management is traditional and relies on judgement and scattered information on debtors. In some cases, banks have problems determining the total loans and other credit facilities of the debtors within the bank and within industry as a whole. Information on individual and group ratings is unavailable because the majority of debtors are unrated.

A unit responsible for problem loan workouts has been set up. However, the recovery rate is still very low due to the complicated legal environment, which makes legal settlements more expensive than private settlements. This condition may create moral hazards for debtors.

Credit risk transfer and new financial instruments

In general, credit risk was the main source of risk in insolvent banks in Indonesia since traditional loans dominate asset portfolios in banking. Therefore, to manage the loan portfolio, banks maintain diversified portfolios of risk assets in line with the capital desired.

Portfolio management is an integral part of the credit process that enables the banks to limit concentrations, reduce volatility, increase liquidity and achieve optimum earnings. A limit concentration is an aggregation of credit with common characteristics or exposures. The concentration may be defined by obligor, business segment, industry, geography, risk rating, tenor, credit programme or other dimensions appropriate to the portfolio.

If the loan exposure is approaching its limits, banks may reduce the portfolio through credit risk transfer as a risk mitigation technique. This technique is recognised in the financial sector, has been endorsed by regulatory authorities, and is stipulated in the Basel II document.

Credit risk transfer (CRT)

Credit risk transfer is an approach to managing a credit risk portfolio that matches credit risk positions, reduces the risk related to a single borrower or industry and achieves capital management benefits through risk transfer. Additionally, credit risk transfer helps optimise the relationship between asset quality and provisioning in the future through loan guarantees, loan sales, loan syndications, credit insurance and through capital market solution (*i.e.* asset backed securities). We will use the term "credit derivative" for credit risk transfer instruments in this paper.

In Indonesia, banks generally use loan guarantees, loan sales, syndication and credit insurance as traditional credit transfer instruments rather than capital market instruments such as asset backed securities (ABSs).

Asset backed securities transfer risk in a pool of related assets from the originator to investors. ABSs also convert illiquid assets into a security. The assets include credit card receivables, auto loans, residential mortgages and other risky assets. Practitioners in the banking industry use ABSs as an efficient instrument to transfer credit risk to investors. The growth of this market in developed countries has been relatively high in the last decade. The Basel Committee on Banking Supervision has become increasingly concerned with the use of credit derivatives to maintain capital commensurate with the risk exposure requirements stipulated in the Basel II document.

The role of policy and process

Credit risk transfer in Indonesia is relatively low due to the absence of a credit derivatives market. Inadequate market infrastructure (such as legal basis, fair value accounting and relatively high credit risk premiums) are the main reasons for the absence of a credit derivative market in the country. The financial market authority and the banking supervision authority are responsible for developing the infrastructure of the credit derivative market. The Bank of Indonesia, the Ministry of Finance and the Capital Market Supervisory Board (BAPEPAM) have an initiative to develop the market in order to help financial institutions mitigate their credit risk.

Credit derivative transactions require players, a code of conduct, regulatory endorsement and supervisory treatment, market transparency and appropriate accounting treatments. The following section outlines the mechanisms of ABSs transactions:

i. The originator

The originator has to satisfy the following requirements:

- Corporate commitment
- Track record of loan portfolio to be transferred
- Internal systems (origination, servicing and collection)
- Loans must be transferable
- Information on loan history including collateral
- Origination capacity
- Market position

Special purpose vehicles (SPVs).

A new legal entity (or special purposed vehicle) is created purely for the purpose of holding and financing the assets to be securitised. The originator will sell and assign certain asset portfolios such as credit card receivables to the SPV. Generally, the nature of the transfer and the legal status of the SPV vary subject to several issues and require careful design.

ii. Credit rating enhancement

Asset selection and structure design to obtain a higher rating from a major credit rating agency.

Cash flow allocation.

The originator, as a service provider, receives payment from the borrower which passes to the SPV less servicing fees. The SPV, in turn, pays a predefined interest rate to investors plus any principal repayment, according to the terms of the ABS.

Transformation of cash flow

When all principle payments have been made and the securities have matured, the SPV is extinguished and any remaining assets are returned to the originating bank or firm.

Are Indonesian banks ready for ABSs?

Some big banks in Indonesia are ready for ABSs, but still have issues with ABS policy and processes such as:

i. Bank regulation and capital constraints have not been treated yet;

ii. Lack of statistical records;

iii. Critical legal issues for SPVs: bankruptcy, tax treatment and type of SPV;

iv. Critical legal issues on transfer that require them to be true sales: off balance sheet treatments, sales and purchase effect, notice of obligor and consent or acknowledgement of obligor;

v. Accounting treatment: sales versus financing, accounting for loan servicing and consolidation; and

vi. Monitoring and reporting systems are not ready yet.

Credit risk transfer market

In general, major Indonesian banks expect the CRT market to be functioning well in the near future. Currently, the potential of the CRT market is considered small since the supply and demand are small. CRT supply is small due to the following reasons: (a) in general, the large banks in Indonesia have high capital adequacy ratios (± 21%); (b) credit risk is still manageable (NPLs gross ± 7%); (c) issues on ABS (as mentioned above); and (d) the technique can be complex and require significant initial investment of financial and managerial resources. CRT demand is small because: (a) potential buyers or investors are unfamiliar with originators and the product because of lack of information; and (b) potential buyers or investors know that the legal status and regulations are not yet clear.

Market in a few institutions

Banks represent the major share of CRT activity. Their involvement can be defined in two categories. First, banks use CRT instruments for portfolio management purposes. Second, banks use CRT instruments for trading purposes as intermediaries. In both portfolio management and intermediary activities, banks can engage in the origination of CRT instruments. Generally, bank involvement is for trading purpose rather than for portfolio management because their capital adequacy ratio is high and their NPLs are still manageable. Other than banks, potential investors involved in the CRT market are mutual funds, insurance company, pension fund, finance companies and individuals.

Role of credit monitoring and credit rating agencies

As mentioned above, a good risk management system in the banking industry will be effective in providing accurate information since the external infrastructure such as credit bureaus, ratings agencies, credit insurance and regulation have been established.

Currently, the credit information centre is under the management of the Bank of Indonesia. It provides limited data on debtors, no information on credit ratings and credit insurance, and does not accommodate information from capital market transactions. To improve this situation, the BI will establish a credit bureau in the near future.

Banks will use rating agencies especially for complicated CRT transactions. This is because banks do not have adequate risk management systems in place. A standardised approach using external ratings is adequate for assessing simple transactions.

Future agenda in credit risk management and the financial safety net

Formal implementation of risk management in banks is the main priority of Indonesian banks. The BI has released risk management guidelines for banks and risk management practices will be enforced in 2005 using a risk-based supervisory approach.

To improve the accuracy of regulatory insolvency, the BI will adjust the calculation of the credit risk component by incorporating a more accurate proxy for credit risk. Risk-weighted assets under the current approach are deficient in estimating credit risk because the approach only employs risk-weighted assets based on owner classification, namely, government, state-owned enterprises and private debtors. This approach assumes that government has no risk, state-owned enterprises have a risk weighting ranging from 20% to 50% and private debtors have a 100% risk weight. The best proxy for credit risk in regulatory insolvency is a rating of debtors. This approach has been recognised in the Basel II document.

The BI will establish a credit bureau with the task of providing information corresponding to credit risk assessments for banks. Raw information will be collected from banks. The credit bureau will be an independent institution.

Government will establish a deposit insurance corporation to replace the blanket guarantee scheme. Relevant law was approved by parliament in the third quarter of 2004. The gradual implementation of the new scheme is stipulated in the law to ensure that there will be no distortion in the implementation.

A draft of a financial safety net law is underway whose objective is to prevent crisis. This law will ensure that each agency has clearly spelled out authorities and responsibilities in crisis prevention and resolution. The Bank of Indonesia Law mentions that this draft will be submitted to parliament by the end of 2004.

Conclusions and recommendations

Insolvency in financial institutions was the main source of financial crisis in Indonesia. Recovery of insolvent banks was the main agenda in the ensuing bank restructuring programme. To speed up the recovery, government rescued systemically important banks and closed small banks during the crisis. Government also issued debts of IDR 431 trillion (roughly USD 47.9 billion) or 52% of GDP in 2000 to bail out the banks. Currently, the financial sector has recovered fully as key financial indicators improve (see Appendix 1).

Following the crisis, government employed initiatives to both prevent further crisis and develop crisis resolution mechanisms that specify the roles and responsibilities of each agency in a crisis. These initiatives were triggered from the finding that crisis management must be in place to ensure a clear segregation of authorities and responsibilities between the central bank and the government. The recommendations of these initiatives were stipulated in the amendment of the central bank law, the deposit protection law and the financial safety net bill.

To prevent insolvency, the supervisory authority (the Bank of Indonesia) adopted the 25 Basel Core Principles (BCP) to improve regulatory and supervisory approaches. The ultimate aim of this effort is to enhance governance in the banking industry by (among others) imposing adoption of risk management. Effective risk management systems will allow management to identify and manage potential losses and minimise the negative impact of loan losses on capital and solvency.

The sources of problems in the banking industry may come from other financial sectors, such as the insurance sector, pension funds and other non-bank financial institutions. In some cases, credit risk transfer from banks to other financial institutions is possible through asset securitisation. Tight regulation and supervision of the banking industry may encourage risk transfer from banks to other financial institutions. However, credit risk transfer is irrelevant for the Indonesian financial sector since credit derivatives and asset sales do not exist. In addition, the market share of non-bank financial institutions in the financial intermediary sector is very small.

Development of the legal and the financial market infrastructure is still underway. This infrastructure includes good governance of the financial industry, transparency, the credit information system (credit bureaus), rating agencies, supervision and regulation by adopting international standards and minimising distortions to the economy.

An advanced approach to risk management includes infrastructure elements such as databases, market discipline and a legal framework. Inadequate infrastructure will create misleading information for management decision-making, which will ultimately lead to financial sector instability.

Notes

1 Law No. 3/2004 on the Central Bank and the Law on the Deposit Protection Agency were passed by the parliament and still await presidential signature.

2 Note that the Law on the Deposit Protection Agency will be in force one year after its enactment on 24 September 2004.

3 This is an unwritten convention that has been practised in Indonesian parliament. See the speech of Akbar Tanjung (parliamentary Chairman) at the closing ceremony of the third meeting session of 2003-2004. See also the explanation of Mr. Zein Badjeber, Chair of the legislative body of the parliament.

4 IBRA was dissolved in March 2004 and was succeeded by an asset management corporation named PT PPA.

5 See Law on the Deposit Guarantor Agency Chapter Bab V, regarding the Settlement and Handling of Failing Banks.

6 It is obvious that the bankruptcy of PT Prudential Life (an Indonesian operation of British Prudential Life) on March 2004, accelerated the amendment process. This was the second time that a high profile solvent company was sent into bankruptcy by the court. In 2002, the court sent the Canadian Manulife into bankruptcy over a dispute with its ousted former partner on dividends. Even though the Supreme Court later overturned these decisions, it is certain that the court's initial rulings had a negative impact on both companies.

7 This provision follows a similar policy set by the 1998 Bankruptcy Law for bankruptcy of banks and securities companies whereby this could only be done by the Central Bank and the Capital Market Supervisory Agency.

8 Article 281 of the Bankruptcy Law.

9 The Commercial Court in Central Jakarta is noted as the most active commercial court in the land and hears the most cases compared to other commercial courts.

10 See article 302 (3) of the amended Bankruptcy Law. Please also note that there is currently no active *ad hoc* judge at any court level. The last batch of *ad hoc* judges was appointed in 2001 and their term has expired.

11 Survey conducted of judges in the court of first instance in the regions, found in *Policy Papers on Judicial Personnel Management Reform*, conducted by the Institute for the Independence of the Judiciary on behalf of the Supreme Court of the Republic of Indonesia, 2003.

12 Before the enactment of Law No. 35/1999 on the Basic Provisions on Judicial Power, the management of the court system was separated into two organisations. The Supreme Court managed the organisation and technical aspect of the judicial corps, while the Ministry of Justice managed administrative aspects, namely the budget, finance and human resources functions.

13 Under the two roof system, the Ministry of Justice and Human Rights runs the management of the lower court. For some aspects, they run it jointly with the Supreme Court. This is to include recruitment, promotion and transfer, and all support systems of the lower courts.

14 The recent Deposit Guarantor Law stipulates that the Commercial Court shall hear settlements of disputes in relation to bank liquidation.

15 Article 75 of the Bankruptcy and Suspension of Payment Law.

16 During the crisis, IBRA recapitalised failing banks and took over their non-performing loan portfolios. These portfolios were later restructured by IBRA. Before its dissolution, IBRA sold most of its remaining portfolio to Indonesian banks. The quality of (and the expected recovery on) these portfolios is low.

17 Indonesian rupiah (IDR).

18 United States dollar (USD).

TRENDS AND DEVELOPMENTS IN INSOLVENCY AND RISK MANAGEMENT IN THE PHILIPPINES

by
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Trends and developments in insolvency and creditor rights

Insolvency

Legal infrastructure

The legal framework for insolvency in the Philippines is characterised by few and far-between landmarks, starting with the antiquated Insolvency Law of 1909. This law dealt simply with suspension of payments and the liquidation process. This was followed by a Presidential Decree issued in 1980 vesting the Securities and Exchange Commission with authority to act on petitions for rehabilitation. Subsequently, in the Securities Regulation Code, enacted in 2000, such jurisdiction was transferred to the regular courts. This code was complemented by the Interim Rules of Procedure on Corporate Rehabilitation issued by the Supreme Court in 2001 to govern rehabilitation proceedings.

Notwithstanding the foregoing enactments and issuances, grey areas have remained such as those on restructuring, rehabilitation, the stay of proceedings, and the treatment of the rights of creditors, both clean and secured. Available substantive law has not provided adequate rules and standards by which insolvency-related issues may be resolved, thereby prolonging almost interminably the actual proceedings which have arisen in the meantime.

Realising the need to consolidate, nationalise and upgrade the insolvency infrastructure, the Legislative-Executive joint council have agreed to include among the priority measures of the Philippine Congress the passage of the Corporate Recovery Act. It was agreed that this measure is an integral element of the restructuring and reform of the financial sector. Draft bills have been filed in both houses of Congress that have the following common objectives:

i. To modernise and clarify the rules for rehabilitation and insolvency in the Philippines;

ii. To define the rights of debtors and creditors in these proceedings and facilitate the adjudication of issues between them;

iii. To provide fair treatment to all parties while maximising the chances for the survival of an enterprise; and

iv. To inject speed and efficiency in the conduct and termination of the proceedings.

More specifically, the proposed Corporate Recovery Act would provide these reliefs and remedies:

i. *Pre-negotiated rehabilitation*: This would allow a debtor that has worked out a rehabilitation plan with its creditors to go to court for official approval. In the meantime,

claims and lawsuits are suspended. When the court approves the plan, all creditors are bound thereby.

ii. *Fast-track rehabilitation:* This would allow the creation of a new, debt-free enterprise based on the assets of the debtor. There will be a transfer of the shares of the new enterprise to the debtor in exchange for the debtor's assets; there may be an auctioning of the shares of the new enterprise to maximise revenues. This approach keeps the enterprise together with the possibility of significantly reducing its debt within a short period of time.

iii. *Court-supervised rehabilitation:* This puts the onus on the shareholders for drafting and selling a rehabilitation plan. They may hire a rehabilitation planner to prepare the plan. The court may approve the plan notwithstanding unresolved claims as long as the plan accommodates payment of the claims regardless of the outcome of the disputes.

iv. *Dissolution-liquidation:* This is the relief of last resort. The proposed liquidation proceedings are straightforward and involve simple and clearer prioritisation of creditors.

Related developments

In June 2004, the Philippine Congress enacted Republic Act No. 9302 which amended the Charter of the Philippine Deposit Insurance Corporation (PDIC). Among other provisions, the amendments authorises the PDIC to: (a) issue cease-and-desist orders; (b) issue directives for corrective actions; and (c) make loans to, purchase assets of, assume liabilities of, or make deposits in a bank to prevent the same from closing. There are also provisions that would expedite payment of insured deposits upon closure. Moreover, actions of the PDIC can be restrained only by the Court of Appeals. These amendments seek preventive measures to avert, if possible, bank closures and, in they event happen, to permit an expedient receivership and liquidation process for the closed bank.

In September 2004, the Bangko Sentral ng Pilipinas initiated efforts to amend its charter. Insolvency-related proposals would include an authority for the receiver of a closed bank to sell, transfer or dispose of the assets of the closed bank or to pursue its merger or consolidation with another institution so as to effect rehabilitation. Under the present law, the receiver does not have such authority. Aside from banks and quasi-banks, the authority of the Bangko Sentral to place an institution under receivership would include trust entities and non-stock savings and loan associations thereby providing clear insolvency rules relative to said entities.

Creditor rights

Creditor rights in the Philippines arising from promissory notes, loan documents, mortgages, pledges and deeds of assignment are substantially similar to those in other jurisdictions except for two features which are peculiar to the Philippine legal system, namely:

i. The right of redemption after foreclosure of real estate mortgages; and

ii. The rule on *pactum commisorium* which disallows the creditor to appropriate to himself the property of the debtor for the purpose of satisfying the debt.

Under the Philippine mortgage law, the mortgagor of real property to a banking institution has a one-year period after foreclosure to redeem the foreclosed property. This period has been shortened to three months in some instances as provided in the General Banking Law. This law impairs the capability of the creditor bank to liquefy, put to use, or dispose the foreclosed assets, or benefit therefrom for the duration of the redemption period. Moreover, since before the creditor files the foreclosure proceedings it has already exhausted all efforts to collect and failed, there is really no

likelihood that the debtor would have the resources to repay. There were proposals several years ago to have the right of redemption repealed but there was no favourable response.

On the rule on *pactum commisorium*, it would technically require all proceedings for the involuntary settlement of debt against the assets of the debtor to be subject to public auction, thereby making collection cumbersome and costly. Private sales by the creditor of mortgaged and pledged assets are not allowed in the event of default. This rule should be subject to review.

Current risk assessment and management systems and policies

Risk assessment and management systems

Credit risk in its most basic form is the risk that a customer or counterparty will be unable or unwilling to pay obligations on time or in full as expected or previously contracted, subjecting a bank to a financial loss. In the Philippines, credit risk management–although the most basic risk that characterises the banking business–is still in its nascent stage. Loan origination standards, the first line of defence against such risk, are still vulnerable and need to be improved. Credit risk rating systems, the second line of defence, are generally crude. Although crude credit risk rating systems are better than none, the reliability of the output of such systems may be in question since unaudited financial statements are still in use. This problem, however, is not a monopoly of the Philippines. As Mr. McDonough remarked in his speech before the Bond Market Association in New York on 21 January 1999: "Let me be a bit more specific about some of the weaknesses found in credit risk management techniques. For example, some institutions routinely performed credit assessments using sparse, often unaudited financial information from valued customers." The Bangko Sentral ng Pilipinas (BSP) has already addressed this problem by requiring banks to use only financial statements audited by accredited external auditors starting in 2005.

To improve banks' credit risk management practices, the BSP has issued a number of regulations that include the following:

i. Circular No. 389, which sets out the basic guidelines for the granting of loans and other credit accommodations;

ii. Circular No. 414, which sets out the principles for the management of large exposures and credit risk concentrations;

iii. Circular No. 423, which sets out specific guidelines regarding banks' dealings with any of its Directors, Officers, Stockholders and their Related Interests (DOSRI);

iv. Circular No. 425, which sets a limit on loans to a single borrower; and

v. Circular No. 439, which requires banks to put in place internal credit risk rating systems for their corporate exposures.

Circular No. 439, in particular, emphasised the role of bank boards of directors in risk management. It requires, among others, that bank internal credit risk rating systems be approved by the bank's board of directors, and designed and implemented by an independent credit risk control function.

The involvement of bank boards in the risk management process is further emphasised in a recent issuance by the BSP which prescribes the creation of a Risk Management Committee (RMC) composed of at least three members of the board of directors. The RMC shall be responsible for the development and oversight of the bank's risk management program. Specifically, the RMC shall

identify and evaluate risk exposures, develop risk management strategies, implement a risk management plan, and review and revise the said plan as needed.

The BSP has also worked with the industry through the Bankers Association of the Philippines (BAP) to improve risk management practices in the banking sector. Together, they came up with the Financial Markets Risk Reference Manual. The manual serves as a basis for commercial bank risk management policies and practices. For credit risk, it prescribes the ideal structure of a bank's Credit Risk Management Organisation, the establishment and operation of a sound credit granting process, the establishment of credit monitoring systems which will track the composition and quality of the credit portfolio, as well as compliance with the banks' internal credit limit and concentration policies.

To encourage banks to further improve their risk management practices and to prevent them from taking on excessive risks, the BSP has issued Circular No. 212 which sets out the types of information that banks should publicly disclose. The said circular adopts the core public disclosure requirements as prescribed in the 1998 Basel Committee on Banking Supervision (BCBS) paper Enhancing Bank Transparency. Aside from the usual information on bank financial and accounting practices, the said paper also prescribed the disclosure of information regarding the bank's risk management philosophy, risk management systems and structures, as well as qualitative and quantitative information on their risk exposures. Unfortunately, Philippine domestic banks are still getting used to the idea of risk-focused disclosures.

Credit information systems

To improve credit risk management in the financial markets, there has to be a source of reliable public information on the creditworthiness of corporate entities. To address this, the BSP has supported the development of two key market infrastructures: credit information bureaus and credit rating agencies.

Credit information bureau

The BSP is supporting the creation of a central credit bureau in order to improve the credit information systems in the domestic financial markets. This central credit bureau brings together the various small credit information bureaus throughout the industry. As such, it will compile credible and reliable information on credit transactions, payment history, and other indicators of creditworthiness from a wide range of consumers and businesses. The proposed central credit bureau is therefore seen to protect the financial system from fraud, improve credit decision-making and promote credit discipline.

The BSP has engaged a comprehensive legal study on how it can put together a central credit bureau at the earliest possible time. Based on the legal study's recommendations, the BSP has the legal authority to establish and operate a credit information bureau as an internal unit within its organisation. Thus, in the interim, BSP will operate a credit bureau while an appropriate enabling law is being worked out with Congress. Once the law is in place, BSP will seek to divest to allow the private sector to take over.

Credit rating agencies

Credit ratings are important for risk management purposes since ratings are perceived to be a major variable that factors into the risk pricing function. The BSP therefore sees it fit to support the development of domestic credit rating agencies. Toward this end, the BSP issued Circular No. 404 containing the guidelines for the recognition and derecognition process of credit rating agencies.

Currently, there is only one credit rating agency in the Philippines that is recognised by the BSP. There is, however, an application pending from a foreign rating agency that has expressed its intent to devise a national rating scale for the country.

Credit risk transfer and new financial instruments

The desire of financial institutions to manage and mitigate credit risks has led to new and more complex credit risk transfer mechanisms, two of which are credit derivatives and securitisation structures.

Credit derivatives

Credit derivatives are a way of transferring the credit risk of a reference asset from a party (protection buyer) to one or more other parties (protection seller). Theoretically, credit derivatives offer protection buyers a means of diffusing risk and thus achieving capital relief because the reference asset is no longer on their books. For protection sellers, credit derivatives offer an opportunity for diversifying investments since they can take positions in certain debts even if the cash market for these debts no longer exist.

In the Philippines, however, a different scenario is taking shape. Offshore banks utilise credit derivatives to reduce their exposures to Philippine sovereign debt by synthetically transferring these exposures to domestic banks. The domestic banks, on the other hand, are more than willing to accept these exposures because, aside from the enhanced yield, exposures to Philippine sovereign debt (even those that are dollar-denominated) are considered by the BSP as risk-free. This results in a growing concentration of exposure of the domestic banking system to dollar denominated Philippine sovereign debt.

To provide a regulatory framework for credit derivative transactions in the Philippines, the BSP issued Circular No. 417 specifying the capital requirements for credit-linked notes. The BSP is now in the process of drafting regulations for unfunded credit derivatives.

Securitisation

On 19 March 2004, the President signed into law R.A. No. 9267, otherwise known as the Securitisation Act of 2004. This sets the legal and regulatory framework for the sale of financial assets like loans, mortgages, receivables, etc., and their transformation into marketable securities. Securitisation is a device of structured financing where an entity seeks to pool together its interest in identifiable cash flows over time, and create securities against these for sale to investors. As such, securitisation presents banks with yet another means of raising funds (in addition to traditional borrowing), and managing credit exposures. However, there are risks inherent to securitisation that have implications for individual entities as well as the macro economy as a whole (*i.e.* the possibility of sub prime lending to feed securitisation, banks carrying excessive risks that are not reflected on their balance sheets, sterilisation of monetary policy, etc.). The challenge is to design an appropriate regulatory environment to minimise these risks.

Currently, the BSP has already exposed a draft circular to the banking industry prescribing the rules for bank investments in securitisation structures including CDO structures.

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TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK MANAGEMENT: THE PHILIPPINE SITUATION

by
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Introduction and summary

As this paper is being written, the Philippines is perceived to be sinking deeper into a debt crisis. The debt stock of the national government grew to some PHP[1] 3.4 trillion at the end of 2003, or 77.4% of gross domestic product (GDP), up from 18.9% in 1981. The total debt servicing in 2003 was PHP 470 billion, equivalent to 10.8% of GDP, compared to 5.4% of GDP in 1996. In 2003, 7% of revenues went into debt servicing and the figure is expected to climb to 80% in 2004. It has been noted that the growth in the country's debt stock can be traced to 1999 when the government resorted to "pump-priming" the economy following the 1997 Asian financial crisis.

As a result, international credit rating agencies[2], have threatened to further downgrade Philippine debts if congress fails to pass new tax measures and the Philippine government fails to come up with new revenue sources.

Insolvency reforms have taken a multi-pronged approach with efforts being pursued by the legislative, administrative and judicial departments in areas where results can be easily and rapidly achieved.

The Philippine insolvency and corporate bankruptcy system is almost one century old, (the Insolvency Act was adopted in 1909). Current reforms have focused on updating bankruptcy laws to current international standards, creating specialised bankruptcy courts with well-defined jurisdictions and rules of procedure and practice, reforming the legal system with respect to credit transactions to afford a healthy and equitable balance between protecting the rights of creditors and borrowers, developing a pool of professional players who would be potent partners in enforcing the bankruptcy system in line with international best practice, strengthening the financial sector to afford the backbone

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1 Philippine pesos.

2 Moody's Investor Services (downgrade to Ba2 in January; negative outlook), FlitchRating (downgrade to BB in June 2003; stable outlook) and Standard & Poor's (July 2004 review warning).

for reforms, putting into place rules that link local systems with international proceedings, such as providing cross-border insolvency, and engendering a culture of compliance with established policies, rules and procedures.

Restructuring and reform efforts have had mixed results:

- The reception of the Special Purpose Vehicle Act and the Securitisation Act has been lukewarm in the financial sector.

- The proposed Corporate Recovery and Insolvency Act, which is envisioned to upgrade the country's insolvency system to conform with international standards and provide for a cross-border insolvency system, has floundered in congress with little expectation that it will be enacted into law soon.

- The Anti-Money Laundering Act was passed to ensure that the Philippine financial system remains legitimate within the ambit of global financial networks.

- Much of the reforms in insolvency law have come from the Supreme Court which exercised its power under the Philippine constitution to promulgate rules of procedure and practices:
  - Designation of special commercial courts in various judicial regions of the country with original and exclusive jurisdiction over corporate suspension of payments and rehabilitation cases;
  - Promulgation in 2000 of the Interim Rules of Procedure for Corporate Rehabilitation;
  - Consolidation of money-laundering cases within the exclusive jurisdiction of the special commercial courts;
  - Consideration and expected promulgation of the Interim Rules of Procedure for Corporate Insolvency and Dissolution, and the consolidation of such cases within the exclusive jurisdiction of special commercial courts; and
  - Ongoing training of judges of special commercial courts.

- The framework set up by the Supreme Court has seen corporate rehabilitation proceedings among some of the largest Philippine corporations:
  - Philippine Airlines
  - Victorias Sugar Milling
  - Maynilad Water System
  - Uniwide Supermarket
  - Pryce Gases

Many of these companies have continued to operate and exhibit viability under the protection of the rehabilitation proceedings.

- On the corporate front, corporate governance principles have been pushed by the administrative departments, essentially through the Securities and Exchange Commission and the Bangko Sentral ng Pilipinas, covering banking institutions, listed and public companies.

Trends and developments in insolvency and creditor rights frameworks and practices

Current legal and institutional developments

1. The bill entitled Corporate Rehabilitation and Insolvency Act (CRIA) was re-filed with the new Philippine Congress as urgent legislation. CRIA is aimed at overhauling and consolidating the entire system governing corporate rehabilitation, dissolution and liquidation, and contains provisions on such important matters as cross-border insolvency, etc.

   The bill seeks to improve the speed and efficiency of rehabilitation and insolvency cases, and at the same time achieve a balance between the rights of creditors and debtors, all in accordance with international standards.

2. Pending the passage of CRIA, the judiciary has taken up the cudgels to bring about an interim modernisation of laws and practice pertaining to corporate rehabilitation and insolvency.

   Pursuant to its constitutional power to promulgate rules of procedure (Section 5(5), Article VIII of the 1987 Constitution), the Supreme Court promulgated the Interim Rules of Procedure on Corporate Recovery which not only contain rules and procedure, but also key provisions that border on substantive law, since such provisions create new substantive rights, or have the effect of supplanting or adversely affecting existing property rights.

   (a) The proceedings under the Interim Rules are mandated to be *in rem*; through compliance with publication requirements, the results of the proceedings are binding on creditors and other affected persons even when they do not participate in the proceedings.

   (b) The proceedings are declared "summary", "non-adversarial", and "technology friendly," such that pleadings that unduly delay causes of actions are prohibited. Oppositions are established based of sworn filed statements, with the actionable documents attached when necessary. Service of pleadings may be effected by fax or e-mail.

   (c) The proceedings are strictly time-bound and the whole process cannot exceed 18 months.

   (d) The orders of the courts are to be executed immediately, even on appeal, unless enjoined by the Court of Appeals or the Supreme Court.

   The Supreme Court also passed a memorandum circular that consolidated the commercial courts' handling of corporate rehabilitation, intellectual property and anti-money laundering cases.

   Currently, the Supreme Court is reviewing the proposed Consolidated Rules on Corporate Insolvency and Dissolution, to be accompanied by a memorandum circular, that will also consolidate such cases with the commercial courts.

3. Another related bill that is pending in Congress is the Corporate Reform Act which seeks to mimic the Sarbanes-Oxley Act in the Philippine setting (House Bill No. 5260) by:

(a) Introducing stricter measures in the production of financial reports;

(b) Establishing new or enhanced standards for corporate accountability;

(c) Seeking to impose significant criminal liability for corporate wrongdoing;

(d) Establishing a Public Company Accounting Oversight Board; and

(e) Providing for mandatory registration of public accounting firms.

4. Another bill filed with Congress is the Personal Equity Retirement Account (PERA), which is intended to provide financial security to millions of Filipinos who are not covered by a retirement plan. PERA will encourage Filipinos to save for their retirement, by institutionalising savings among public and private sector employees and creating an environment that encourages savings. Contributions will be deductible from taxable income and earnings on contributions will also be tax-exempt. Only withdrawals from PERA will be taxed.

   Patterned after Singapore's Central Provident Fund, PERA will offer investment vehicles that offer higher returns, such as common trust funds, mutual funds, approved annuity contracts, or pre-need pension plans. Investments in any of these vehicles will be reinvested in national government securities or issues, corporate or government bonds, deposits in local or foreign currencies in the Philippines, financial institutions, foreign currency denominated investments authorised by the BSP, and non-speculative equities listed on the Philippine Stock Exchange.

Institutional developments

The training of commercial law judges

The Philippine Supreme Court has pursued the training of commercial law judges in earnest.

In September and October, commercial law judges from all over the country (there are 64 duly designated judges) attended seminars and workshops to discuss reform of the existing corporate rehabilitation structures. They also received training seminars in the proper handling of intellectual property and anti-money laundering cases.

Through the Philippine Judicial Academy (PHILJA), the Supreme Court is also promoting the following reforms in the judiciary:

- Commercial mediation and ADR forms of conflict resolution;
- Distance learning and training of judges through internet facilities;
- Case loading and monitoring through internet facilities;
- Number of judges, qualifications, independence, appointment procedures and transparency, extent of interference by government, standards of performance, use of and dependence on professionals and experts, use of information technology;
- Role of professionals (lawyers, accountants and others), institutionalisation of the insolvency profession, qualifications, training, admission criteria, disqualification, standards on fees,

training, synergies between different professions, best practices and standards, their regulation etc.;

- Powers of regulators, their qualifications, appointment, training, efficiency, remuneration, transparency, independence, disqualification/removal, penalties etc.; and

- Status of other institutions, such as AMCs, those that are continuing and about to expire, and who will inherit their tasks.

The Special Purpose Vehicle Act of 2000

The Special Purpose Vehicle Act of 2000 (Republic Act 9182) seeks to speed the recovery of the Philippine financial sector, by providing for tax and financial incentives for the liquidation of existing non-performing assets (NPAs) and the ROPOAS of banks and financial institutions. Under the SPV Law, a highly capitalised corporation is formed for the purpose of purchasing and then disposing of the NPAs of banks and banking institutions, consisting of non-performing loans, and real and other properties owned or acquired. The SPV assumes all of the rights and obligations of the financial institution so that it can collect and restructure the NPLs or sell the ROPOAS. The SPV can also issue debt instruments in the form of IUIs or investment unit instruments, backed by the receivable from the NPAs. The purchase and sale of the NPAs are tax-free (exempt from documentary stamp, capital gains, creditable withholding, gross receipt and value-added taxes). On the side of the banks, the losses incurred from the sale of NPAs is considered an ordinary loss and carried over for a period of 10 years (extended by the BSP from the previous five-year period).

SPV Law incentives are time-bound, and the primary deadline ended on 18 September 2004. SPVs must be registered within 18 months from the taking effect of the IRR, which ended last September. Transfer of NPAs from the financial institutions to SPVs enjoying incentives only for two years from the date of the taking effect of the IRR. Transfers of NPAs by SPVs to third parties enjoy the incentives for only five years from the start of operation. The SPV Law will expire on 18 April 2005.

Response to the SPV Law has been very disappointing, with the only notable taker being the PHP 10 billion disposition of NPAs by the Philippine Bank of Communications, which was a condition of the extension of a PHP 8 billion credit to the bank by the Philippine Deposit Insurance Corporation (PDIC).

The only other bank that has expressed its intent to avail of the SPV Law is the United Coconut Planters Bank (UCPB), which is targeting to dispose of PHP 15 billion worth of NPAs. There has been no report on its achieving the 18 September 2004 deadline for setting up the corresponding SPV.

The following reasons have been attributed by both the public and private sectors to why the SPV Law has not met its objectives:

i. The tax breaks and fiscal incentives being offered could not outweigh the huge amount of capitalisation required in setting up SPVs, the large discounts demanded by interested (mostly foreign) buyers of NPAs, and the difficulty of getting a fair return on the NPAs considering the lacklustre property market in the Philippines;

ii. The constitutional ban on foreigners from owning real estate in the Philippines;

iii. The big gap between what sellers (Philippine financial institutions) expect and what buyers (mostly foreign entities) are willing to pay for idle assets.

Even in August 2004, the BIR Commissioner was quoted by newspapers as saying that the BIR may no longer issue a review order that would serve as guidelines on how the tax exemption granted under the SPV Act would be availed: such "revenue regulation may no longer be needed given the lukewarm response of the private sector on the reform."

The Securitisation Act of 2004

The Securitisation Act of 2004, allows assets to be sold without recourse to a special purpose corporation or, in the case of banks, a special purpose trust. The special purpose entities (SPEs) can then issue securities backed by a pool of similar assets, in the process of distributing risk.

To help spur the Philippine housing sector, only securities backed by residential mortgage and other housing-related financial instruments can be resold in the secondary market, to be carried out through secondary mortgage institutions (SMIs), similar to the US Fannie Mae and Freddie Mac.

The acts grants several tax incentives to encourage financial institutions to transfer housing mortgages to SPEs:

i. SPEs will pay income tax as any other corporation but transfers of assets will be exempt from value-added and documentary stamp taxes;

ii. SPEs will also be given a 50% discount on all applicable registration and annotation fees;

iii. SPEs will be classified as banks, quasi-banks and financial intermediaries, and thereby be exempt from the 5% gross receipts tax;

iv. Asset-backed securities will not be classified as deposit substitutes, but yields will be subject to a 20% final withholding tax; and

v. Property transfers through *dacion en pago* (payment in kind) will be exempt from the 6% tax on capital gains.

TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK MANAGEMENT: THE EXPERIENCE OF THE PHILIPPINES

by
Gilbert Gallos

Introduction and summary

Recent developments in the financial system of the Philippines and the growing clamour to update antiquated laws relating to rehabilitation and insolvency to comply with international best practices have led to a series of new and proposed legislation. Philippine legislators have been busy revising and updating the legal framework of the Philippine capital markets with the aim of attracting investors, both foreign and local, to the capital markets and, at the same time, adopting the values of good governance.

Recently, the Special Purpose Vehicle (SPV) Act of 2002 and its companion law, the Securitisation Act of 2004, were passed by Congress to spur foreign investment and economic growth in the banking and securities sectors. Currently, Congress is deliberating the passage of the Corporate Rehabilitation and Insolvency Act, which envisions introducing international best practices in insolvency and harmonising the antiquated insolvency law with them.

Together with the other recently passed laws and regulations such as the General Banking Law of 2000 (GBL), the Securities Regulation Code of 2000 (SRC) and the Interim Rules on Corporate Rehabilitation (Interim Rules), the aforementioned laws and regulations have updated the Philippine legal framework for corporate finance and insolvency to enhance Philippine competitiveness in the international capital markets.

Trends and developments in insolvency and creditor rights: frameworks and practices

Current legal and institutional developments

Interim rules on corporate rehabilitation

The principal laws governing insolvency and rehabilitation are the Insolvency Law, enacted in 1909, and Presidential Decree No. 902-A (PD 902-A), enacted in 1976. PD 902-A vested the Securities and Exchange Commission (SEC) with jurisdiction over, among others, petitions for suspension of payments and rehabilitation of corporations. However, on 19 July 2000, Congress enacted the Securities Regulation Code (SRC or RA 8799). The SRC transferred jurisdiction from the SEC to the regular courts over petitions for suspension and rehabilitation, and allowed the Supreme Court to designate branches of the appropriate Regional Trial Courts to hear and decide cases of such nature. Pursuant to the Securities Regulation Code, the Supreme Court promulgated in December 2000 the Interim Rules of Procedure on Corporate Rehabilitation (Interim Rules) setting forth the procedure for corporate rehabilitation.

The Interim Rules authorise a distressed debtor to file a petition for rehabilitation. They also authorise a creditor or a group of creditors holding at least twenty-five percent of the total liabilities of the debtor to file a petition to rehabilitate the debtor.

If the court makes a determination that the petition is sufficient in form and substance, it then issues a stay order that, among others, stays enforcement of all claims against the debtor. All claims, whether secured or unsecured, are stayed for the duration of the rehabilitation proceedings, which must not exceed eighteen months from the filing of the petition. If no rehabilitation plan is approved within said period, the petition is dismissed.

The rehabilitation court also appoints a rehabilitation receiver, whose primary tasks are to monitor the operations of the debtor under rehabilitation, evaluate the feasibility of rehabilitating the debtor, and implement the rehabilitation plan if approved by the court. Once the rehabilitation plan is approved, it is binding upon the debtor and the creditors, whether or not they participated in the proceedings or opposed the plan. An approved rehabilitation plan may, on motion, be modified if, in the judgment of the court, such modification is necessary to achieve the targets or goals set forth therein. If the plan is successfully implemented, then the court shall terminate the rehabilitation proceedings.

Proposed Corporate Rehabilitation and Insolvency Act

Considering the current piecemeal legislative state of the insolvency and rehabilitation laws of the country, the Philippine Congress is currently deliberating on the proposed Corporate Rehabilitation and Insolvency Act which attempts to harmonise the aforementioned laws taking into account international best insolvency practices. There are two bills now pending in both houses of Congress.

SPV Act of 2002

As a response to the growing non-performing assets problem besetting the Philippine banking sector, Congress passed the SPV Act of 2002, essentially granting tax exemptions and fee privileges to transfers of the non-performing assets (*i.e.*, non-performing loans and real and other assets owned and acquired by financial institutions) to and from the SPVs. The law calls for the creation of SPVs as the corporate vehicle to acquire such non-performing assets and, in turn, dispose of them in the market.

While the law was principally designed to address the non-performing assets of the financial sector, it is also an attempt to encourage private sector investments in the banking and financial sector. The law mandates the issuance of investment unit instruments (IUIs) by the SPV as a means of raising funds. Such IUIs are securities and therefore required to be registered with SEC.

The SPV Act of 2002 provides an 8 April 2005 deadline for the disposition of the non-performing assets by the financial institutions. There have been several banks which have transferred or are currently planning to transfer their non-performing assets under the SPV Act of 2002, including the Bank of the Philippine Islands, Rizal Commercial Banking Corporation, United Coconut Planters Bank, Philippine Bank of Communications, Land Bank of the Philippines and the Philippine National Bank.

The sale of the assets of the National Steel Corporation, the Philippines' only steel plant, to the Ispat Group of India was conducted under the provisions of the SPV Act of 2002, as well.

There are moves in Congress to have the law amended by extending the deadlines on the transfer of the non-performing assets.

Securitisation Act of 2004

Crafted primarily as the companion bill for the SPV Act 2002, the law calls for the rationalisation of the laws, rules and regulations relating to the securitisation or the sale on a without recourse basis to special purpose entities (SPE) and the issuance of asset-backed securities (ABS) by the SPE, which depend for their payment on the cash flow from the sale of the assets.

The law likewise rationalises the various regulations on the development of a secondary market for ABS. As with the SPV Law of 2002, the law grants certain tax exemptions and fee privileges to the transfer of assets to the SPE and the issuance of ABS related to the securitisation transaction.

The appropriate regulatory agencies have yet to issue their respective implementing rules and regulations.

General Banking Law of 2000 and the Anti-Money Laundering Act, as amended

The General Banking Law of 2000 (GBL) is the basic law governing the banking sector, including the grant of loans and other forms of credit accommodation, enforcement of security by banks, allowable equity investments of banks and determination of the banks' prescribed risk-based capital.

In enacting the GBL, Congress took into account the role of banks in providing an environment conducive to the sustained development of the national economy and the fiduciary nature of banking that requires high standards of integrity. The General Banking Law is an attempt by the government to promote a stable and efficient banking and financial system that is globally competitive, dynamic and responsive to the demands of a growing economy.

In response to the requirements of a stricter post-9/11 financial community, Congress, taking into account the recommendations submitted by the Financial Action Task Force, enacted stricter guidelines in handling of bank accounts and transactions to prevent money laundering. The Anti-Money Laundering Act, as amended, requires banking institutions to maintain a system of verifying the identity of both individual and corporate clients and develop clear customer acceptance policies and procedures for various bank transactions. The law mandates the creation of the Anti-Money Laundering Council, with broad powers of inquiry and examination of bank deposits in cases contemplated by the law. The Anti-Money Laundering Act was recently amended to, among others, expand the powers of the Anti-Money Laundering Council.

Securities Regulation Code

Signed into law on 19 July 2000, the Securities Regulation Code (SRC) is the charter governing the issuance, trading and settlement of securities. Basically, the Securities Regulation Code requires that all securities sold or offered for sale within the Philippines be registered with the SEC. It likewise regulates all the players in the securities market including buyers, sellers, issuers, market professionals (brokers and dealers) and exchanges and provides for penalties for prohibited or regulated acts such as insider trading, manipulation of security prices and option trading.

Institutional developments

To implement the provisions of the Securities Regulation Code, and in the interest of the speedy administration of justice, the Supreme Court, through AM No. 001103-SC, dated 21 November 2000, designated 60 branches of the various Regional Trial Courts all over the country (including 14 within

the metropolitan Manila area) to hear, among others, petitions for rehabilitation. These courts are referred to as Special Commercial Courts.

The Insolvency Law does not provide for the qualifications of insolvency administrators, nor is there a system of regulation of insolvency administrators in the Philippines. For rehabilitation proceedings, Section 13 of Rule 4 of the Interim Rules specifies the qualifications for rehabilitation receivers as follows:

- expertise and acumen to manage and operate a business similar in size and complexity to that of the debtor;
- knowledge in management, finance, and rehabilitation of distressed company;
- general familiarity with the rights of creditors in suspension of payments or rehabilitation, and general understanding of the duties and obligations of a rehabilitation receiver;
- good moral character, independence and integrity;
- lack of a conflict of interest; and
- willingness and ability to file a bond in such amount as may be determined by the court.

To train and update the commercial court judges, the Supreme Court, through the Philippine Judicial Academy (Philja) has been conducting regular training sessions and seminars. In addition, several projects have been undertaken by the Philja to engage commercial law experts to draft benchbooks to guide the commercial court judges. Some of there benchbooks include topics on insolvency laws and corporate rehabilitation.

Professional associations such as the Integrated Bar of the Philippines (IBP) and the InsolPhil conduct regular seminars on insolvency and corporate rehabilitation for lawyers as well as the judges.

Nevertheless, there is still much that can be done to improve the Philippine insolvency regime. The judges of the Special Commercial Courts can not yet be considered specialists in insolvency and rehabilitation proceedings, in terms of mastery of the applicable law/procedure or experience in handling these types of cases. The RTCs are courts of general jurisdiction. While the Insolvency Law was enacted in 1909, there have been relatively few petitions for insolvency filed since then. As for rehabilitation, jurisdiction was transferred to the RTCs only in August 2000, and the Interim Rules were promulgated only in December 2000. In this sense, the experience of Special Commercial Courts in these cases is limited.

Moreover, commercial court judges are required to handle other cases, which may not be commercial in nature (*e.g.* criminal or other civil cases). This is a continued drain on the time and efforts of the commercial court judges.

There is also a perception that it is difficult to find qualified private individuals who will act as receivers, either because of lack of training, or because of inadequate compensation for serving as such. At present, there is no institutionalised system of accreditation for these private individuals, so that it becomes more difficult for the courts and other interested parties to identify who can be appointed as a liquidator. There is also no system of training court-appointed liquidators, nor is there a code of conduct governing them. These are believed to be important components in improving the administration of corporate liquidation.

Current practices in various areas

As more and more companies avail of the remedy of corporate rehabilitation and insolvency, there has been a realisation that the current legal regime governing insolvency (which is almost 100 years old) is antiquated and requires updating to conform to current international best practices on insolvency. Likewise, the recent rehabilitation case involving Bayan Telecommunications Inc. has prompted legal experts to review the status of secured and unsecured creditors in relation to a rehabilitation proceeding.

As there is no central database for petitions for insolvency and corporate rehabilitation filed before the various RTCs all over the country, it is very difficult to determine the rate of recourse to liquidation or rehabilitation (to total NPAs).

Current risk assessment and management systems and policies

Risk assessment and management systems

Many have opined that one reason for the reluctance of financial institutions to continue extending credit (especially during these times of economic difficulty) is that the secured transactions and insolvency regimes existing in the country are not only amorphous, but even debtor-friendly. The legal and/or administrative process to enforce one's security is described as arduous and protracted. Moreover, recovery of loans, even when fully secured, is always uncertain. There have also been reports that, due to the difficulties being encountered by export credit agencies in the debt-relief petition of Philippine Airlines, export credit agencies are not inclined to extend credit to Philippine companies for fear that recovery of machinery and equipment, the object of the credit, may be difficult once a petition for suspension of payments or other similar proceeding is filed before the courts.

There are disclosure requirements provided under the rules implemented by the SEC pursuant to the Securities Regulation Code. These rules apply to public companies or companies having issued registered securities. Likewise, the Philippine Stock Exchange has its own disclosure requirements for listed firms.

Considering the limited resources of the SEC, the enforcement of the disclosure rules under the Securities Regulation Code has sometimes been described as wanting. The Philippine Stock Exchange is viewed as more vigilant in the enforcement of its disclosure rules.

The majority of the large debt security issuances in the Philippines are conducted by the national government (including government financial institutions and government-owned and controlled corporations). The private domestic market is less developed in terms of product range, profile of issuer and investor base.

In the past few years, both the government and private sectors have attempted to help develop the domestic market by broadening the investor base, granting more licenses for primary dealers, and developing new debt instruments for retail investors.

There has been a recent move to establish a fixed income exchange. The Bankers Association of the Philippines, and the Philippine Stock Exchange have made significant developments in establishing a fixed income exchange for the trade of debt instruments. In addition to the Fixed Income Exchange, there are plans to establish a Qualified Buyers Board similar to the Rule 144A Market in the United States of America.

Because of this development, there is an expected improvement in the quality of debt instruments. The Fixed Income Exchange would serve a similar role (for debt instruments) to that of the Philippine Stock Exchange (for listed shares). With more private sector involvement, it is hoped that the Philippine debt market would improve.

Credit information systems

Currently, there is no centralised computer database for cases filed in the various Regional Trial Courts and other lower courts in the country. The legal framework for information sharing, information dissemination, credit scoring and credit rating is next to nil. It is expensive and time-consuming to conduct a thorough legal due diligence covering all courts in the country.

PhilRatings continues to be the prime credit rating service in the Philippines. Since 1985, it has assigned ratings to hundreds of debt issues with an accumulated face value of PHP[1] 302.9 billion as of the end of December 2003. It has evaluated commercial papers and bonds in the following sectors: manufacturing (*i.e.* cement, food and beverage, chemicals, personal care products, tile, steel, copper wires, aluminium products, appliance, tyre, oil products, packaging, paper), construction and property development, port services, broadcast, telecommunications, electric utilities, gaming and leisure, and financial institutions (*i.e.* leasing and finance, credit card, and investment houses). PhilRatings is Standard & Poor's affiliate in the Philippines. Aside from rating commercial paper issuers, PhilRatings also offers ratings for banks and financial institutions, local government units, project finance transactions, and asset-backed securities. Other services include: credit training, financial or credit indicators based on publicly available information, business valuation, and due diligence studies.

Conclusions and recommendations

In sum, there have been significant developments in the Philippine insolvency regime, including the passage of the SPV Law, Securitisation Law, General Banking Law and the Securities Regulation Code. However, more significant bills are still pending in Congress, such as the Corporate Recovery and Insolvency Act. The Corporate Recovery and Insolvency Act, if properly drafted, will be a significant step towards the development of the insolvency regime of the Philippines in accordance with international best practices.

Likewise, there is a need to improve the credit rating system, specifically the information dissemination system of the Philippines. Without proper information dissemination and sharing systems, the Philippine debt market will not improve. It is to be hoped that with the establishment of the Fixed Income Exchange, the Philippine debt market will progress.

Finally, there is a need to further educate both Philippine commercial court judges and practitioners on international insolvency and rehabilitation best practices. A consistent legislative policy on insolvency and the training of judges and practitioners are both required to improve and update the Philippine insolvency regime.

[1] Philippine pesos (PHP).

TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS: THE SINGAPORE EXPERIENCE

by
Sean Tan, Eddee Ng and Kevin Lim*

Existing framework, practices and developments

Overview

Singapore has an extensive and generally effective arsenal of insolvency regimes to deal with corporate and personal insolvencies. There has been commendable development in its insolvency jurisprudence in recent years, resulting in the main from the large number of corporate insolvencies brought about by the fallout of the Asian economic crisis of the late 1990s. Singapore's insolvency legislation has different regimes modelled on the insolvency provisions of different jurisdictions. Legislative reforms in personal and corporate insolvencies have taken place at different paces. The incompatibilities and inconsistencies of some of these regimes have posed difficulties for insolvency practitioners, particularly when implementing strategies for insolvent companies or when the courts are asked to determine insolvency issues. All this is set to change when Singapore's insolvency landscape experiences a major reform, expected to take place towards the end of 2005, with the enactment of the long-awaited Omnibus Insolvency Act.

The first part of this paper discusses some of the problems experienced with the current legislation and what the new act will address. The second part of the paper will discuss issues relating to Singapore's insolvency laws in multi-jurisdictional or cross-border matters. This paper is not meant to set out an exhaustive discussion of all recent insolvency cases.

Insolvency regimes in Singapore

Presently, there is separate insolvency legislation for individuals (the Bankruptcy Act[1]) and companies (the Companies Act[2]). As will be discussed later, some aspects of the insolvency legislation for companies is borrowed or imported from the bankruptcy provisions.

The main insolvency regimes are:

- *Liquidation (for companies) and bankruptcy (for individuals):* These apply when there is no prospect of resuscitation or rehabilitation. Typically, there is realisation of whatever assets are remaining, determination of the debts claimed, and distribution of dividends to creditors. The legal existence of companies is thereafter terminated. As for individuals, they remain bankrupt until they are discharged.
- *Scheme of arrangement (companies) and voluntary arrangement (individuals):* Both these work by allowing the rescue of the company or the individual by the approval of a scheme (by a majority of creditors holdings 75% of the total debts) after sanction by the court. Schemes of arrangement require the creditors to be split into different classes and each class

votes separately. Moratoriums against commencement and continuation of court proceedings are available upon application to provide relief so that the debtors can formulate, propose and, if approved, implement the schemes.

- *Judicial management:* This is a mechanism similar to administration orders under the UK Insolvency Act of 1986. Creditors or the company itself can file the petition for judicial management. The company must first be insolvent, and the order for judicial management will only be granted if the court is satisfied that one or more of the following objectives can be achieved: (i) rehabilitation of its business; (ii) a more advantageous realisation of its assets than in liquidation; and (iii) to implement a scheme of arrangement. A statutory moratorium against court actions is granted upon the filing of the petition. The judicial manager has to present a statement of proposal to the creditors for approval and, if approved, the judicial manager will proceed to implement the same. In the event there is no approval, or if the judicial manager reaches the conclusion that the objectives of judicial management cannot be achieved, the judicial manager will apply for the judicial management order to be discharged and usually apply for the company to be liquidated.
- *Receivership:* This is where the company grants a fixed and/or floating charge over its assets/undertakings to a creditor under a debenture. The debenture usually provides for the creditor to appoint a receiver *simpliciter* or a receiver and manager to administer and realise the assets of the company for the main purpose of settling the debts secured by the charge. It is noteworthy that under Singapore law receiverships are accorded priority over liquidation and judicial management.

Need for reform: mismatch of the existing legislation

The incongruity of the existing legislation pertaining to the various insolvency regimes is explained below. Singapore's insolvency legislation has various origins. This has contributed to difficulties in employing a consistent approach in practice and when the courts are asked to determine various questions.

Liquidation

Part X of the Companies Act, which sets out Singapore's liquidation provisions, is based on the repealed UK Companies Act of 1948. The provisions of the UK Insolvency Act of 1986 have not been imported. Yet, the provisions in the UK Insolvency Act of 1986 relating to bankruptcy were referred to and adopted when Singapore's Bankruptcy Act was enacted in 1995. Despite the different genesis of the Bankruptcy Act and the liquidation provisions in the Companies Act, the Companies Act provides for the import of bankruptcy provisions for liquidations.[3] There is an obvious mismatch, and this has resulted in difficulties in application and interpretation.

Judicial management

Judicial management was introduced in Singapore in 1987 after the crisis involving the Pan-Electric group of companies where thousands lost their jobs and the Singapore Stock Exchange for a few days.[4] The judicial management regime was modelled on the administration regime in the United Kingdom, but it should be noted that what was referred to was the UK bill on administration, and not the UK act itself. As a result, Singapore's judicial management provisions[5] differ in some respects from the respective UK legislation. Further, Singapore's judicial management provisions resort to the import of certain provisions relating to bankruptcy[6], liquidation[7] and schemes of arrangement[8].

Receivership

The Singapore provisions on receivership are outdated and were modelled on the provisions of the Australian Companies Act of 1961, which have been repealed. The rest of Singapore's Companies Act is modelled on the UK provisions and the receivership provisions are, as such, somewhat incongruous.

Legislative reform

In December 1999, the Singapore government appointed professionals in the private sector to the Company Legislation and Regulatory Framework Committee (CLRFC). The goal of this body was to review and put forward recommendations in respect of the legal and regulatory framework for companies in Singapore. The CLRFC's final report[9] was published in October 2002, and put forward a total of 77 recommendations of which all 77 have been given government approval[10]. In that regard, an entire chapter of the report was devoted to the issue of corporate insolvency[11] and the CLRFC made three recommendations therein. The Singapore government is expected to put these recommendations into effect in the near future.

The three recommendations of the CLRFC in respect of corporate insolvency were:

- The introduction of an Omnibus Insolvency Act and associated subsidiary legislation that would be applicable to both companies and individuals modelled on the UK Insolvency Act of 1986;[12]
- The introduction of company voluntary arrangements, again modelled on the UK Insolvency Act 1986;[13] and
- The establishment of a common qualification for all insolvency practitioners (*e.g.* receivers, administrative receivers, liquidators and judicial managers) with the expansion of the range of persons qualified to practice as insolvency practitioners to include finance and other professionals. It was further recommended that an Insolvency Practitioners Association be established for the accreditation and continuing education of practitioners, and the setting of professional standards.[14]

The Omnibus Insolvency Act

As mentioned, the Singapore government intends to consolidate bankruptcy and insolvency legislation and practice under a single piece of legislation. While the Omnibus Insolvency Act has yet to be passed, the CLRFC's comments in their report are insightful as to the potential direction of this consolidation:

- The resolution of outstanding areas of uncertainty and areas where insolvency and bankruptcy practices diverge;[15]
- The CLRFC has particularly noted the UK Department of Trade & Industry's review of the UK insolvency regime. In the same, it was recommended that the insolvency regime be geared towards encouraging an enterprise culture designed to encourage entrepreneurs who have failed honestly to try again.[16] These views have been echoed by the government;[17]and
- A review of the success of judicial management regimes and moratoriums for schemes of arrangements as rescue procedures for struggling companies. The CLRFC has also suggested revisiting the merits of introducing management-in-control US Chapter 11 style bankruptcies to Singapore's insolvency regime.[18] In our view, any introduction of such a regime should take into account a common complaint in the US that Chapter 11 bankruptcies

create harmful market and competition distortions because the debt moratorium so afforded allows these companies, under the same management, to compete against their healthier (and presumably better-run) competitors on an uneven playing field. The better course for introducing Chapter 11 bankruptcies in Singapore may be to require a higher standard of proof of a company's chances of recovery compared to that applicable in the US.

Company voluntary arrangements (CVAs)

In its report, the CLRFC had noted that initiating a scheme of arrangement under the act was complex, time consuming and expensive,[19] requiring at least two applications to court and a potentially contentious meeting with creditors. By contrast, the CVAs recommended by the CLRFC are modelled on similar mechanisms in the UK Insolvency Act of 1986 which eschews the need for applications to the court, and merely requires the assent of a simple majority of shareholders and a 75% majority in value of the creditors in order to become binding. To further ease difficulties in getting a CVA approved, the CVA will come with a statutory moratorium on legal proceedings of 28 days, extendable to 60 days with the court's approval.

Receiverships

The CLRFC has recommended the introduction of administrative receivership in Singapore.[20] This is modelled after the provisions in the UK Insolvency Act of 1986 although, in the United Kingdom, administrative receiverships are not commonly employed (administration orders are gaining prominence). It remains to be seen in what form receiverships will be given statutory effect in the new Omnibus Insolvency Act.

Institutional developments arising from the CLRFC report

As mentioned above, the CLRFC has recommended the establishment of a common qualification for all insolvency practitioners with the expansion of the range of persons qualified to practice as insolvency practitioners, and the establishment of an Insolvency Practitioners Association.

The first step taken in this respect is the proposed amendment to Section 9 of the Companies Act, as set out in the Companies (Amendment) Bill of 2004[21] (the Bill) to expand the scope of persons who can be appointed as a company liquidator. In its unamended form, section 9(3) dictates that only an approved company auditor may be appointed by the Minister of Finance as a company liquidator. The anticipated amendment will enable the Minister of Finance, *inter alia*, to declare any specified class of persons as approved liquidators. This is only a partial implementation of the CLRFC's recommendation since the restriction to approved company auditors will still apply to other types of insolvency practitioners such as judicial managers.[22]

It is not yet certain to what extent the government will expand the scope of professionals who can qualify as insolvency practitioners or what shape the "common qualification" for insolvency practitioners might take. However, in the second reading of the Bill, the Minister for Trade & Industry stated that in both respects the government intends to look at practices in other countries for guidance, and in particular singled out the practice under the UK Insolvency Practitioners Regulations.[23]

With regards to the CLRFC recommendation to set up an Insolvency Practitioners Association, the CLRFC envisioned that such an association would be responsible for the setting of professional standards, the continuing education of insolvency practitioners and the accreditation of insolvency practitioners. The government has not taken any concrete steps to start such an association, but the Minister for Trade & Industry, in the same speech, did specifically eschew establishing or regulating

the association by legislative means (as was done with the Singapore Law Society). Instead, the government has in mind a "professional association".

Issues pertaining to multi-jurisdictional or cross-border insolvencies

This part of the paper highlights some issues recognised by the insolvency practitioners in Singapore. It remains to be seen if any of these issues will be addressed in the forthcoming Omnibus Insolvency Act.

Liquidation

Any foreign corporate body, association or partnership may be wound up in Singapore, so long as there are substantial assets within the jurisdiction, there is a sufficient connection with Singapore, or there is a reasonable possibility of benefit accruing to the creditors.[24] However, in Tohru Motorbayashi versus Official Receiver[25] the Singapore Court of Appeal held that where a foreign registered company was liquidated in Singapore, its Singapore assets are "ring-fenced" for payment to the creditors in Singapore in priority to the other creditors. This is contrary to what has been viewed as an acceptable standard of a cross-border insolvency regime. This is in fact a set-back in terms of getting courts in foreign jurisdictions to assist in insolvency proceedings commenced in Singapore. It should be noted that the CLRFC has not recommended the enactment of the UNCITRAL Model Law on Cross-Border Insolvency in Singapore, and has proposed that Singapore should wait to see how this Model Law affects other countries.[26] Whether this view taken by the CLRFC means that this approach towards locally sited assets in cross-border insolvencies is to be given statutory recognition remains to be seen.

Judicial management

As stated earlier, judicial management was introduced into Singapore in 1987. While the regime has been welcomed for adding to the breadth of insolvency measures available, the current regime is not without its shortcomings. The report card for judicial managements has not been impressive, with few successful business rehabilitations. In recent times, a number of judicial managements have been short-lived, with the judicial managers applying for a discharge and for the companies to be liquidated.[27] Indeed, it appears that judicial managements are being applied for in order for the insolvent companies to avail themselves of the statutory moratorium once the petition is filed, without having a real or serious plan to achieve any of the statutory objectives of judicial management. While in theory companies under judicial management avoid the stigma of carrying the liquidation label, in reality, creditors in Singapore have come to realise that it is but a precursor to liquidation.

Judicial management does not apply to foreign companies, whether or not they have substantial assets or business operations in Singapore. The UK Enterprise Act of 2002 allows for the Secretary of State to order that a provision of the UK Insolvency Act of 1986 be applicable to a foreign company.[28] If the equivalent is adopted in Singapore's Omnibus Insolvency Act, that would resolve this problem.

The case of Deutsche Bank AG versus Asia Pulp & Paper Co Ltd.[29] has highlighted the difficulties faced where the insolvent company has cross-border operations and overseas subsidiaries. The Asia Pulp & Paper group had chalked up debts in excess of USD[30] 14 billion. A judicial management petition was presented by two of its creditors, but was dismissed by the Singapore Court of Appeal. The Court of Appeal was of the view that any prospective judicial manager was likely to have difficulty securing the co-operation of the company's foreign subsidiaries to keep the company afloat. Furthermore, it was noted that there would be great difficulty in taking control of the company's assets, the majority of which were located abroad.

Other legislative responses to recent insolvencies

The construction industry in Singapore is plagued by payment and cash flow difficulties. The many different layers of entities in a construction project (the employers, main contractors, sub-contractors, suppliers, and consultants) result in payment inefficiencies where payments only trickle downstream after those upstream have received payment themselves. Current industry practice continues to strictly adhere to privity of contract between employers and main contractors on the one hand and main contactors and sub-contractors on the other hand. The standard terms of these contracts usually provide that main contractors are not liable to pay their sub-contractors until they themselves are paid by their employers (pay when paid clauses) whilst also providing that employers are not liable to pay their main contractors until they are satisfied that the building project is free of defects. While this is hardly objectionable *per se*, an unfortunate consequence of this is that so long as any defects subsist, a sub-contractor will not receive full payment for works done even if the defects do not relate to him. In effect, defective work by the main contractor or any of the sub-contractors can halt payment at large.

The Asian financial crisis exacerbated the problem as it brought about further leveraging of companies in the construction industry. In the preceding construction boom, banks and other financial institutions were relatively lax in lending and were not averse to accepting security in the form of fixed and floating charges over construction equipment and materials or personal guarantees from the directors of the construction companies. It became clear that this security was of scant value because (i) the realisable value of the collateralised construction machinery often falls short of its paper value, and (ii) the financial health of the company directors is rarely any better than the companies themselves. As a result, when the crisis hit and projects were put on hold, even the larger construction companies could not survive any strain on their cash flow. The industry went in a downward spiral with companies under-bidding for projects in the hope of being awarded the project so that there could be temporary relief in terms of cash flow. Many companies were aware that under-bidding was done at great risk but, with other companies already doing it, these companies were compelled to follow suit. Having no projects in hand was seen as being a worse problem. All hoped that this would be a stopgap measure to ride out the financial crisis. Unfortunately, the crisis continued and one by one construction companies tumbled. It offered the companies no relief when the standard construction contracts also made insolvency and/or even the initiation of insolvency proceedings acts of contractual default. The end result was that the insolvency of each company had a domino effect on other companies it works with, dragging them into insolvency as well. This is the reason why the biggest contributors to recent insolvency jurisprudence in Singapore have been companies in the construction industry.[31]

To address these payment issues in the building and construction industry, the Singapore government has introduced the Building and Construction Industry Security of Payment Bill.[32] The object of this bill is to improve cash-flow by expediting payment in the industry.

Conclusion

Singapore does not presently have a comprehensive piece of insolvency legislation for personal and corporate insolvencies. It has imported and borrowed parts of its insolvency laws from a variety of jurisdictions and their respective legislation. While this has not been ideal, much credit must be accorded to the Singapore judiciary for approaching each insolvency matter in a practical and business-oriented manner. The judiciary has not been dogmatic about technical readings of the insolvency provisions, preferring to seek out ways to assist in seeing out the wishes of the individuals and companies, or their respective creditors (whose views invariably prevail in insolvency situations). As a result, despite the mixed heritage of our insolvency laws, Singapore has a wealth of well-

considered and reasoned decisions in insolvency cases. The writers of this paper are confident that with this in hand, the drafters of the new Omnibus Insolvency Act will be well-equipped to satisfactorily address the difficulties and problems experienced with the current legislation.

Notes

1 Chapter 20, 1996 Edition.

2 Chapter 50, 1994 Edition.

3 Section 327(2) and Section 329 of the Companies Act, and the Companies (Application of Bankruptcy Act Provisions) Regulations.

4 See report on: http://www.ntu.edu.sg/nbs/publications/regional_issues_in_exonomics/06-kts97.pdf.

5 Part VIIIA of the Companies Act.

6 Section 227T of the Companies Act.

7 Section 227X(b) of the Companies Act.

8 Section 227X(a) of the Companies Act.

9 A copy of the report can be found at the following URL: http//www.mof.gov.sg/cor/clrfc_reports.html.

10 Then-Deputy Prime Minister Lee Hsien Loong announced the government's unqualified approval in a speech dated 22 October 2002. A copy of the full text of the speech can be found at the following URL: http://app.mof.gov.sg/pressrelease/speechdetails.asp?speechID=74.

11 Chapter 4 of the report.

12 Recommendation 4.1 of the report (It remains to be seen if the new Omnibus Insolvency Act will incorporate provisions from other Commonwealth countries – *e.g.* as regards dispositions of a company's assets after liquidation commences, the CLRFC has recommended that the Australian approach of exempting certain transactions should be preferred over the UK approach that all dispositions are void unless otherwise ordered by the court – paragraph 2.3(h) of the report).

13 Recommendation 4.2 of the report.

14 Recommendation 4.2 of the report.

15 Set out in greater detail in paragraph 2.5 of the report.

16 White Paper (2001), "Productivity and Enterprise – Insolvency: A Second Chance", CM 5234, July 2001.

17 See paragraphs 25 to 27 of the speech at footnote above; see also Column 60 of the Annual Budget Statement of Deputy Prime Minister Lee Hsien Loong before Parliament on 28 February 2003;

18 Paragraph 2.9 of Chapter 4 of the report.

19 Paragraph 3.1 of Chapter 4 of the report.

20 Recommendation 4.3 of the report.

21 Bill 3 of 2004.

22 The bill also proposes amending Section 10 of the Companies Act such that any person who satisfies the registration requirements to be a public accountant under the Accountants Act will automatically be an "approved company auditor" for the purposes of the Company Act.

23 See parliamentary speech of Mr. Lim Hng Kiang, 10th Parliament, 1st Session, Vol 77, Sitting date 6 February 2004, at column 375.

24 Re Griffin Securities Corporation [1999] 3 SLR 346.

25 [2000] 4 SLR 529.

26 Chapter 4 of the report, paragraph 1.3.

27 Re Econ Corp Ltd [2004] 1 SLR 273; Re Wan Soon Engineering Pte Ltd., Originating Petition No. 6 of 2004; Re Chip Huat Construction Pte Ltd., Originating Petition No. 16 of 2003.

28 Section 254 of the Enterprise Act 2002.

29 [2003] 2 SLR 320.

30 United States dollars (USD).

31 Re Chip Huat Construction Co. Pte. Ltd., *ibid*; Econ Corp Ltd., *ibid*; Neo Corporation Pte. Ltd., Originating Petition No. 2 of 2004/F; Wan Soon Engineering Pte. Ltd., *ibid*; Wan Soon Construction Pte. Ltd., Originating Petition No. 8 of 2004.

32 Bill No. 54 of 2004, read for the first time on 19 October 2004

CURRENT RISK ASSESSMENT AND MANAGEMENT SYSTEMS AND POLICIES IN SINGAPORE

by
Eng Hai Aw

Introduction

The volatility of global financial markets has increased over the last few years. At the same time, financial markets have also become more closely integrated. This has increased the correlation and the transmission of volatility from one financial market to the next. A good example of this is the rapidity with which the Asian crisis spread across East Asia in 1997 and 1998. The frequency of shocks to the financial markets has also increased. This has resulted in a paradigm shift over the last decade in regulation and supervision. Regulators have moved away from the traditional rule-based approach towards risk-based supervision.

As the regulator in Singapore, the Monetary Authority of Singapore (MAS) has also found the traditional rule-based approach to be unnecessarily restrictive and ineffective, and has moved towards risk-based supervision. However, risk-based supervision relies heavily on the quality of an institution's own risk management approach. To help financial institutions adopt sound risk management practices, MAS issued guidelines that are updated regularly taking into consideration industry feedback and ongoing developments in risk management. MAS also benchmarks risk management and control systems adopted by financial institutions against evolving industry standards and best practices around the world.

Risk management practices and policies

The guidelines issued by MAS[1] on risk management practices are based on best practices and are not meant to be prescriptive. For effective risk management, the guidelines emphasise four key pillars, namely:

- Adequate board oversight;
- Senior management accountability;
- Sound risk management policies and operating procedures; and
- Strong risk measurement, monitoring and control capabilities commensurate with the risk taken.

The guidelines are organised by risk type, namely credit risk, market risk and liquidity risk. However, it is common for causal relationships to exist between risk types, as well as different risk types manifesting themselves concurrently in a given situation. Financial institutions are therefore encouraged to adopt a holistic approach towards risk assessment and management.

Credit risk

Credit risk is defined as the risk of loss that arises when an obligor fails to perform its obligations under a contract or when its ability to perform such obligations is impaired. Credit risk could stem from activities both on and off the balance sheet and, for banks, in both the banking and trading books. Financial institutions are encouraged to establish a risk management framework to adequately identify, measure, monitor and control credit risk.

In relation to the management of credit risk, financial institutions are encouraged to adopt, amongst many others, the following guidelines:

- Set the level of credit risk that the institution is prepared to bear;
- Empower a committee to oversee credit risk-taking activities and the overall credit risk management framework;
- Establish credit policies laying down parameters and guidelines for the granting, maintenance/monitoring and management of credit, at both the individual transaction and portfolio level;
- Delegate lending authority, based on experience, ability and personal character, to senior management and a credit committee;
- Grant credit based on understanding of the obligor, the source of repayment, as well as the purpose and structure of the credit, to ensure that the obligor meets the criteria rather than relying on the collateral or guarantee;
- Specify and monitor key indicators of credit condition to identify and report potential problem credits;
- Perform credit reviews on an annual basis with updated information on the obligor's financial and business conditions, as well as the conduct of account;
- Make adequate provision for classification and provision of loans in line with regulatory guidelines and internal policies; and
- Perform adequate stress testing to determine potential credit risk due to adverse market conditions.

Market risk

Market risk is defined as the potential loss in on and off-balance sheet positions, in an institution's books, resulting from movements in market risk factors such as interest rates, equity prices, foreign exchange rates and commodity prices. Sound management of market risk is essential to ensure that the market risk faced by institutions does not reach levels detrimental to their financial condition.

The following guidelines, amongst many others, were suggested for financial institutions to consider adopting:

- Set the level of market risk that the institution is prepared to bear;

- Formulate market risk policies that, where practicable, delineate the line of authority and the responsibilities for managing market risk;

- Identify pertinent market risk management issues;

- Establish a sound and comprehensive risk management system for their business activities;

- Adopt a risk management system that is able to quantify risk exposures and facilitate stress testing;

- Establish market risk measurement systems and models that are able to measure interest rate risk, equities risk, foreign exchange risk and commodities risk; and

- Establish risk limits for business units and conduct periodic reviews of the risk limit.

Liquidity risk

Liquidity risk is the risk of financial loss to an institution arising from its inability to fund increases in assets and/or meet obligations as they fall due without incurring unacceptable cost or losses. A liquidity crisis can have a negative impact on earnings and capital, and in a worst-case scenario, cause the collapse of an otherwise solvent institution.

Among the guidelines recommended for adoption by financial institutions are the following:

- Define a liquidity strategy that enunciates specific policies on particular aspects of liquidity risk management such as the composition of assets and liabilities, the diversification and stability of liabilities, access to interbank and other wholesale markets, the management of liquidity in different currencies and the management of intra-group liquidity;

- Establish liquidity policies that include liquidity strategy, management responsibilities, liquidity risk management structure, liquidity risk management tools, liquidity risk management in individual currencies and contingency plans to handle liquidity crises;

- Establish a risk measurement system to ensure that liquidity measurement is identified and managed on an ongoing basis, and a monitoring system that enables management to monitor compliance with approved risk tolerances and to pinpoint variances;

- Maintain diversified and stable funding sources; and

- Construct plausible event-driven scenarios and examine the resultant cash flow needs.

Non-performing loans (NPLs)

Classifications of NPLs

In line with international practice, banks in Singapore will automatically classify loans as NPLs once the principal or interest payments are three months or more in arrears under MAS guidelines. In addition, banks are continuing to treat all loans to borrowers with weak financials as NPLs, regardless of whether they are in arrears.

NPLs are further classified as *substandard*, *doubtful* and *loss*. The definitions are as follows:

a) *Substandard* loans are classified substandard when their normal repayments are overdue or may be in jeopardy. Also included in this category are performing loans, which are graded substandard solely because of the borrowers' weak financials. For substandard loans, provision has to be made for 10% of the unsecured portion of the substandard loan.

b) *Doubtful* loans are classified doubtful when full liquidation of outstanding debts appears questionable and the accounts suggest that there will be a loss, the exact amount of which cannot be determined as yet. For doubtful loans, a 50% provision is required.

c) *Loss* loans are classified as loss when outstanding debts are regarded as uncollectible. A full (100%) provision has to be made for loss loans.

Table 1. NPLs of Singapore Incorporated Banks

	NPL Ratios	
	Regional Countries NPLs[1]	Global NPLs
	As percentage of	
Year ending	Gross Regional Countries Exposure	Global Assets
December 1998	22.7	6.9
December 1999	21.7	7.2
December 2000	14.1	5.1
December 2001	11.8	4.5
December 2002	11.3	4.2
December 2003	8.2	3.6

Source: MAS
Notes: (1) Regional countries are Malaysia, Indonesia, Thailand, Korea and Philippines

During the above period, despite the criteria for classification of NPLs becoming more stringent, there has been a decline in the NPLs ratios of Singapore incorporated banks. The decline in the NPL ratio for the regional countries is reflective of the improving economies in the region as well as the successful resolution of NPLs in the regional countries. Another contributing factor to the decline in NPL ratios is the ability of the banks to better manage their risks.

Sources of major credit problems

There will always be a certain level of NPLs as a result of an inevitable number of incorrect economic decisions by individuals and plain bad luck. Less predictable incidents, such as when oil prices, key raw materials prices, foreign exchanges rates, or interest rates change abruptly, may cause NPLs to rise considerably. A similar effect may be caused by the sudden failure of a major company in an overly optimistic financial market. Within an industry, failure of major players may also lead to an increase in NPLs within that particular industry as the financial problem is passed down the supply chain.

Shocks to the financial markets, such as those experienced during the Asian crisis, may result in loss of confidence in consumers and companies. If the loss of confidence begins to snowball towards a crisis, it may lead to job losses, a fall in the prices of loan collaterals (often real estate and possibly equities) and a liquidity crunch faced by financial institutions resulting in a reduced ability of banks to provide loans. In the last couple of years, the unemployment rate increased in Singapore as the economy underwent restructuring resulting in job losses not only for the blue-collar workers but also

executives. Partly as a result of the increased unemployment rate, credit card debt grew and the number of defaults and bankruptcies went up.

Credit information system

There are various publicly available sources where one can gather basic financial and litigation information to determine the credit-worthiness of a consumer or corporate customer. These include court writ of summons and bankruptcy data, databases on companies and businesses maintained by the Accounting and Corporate Regulatory Authority (ACRA) and property databases maintained by the Land Dealing Office. In addition to these publicly available sources, there are two private credit bureaus where members of the credit bureaus are able to share information on the credit-worthiness of their customers.

Litigation searches

Litigation searches on a potential customer can be conducted through the databases maintained by the courts in Singapore. These searches will reveal the legal suits that the potential customer is involved in, either as a plaintiff or defendant, and the stages that the legal proceedings are at. The databases are updated regularly, searches can be done online, and the results can be generated instantaneously. The results will contain information about the sums involved in each legal suit and brief details on the nature of the claim.

Bankruptcy searches

Searches can be conducted on an individual to identify whether he/she is facing bankruptcy proceedings. Results will contain details of the amount owing to the petitioning creditor(s). Bankruptcy searches on a company will reveal whether the company has any winding-up petition being filed against it.

ACRA databases

Extracts of the annual returns filed by companies and businesses can be obtained from ACRA. The amount of financial information that a company has to disclose in its annual return is dependent on the type of company it is classified as. A private exempt company is only required to file a summary of its financial highlights. These financial highlights do not usually provide sufficient information for one to assess the credit-worthiness of a company. Private companies are required to file their audited accounts with ACRA as part of their annual returns. These contain much more financial detail about the company. One weakness of these databases is that they only contain historical information that may not be an accurate predictor of the future performance and credit-worthiness of the company.

In assessing the credit-worthiness of an individual or company, it is rare to rely on the results of a single search with any of the above databases. More commonly, companies or financial institutions will rely on the cumulative information from the searches done on the different databases

Consumer credit bureau

Traditionally, due to provisions in the Banking Act, banks were unable to share information about their customers. In 2002, in line with the MAS direction towards enhancing risk management capability, the Association of Banks in Singapore set up the first consumer credit bureau in Singapore. Only banks, finance companies and credit card companies recognised by the MAS are authorised to be

members of the bureau. Access to the bureau's information is governed by a code of conduct, which lays down strict privacy principles by which members must abide. The code of conduct is aligned with the Banking Act restrictions on the release of consumer information.

The credit report issued by the bureau is based on inputs from members and information obtained from publicly available sources. The credit report will include the following information:

- Basic personal profile data (excluding contact addresses and telephone numbers);
- Records of all credit checks made on the consumer;
- Credit repayment trend of the past 12 months;
- Default records;
- Bankruptcy records; and
- Litigation records.

Individuals are able to obtain a copy of his/her credit report and notify the credit bureau of any discrepancies. Where there are discrepancies, investigations are carried out by the bureau and changes made to the credit report, if required. In the event of disagreement between the bureau and the consumer on the outcome of the investigation, the consumer can raise his/her dispute with the Consumer Mediation Unit, which is an independent unit established under the Association of Banks in Singapore to resolve disputes between consumers and banks.

DP Credit Bureau

DP Credit Bureau was set up by DP Information Network Pte. Ltd. (DP Info) in May 2002 as a formal information-sharing platform to improve credit transparency in Singapore. It currently has about 200 corporate members. These members input data on their debtors (both consumer and corporate) into a common database. The data are analysed and payment patterns of the debtors are generated. Based on the payment patterns, a potential lender is able to assess whether a company or individual has been or would be a good or bad paymaster.

Members are able to access the database through the Internet and have access to all the credit bureau records in the system. They are able to have a complete analysis of the debtors, minimise credit risk and reduce the bad debt rate.

Credit rating agencies

International ratings agencies such as Standard & Poor's and Moody's issue credit ratings on publicly listed companies in Singapore. Such ratings provide an indication of the creditworthiness of companies. For small and medium enterprises (SMEs), credit extenders can obtain credit ratings from DP Info whose credit rating provides an indication of the likelihood of a credit default.

Credit risk transfer

Global and regional financial derivatives markets have seen phenomenal growth in recent years. Prospects for derivatives in the Asian region have brightened as a result of governmental efforts to promote and develop the region's capital markets. There is also increased awareness by corporations

and financial institutions of the need for better risk management. However, the rapid growth of the industry is also likely to pose major challenges to policy makers and regulators as they grapple with its implications for the maintenance of macroeconomic and financial stability.

In 2000, MAS issued guidelines on the regulatory treatment of banks credit derivatives[2] and securitisation activities[3]. The guidelines are in recognition of the need to ensure that Singapore's regulatory framework provide clarity and allow growth and innovation, as the market makes use of more sophisticated treasury and capital market products.

The guidelines for credit derivatives address the capital treatment for three main credit derivatives products that are actively being used as instruments for credit risk mitigation: the credit default swap; the total rate of return swap; and the credit-linked note. The guidelines retain the principle of maintaining capital against credit risk exposure, requiring a credit charge for credit exposures that banks assume via the use of credit derivatives.

Existing credit risk instruments

In a credit default swap (CDS) transaction, the protection seller agrees to pay the protection buyer if a reference entity (a company or sovereign) experiences a predefined "credit event", such as a default on a debt obligation. The protection seller receives a premium (typically paid quarterly) from the protection buyer over the lifetime of the transaction. In substance, a CDS functions like a guarantee. The protection seller assumes credit risk on the reference entity without funding the position. The protection buyer obtains credit protection on the reference entity, but acquires credit exposure to the protection seller since it depends on the protection seller to make the credit event payment.

A total rate of return swap (TROR) transfers the "total return" or the total economic performance of the reference entity from the protection buyer to the protection seller. The protection buyer pays all cash flows arising from the reference entity plus any increase in market value of the reference entity to the protection seller. In return, the protection seller pays the protection buyer a contracted rate of LIBOR plus a premium and any decrease in the market value of the reference entity. Upon the occurrence of the credit event, the contract will usually terminate and the credit event payment will be calculated as though the next normal payment date had been brought forward. In substance, a TROR is like an unfunded purchase of the reference entity, *i.e.* the protection seller acquires the full economic performance on the reference entity without funding the position. The payment of LIBOR + premium represents the fee paid to the protection buyer to fund the position. The protection seller acquires from the protection buyer the credit risk and market risk on the reference entity. The protection buyer and seller are also exposed to each other for the payments due under the swap.

A credit-linked note (CLN) is a debt instrument with an embedded CDS. In a standard contract, the protection buyer, or a special purpose vehicle (SPV) set up by the protection buyer, issues a note referenced to the reference entity. The protection seller pays cash up front for the note in exchange for a stream of fixed or floating interest payments on the note. If a credit event occurs, the note is redeemed for the credit event payment as agreed by the parties. If no credit event occurs, the note is redeemed at maturity. Unlike a CDS or TROR, a CLN is a funded credit derivative instrument since the protection buyer receives protection (the principal on the CLN) on the reference entity up front from the protection seller. The protection buyer transfers the credit risk on the reference entity to the protection seller but does not acquire an exposure to the latter. On the other hand, the protection seller acquires credit risk on the reference entity, and is also exposed to the protection buyer (or note issuer) for the amount of funding provided.

Asset securitisation in its basic form is the process by which assets or interests in assets are sold, or otherwise transferred to a special purpose vehicle, which is funded by the issue of securities secured primarily by these assets. Banks may undertake one or several roles in a securitisation transaction. The extent of a bank's participation may be limited to the provision of a particular service, or it may participate as seller in securitisation transactions managed by independent parties. Alternatively, a bank may establish and manage its own securitisation transactions.

The guidelines for asset securitisation by banks set out the capital treatment of securitised assets, as well as the disclosure, separation and other requirements applicable to banks assuming various roles in a securitisation transaction. The guidelines seek to ensure that banks involved in the securitisation transactions fully understand their roles, responsibilities and risks, and that they hold appropriate capital against the risks they accept.

Credit risk transfer driver

After the MAS published guidelines on the securitisation of real estate assets in January 1999, allowing banks to off-balance their properties through securitisation, DBS launched a landmark Commercial Mortgaged Backed Securities (CMBS). Subsequently, other CMBSs have followed suit. More CMBSs are expected to be launched in the near future as, under the latest MAS regulations, banks are not allowed to hold major stakes in non-financial businesses and all such stakes have to be divested by 17 July 2006.

Data on the growth of other types of credit risks instruments are not readily available. However, in their annual report in June 2003, the Bank of International Settlements (BIS) drew attention to the huge growth of credit risk transfers globally, shifting risk from banks to the buyers of securities and loans. From a few billion dollars worth of loans passed on through credit risk transfers in the early 1990s, the figure has grown to an estimated USD[4] 2 trillion by 2002. While credit risk transfer in Asia is still in its infancy, it is likely that financial institutions in Singapore have been hedging their credit exposures by selling the risk to others.

Due to the huge growth experienced by credit risk transfers, from March 2004, financial institutions are required to provide information on the gross and marked to market values of all derivatives used by banks, including credit derivatives, to MAS on a monthly basis.

MAS has also completed the second phase of the study to establish the Deposit Insurance (DI) scheme in Singapore and released a second consultation paper on the scheme in April 2004. The paper makes recommendations on the implementation details for the administration of DI including the mandate and governance of DI, coverage of specific deposits and depositors, the depositor payout process and management of the DI fund.

The government recently announced plans to launch a pilot SGD[5] 300 million Loan Securitisation Scheme for small and medium-sized enterprises to tap the capital markets in January next year. The loan securitisation scheme provides alternative financing for SMEs which do not qualifying for existing loan schemes. The SME loans will be packaged into tradable bonds that offer competitive yields and sold to institutional investors. SMEs that will benefit are those with little or no track record or collateral as well as those seeking small loan amounts or requiring loans to venture abroad. A well-diversified portfolio of SMEs will collectively reduce the risk level of the portfolio and make it more appealing to investors.

The bulk of derivatives trading and contracts issuance occurs in North America and Europe while Asia has lagged behind in market share. Although exchange traded derivatives in the region have

grown rapidly in recent years, there remains much more room for growth in Asian derivatives markets, which represents a major opportunity for Singapore's financial services industry.

Accounting policies

The main accounting standards that deal with the accounting of financial instruments are Financial Reporting Standards (FRS) 32 and FRS 39. FRS 32 sets out the requirements for the presentation of financial instruments and identifies the information that should be disclosed about them. FRS 39 deals with the recognition and measurement of financial assets, financial liabilities and some contracts to buy or sell non-financial items.

Under FRS 32, there is a requirement to disclose information about factors that affect the amount, timing and certainty of future cash flows relating to financial instruments[6] and the accounting policies applied to those instruments. The standard also requires the disclosure of information about the nature and extent that financial instruments are used, the business purpose they serve, the risks associated with them and the management's policies for controlling those assets.

The purpose of the disclosures required by FRS 32 is to provide information to enhance the understanding of the significance of financial instruments to the financial position, performance and cash flows of the entity, and assist in assessing the amounts, timing and certainty of future cash flows associated with those instruments.

An entity is required under FRS 39 to recognise all its contractual rights and obligations in a financial instrument as assets and liabilities when it becomes a party to the contract. It derecognises the financial asset or liability when its contractual rights have expired or when it has substantially transferred the risks and rewards of ownership. Subsequent to the initial recognition, the entity has to measure the financial assets at their fair values. For financial liabilities, they have to be measured at amortised cost using an effective interest method. Gain or loss arising from the change in the fair value of a financial asset or liability is to be recognised as profit or loss, or equity depending on how the financial asset or liability is classified.

Concluding remarks

MAS has taken an active approach to promoting industry best practices in risk management, and actively engages the risk management community in their efforts to develop and encourage adoption of good risk management standards. Guidelines issued by MAS are regularly updated as the science of risk management evolves.

Steps are continuing to be taken by MAS to build specialist expertise in key areas, including credit, market, liquidity and technology risks, and in risk management areas such as corporate governance. It is also enhancing its risk-based supervision methodologies and capabilities by modifying and updating specific supervisory practices. To maximise the effectiveness of supervision, work is ongoing to further enhance frameworks for risk-focused and integrated supervision of financial institutions.

As the level of competition in the banking sector increases with liberalisation of commercial banking in Singapore, there is a greater need for financial institutions to manage their risks effectively. Financial institutions that manage their risk effectively will find opportunities to improve their profitability notwithstanding the increased competition.

An important aspect of credit risk management is the availability of better information for making decisions on the granting of credit. While much more information is now available to a lender compared to a few years ago, there is scope for greater sharing of information among lenders.

One development announced recently is the proposed establishment of Singapore's first Small and Medium Enterprise-based Credit Bureau (SME Credit Bureau) by the first half of 2005. Membership to the SME Credit Bureau will be open to all businesses with fixed assets of less than SGD 15 million or not more than 300 employees for the service industry. The SME Credit Bureau will rank SMEs within six risk categories, based on factors such as company set-up, finances and payment records. The database will remain updated and provide banks, financial institutions and MNCs with relevant and objective credit information.

DP Info is leading another initiative using credit score technology to help lenders sharpen their evaluation of consumer risk, streamline decision processes and increase profitability. The technology provides a way for lenders to quickly implement highly predictive risk assessment solutions and realise the results of consistent, accurate credit decisions. Consumers will also benefit as the credit score provides an objective assessment of the credit risk of applicants and existing accountholders.

The effectiveness of these new initiatives will depend on the participation rate. A high participation rate will mean that more information will be shared, better analysis can be conducted and sound credit decisions made.

Notes

1 MAS Guidelines on Sound Risk Management Practices, 30 October 2002

2 MAS Notice 627 (last updated on 22 March 2004)

3 MAS Notice 628 (last updated on 20 Aug 2002)

4 United States dollar.

5 Singapore dollars.

6 A financial instrument is defined under FRS 32 as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

THAILAND'S POST CRISIS INSTITUTIONAL CHANGE: CORPORATE RESTRUCTURING AND FINANCIAL INSTITUTION RISK MANAGEMENT

by
Pairoj Vongvipanond*

In the aftermath of the 1997 crisis Thailand has undergone changes in insolvency law, risk management (especially with respect to changes in the Bank of Thailand monetary regime), conduct of monetary policy, internal reorganisation, and risk management of financial institutions. Commercial and central bank regulators gradually learned from the crisis and responded by changing financial practices, consolidating business and introducing a new institutional infrastructure that is already in place and will be enforced in the coming years. Better prospects for growth and stability, and improved risk management at both the macro and micro levels seem certain. Governance, however, is still in need of much real change.

General background and overall development

The macro picture and micro solutions to firm distress

By any measures or criterion, it can be concluded that, as of October 2004, Thailand has recovered with resilience from the twin banking and currency crises of 1997. The fundamental macroeconomic causes of the crises were overinvestment, financed primarily by domestic savings and propelled by low interest rates, and unhedged foreign borrowing. The above-mentioned causes are, in turn, traced to fixed exchange rate policies, capital account liberalisation, imprudent bank lending, unsatisfactory banking supervision and poor corporate governance. Overall, recovery has cost the country dearly. The banking sector loss has been estimated at THB[1] 1 390 billion or 25% of GDP. Thailand's public debt suddenly soared to half of GDP. Worse still, total private sector losses were estimated to exceed GDP at THB 5 337 billion. (See Table 1).

Table 1: Thailand Economic Indicators (In percentage)

Indicator	1995	1996	1997	1998	1999	2000	2001	2002	2003
GDP Growth Rate	9.2	8.9	-1.4	-10.5	4.4	4.8	2.2	5.4	6.7
Current Account (% of GDP)	-7.86	-7.90	-2.00	12.70	10.20	7.60	5.40	5.5	5.6
Growth Rate of Manufacturing Production	9.1	7.8	-0.6	-9.9	12.5	3.3	1.3	8.5	12.3
Capacity Utilisation (1995 = 100)	77.5	72.5	64.9	52.8	52.8	55.8	53.5	59.3	66

Source : Bank of Thailand

[1] Thailand baht (THB).

Amid losses of output and employment, it is noteworthy that Thailand's growth and unemployment record performed much better than that of the US during the Great Depression of the 1930's. Though strong negative growth was observed due to the contractionary effects of the exchange rate collapse, it was not prolonged. Growth was moderate until 2002. Meanwhile external stability was restored. External reserves rose and foreign debt was gradually reduced as the current account generated continuing surpluses.

Macroeconomic balance was gradually attained through natural forces as well as changes to the policy regime, and institutional and organisational changes, especially at the micro level of firms and financial institutions. In the monetary and fiscal sphere, countercyclical fiscal and monetary policies were pursued within a framework of inflation targeting and a flexibly managed exchange rate system. Change and adjustment at the financial institution and firm level was gradual in order to generate a sustained effect on the real economy. During the first two to three years of the crisis, concerted efforts were directed by the authorities at restructuring and consolidating the banking sector through government assisted capital increases.

The solution to the non-performing loan (NPL) problem of commercial banks in this first phase was primarily through a decentralised, market-oriented approach. It was not until 2001 that a new government formed the centralised Thai Asset Management Corp (TAMC). However, its actual role in debt restructuring and economic recovery was marginal since, by then, a substantial amount of the debt owed to financial institutions was already restructured. State-owned and private bank NPLs that were transferred to the TAMC were modest. Compared to Korea, whose NPLs peaked at around 15% in 1999, Thailand's banking system NPLs were 50% of loans, which was not only substantially greater but also meant that their reduction would be gradual. Currently it stands at approximately 12%.

Concerning the progress and outcome of debt restructuring, it should be noted that though genuine corporate restructuring is observed in some large enterprises, it is correct to say that financial restructuring is more significant. This is understandable since the systemic and corporate distress of over half of the medium and large-sized firms originated from unhedged US dollar over-borrowing that left them fully exposed to currency devaluations. There is a positive correlation between firm insolvency and the debt equity ratio together with the proportion of foreign borrowing. As for the organisational mode used in the settlement of debtor-creditor disputes, it is interesting to find that roughly equal proportions (about one third) of debt negotiation and restructuring processes take place through these major channels:

i. *Private bargaining and settlement* with or without litigation through civil court procedures;

ii. *Intermediaries* (similar to the London Approach) like the Bank of Thailand in co-operation with business organisations which managed the CDRAC (Corporate Debt Restructuring Committee). Thailand Asset Management Corp may also fall into this category; and

iii. *Formal bankruptcy and corporate reorganisation* procedures handled by the Central Bankruptcy Court (CBC).

Several patterns or regularities were found. The first channel was prevalent among small corporate and individual borrowers. Foreign loans are not significant. CDRAC and the Central Bankruptcy Court (CBC), which also handled corporate reorganisation, share a common pattern in terms of the size of debt. A number of firms did pre-packaged restructurings at CDRAC and finalised them at CBC since CDRAC is not legally binding. However, firms having restructuring deals done through CDRAC, unlike those being reorganised in the CBC, are usually not financially insolvent in the legal sense of having negative equity. This led to a number of major differences in process and outcome.

Relatively speaking, foreign currency debt was given a larger haircut by foreign banks than domestic banks. This phenomenon, coupled with severe financial insolvency, was usually accompanied by a sizable debt haircut, and/or debt-equity conversion with the consequent loss or large reduction of the original owner's equity stake. This regular pattern is observed more among firms being reorganised at the Central Bankruptcy Court than at CDRAC. An additional interesting fact is that whereas crisis caused losses to foreign firms and foreign firms increased their equity stakes (as evidenced by capital inflows from abroad), crisis did not increase foreign ownership of the Thai economy on the gigantic scale that was observed in Latin American countries. It is also noteworthy that, with the exception of Thai Petrochemical Industry (TPI) and a small number of hostile cases, co-operative restructuring and negotiation between creditors and debtors dominated. *De facto* quasi US Chapter 11, in which debtors prepared and managed the reorganisation plan, was also observed (Pairoj and Nuttanand 2004). By the end of 2003, THB 1 500 billion of debt (one third of GDP) from about 300 medium and large-sized firms had been approved by the courts for reorganisation.

In tandem with the surge in corporate reorganisation, bankruptcy cases soared from 6 993 in 1998 to a peak of 42 413 in 2002. That year also recorded the largest bankruptcy debt claims from creditors valued at THB 1 387 billion. Of the THB 3 470 billion in bankruptcy debt claims from 1998-2004, most were concentrated in the three years from 2001 to 2003.

Crisis inevitably brought about policy and institutional changes. These changes (with the exception of exchange rate regimes) were not drastic. Foreign participation in the banking sector was allowed to increase to majority ownership in order to facilitate bank restructuring and needed capital injections. In April 1998, the bankruptcy law was revised to include corporate reorganisation and allow for the establishment of the Central Bankruptcy Court. Civil court procedures dealing with debt disputes were made continuous to speed up process. These were part of 11 major legislative changes made during the crisis, which later caused opposition from certain interest group.

There is no doubt that the crisis generated social conflict, especially among creditors and debtors. These conflicts raised the social costs of collective action and intergroup co-operation, as well as destroying the country's social capital. Dishonest debtors, who siphoned off company wealth and employed deceitful NPL tactics, frustrated creditors who then refused large haircuts. Some debtors who refused to relinquish ownership resorted to all manner of unethical schemes (with court approval) such as inventing new contingent obligations to create new debt claims in order to eventually win the proposed reorganisation plan. The debtors' incentive to organise individually or collectively was stronger than creditors. TPIs original owners regularly used and paid the state-owned TV channel to influence the public and voice complaints. The Thai Rak Thai election campaign in early 2001 promised to revise these 11 acts. Among them, debtors consistently demanded that the Bankruptcy and Reorganisation Law be amended to give initial rights to manage the reorganisation plan to debtors and to automatically absolve the guarantor of debts once the firm is authorised by the court to reorganise.

These issues are still current. To date, however, the Thai Rak Thai government has reneged on its promises and is now noncommittal about revising the bankruptcy law to make it less protective of creditors since it does not wish to undermine foreign investor and creditor confidence. Major legislative changes with respect to reorganisation are still in the doldrums. This is to be expected in Thailand where laws are changed or introduced only in crisis. The introduction of reorganisation into The Bankruptcy Act of 1942 supports this assertion.

However, the government did intervene in the case of TPI in mid-2003 to remove the previous planner consequent to a court order. This was to the great consternation of creditors and legal scholars, and to the joy of the debtor's executive and the original family owner. The government

appointed planner is waiting for a new plan to be approved by the court. This new plan does not apparently help the original owner much in terms of ownership, and the acrimonious relationship between the original owner and the appointed planner has resumed. This time, however, the debtor's bargaining power may not be so strong.

This isolated case of hostile restructuring does not diminish the general progress achieved through legal changes. The law does facilitate and speed up reorganisation, but with a level of bias towards protecting domestic firms' interests (sometimes at the expense of domestic creditors, foreign creditors, or debtors, depending on the situation). Meanwhile, there were positive changes at the Legal Execution Department (LED), where proactive concerted efforts were launched to accelerate and improve the bidding and auction process of foreclosed assets. Compared with the past, more property was sold and auctions became more frequent.

Risk management: Institutional and policy change in financial institutions

Thailand's risk profile fluctuated widely since the 1997 currency and banking crisis. Peak uncertainty about recovery prospects diminished gradually once banks were recapitalised and stability was restored to the financial system. However, risk remained high in mid-1999 with peak NPLs reaching 47% and with industrial capacity utilisation of 50-60%. By 2000, three years after the crisis, between two-thirds and three-fourths of NPLs were restructured. The restructuring paved the way for a strong economic recovery from 2002 onwards, supported by a surge in export and domestic consumption demand. During the last two to three years of economic recovery, banks began to be profitable and the overall risk in the economy stayed low despite increasing household debt and a turnaround in real-estate demand. Market confidence improved when the financial costs of restructuring were settled by mid-2002. The main factors contributing to lower risk were:

i. The early stage of the recovery cycle;

ii. Huge excess banking liquidity and very low interest rates;

iii. Generally low inflation, and stability in exchange and interest rates;

iv. Good bank capital positions in excess of the required BIS ratio;

v. Increased vigilance and changes in risk management and lending practice, especially in housing loans; and

vi. Changes in the regulatory framework, notably in risk management and financial infrastructure development.

All these changes affect the risk and risk management of financial institutions.

Crisis has gradually led to changes in lending behaviour among Thai bankers who have become more prudent. While personal guarantees and the use of real estate and other tangible assets as collateral still matter a great deal, these are now used in conjunction with cash flow and ability to pay analyses, which receive greater attention.

The last few years have seen a surge in real estate lending and consumer finance, primarily in the form of credit card lending. Unsecured credit card lending is obviously the riskiest form of lending and the Bank of Thailand has repeatedly tightened regulations in order to minimise potential problems. Household debt has also increased. Yet, one can safely say that Thailand has a much lower debt to income ratio at the household level and debt to GDP ratio at the macro level than Korea or other developed economies.

Apart from better internal risk management systems at the banking system level, there were also changes at the structural level with implications for risk management in real estate and mortgage finance. The real estate boom contributed to an asset price bubble fuelled by commercial bank lending which, in turn, made commercial banks vulnerable. Developers now rely more on the capital markets (debentures) and internally generated funds. Commercial bank credit exposure to developers was much reduced and the expected risk will be lower.

Commercial banks and the government housing bank together contribute 80% of housing finance for households. These are secured low risk loans with a risk weight of only 50% and are attractive to banks with low levels of capital. Housing loan packages have also improved to suit consumer needs. Loans which previously carried 20 year terms can now be had for 30 years. In addition, the principal requirements and interest rates are now lower, making them attractive for moderate and lower income households. A one million THB mortgage now requires a monthly payment of only THB 5 000, or half the previous level.

Mortgage lending is competitive and low risk, with interest rates lower than the general minimum lending rate. When interest rates were very low, consumers benefited from low fixed rate short-term loans. It is no wonder that housing demand recovered strongly. Also, risk management for housing loans is more efficient now that loan processing is centralised. Access to consumer credit information has also improved through the establishment of credit bureaus.

The Bank of Thailand, as monetary authority and supervisor of most private financial institutions, maintains a central credit file containing information on the major borrowers of a number of financial institutions. However, credit information is not comprehensive and is only for Central Bank use. The need for pooling and sharing of credit information became urgent after the crisis and led to the emergence of two credit information agencies in 1999 before the passage of the Credit Bureau Act.

The passage of the Credit Bureau Act in November 2002 (effective March 2003) paved the way for the development of the pooling and sharing of credit information from many financial institutions. The act empowers the Credit Information Protection Committee, which is chaired by the governor of the Bank of Thailand, to regulate and oversee the rules and operation of private organisations and protect the privacy of borrowers. It is hoped that private or quasi public organisations can also enter the credit information market.

Currently there are two credit information organisations: the Thai Credit Bureau Co. (TCB); and the Central Credit Information Services (CCIS). TCB was created by the Ministry of Finance and is majority owned by the Government Housing Bank and an information technology firm named Processing Centre Co. CCIS was initiated by the Thai Bankers Association and is owned by 12 Thai commercial banks and two other private firms, namely Transunion Co. and Business Online Co. Their membership includes insurance companies, leasing agencies, and credit card companies among others. These two firms are in the process of being merged for operational efficiencies.

The changing supervision paradigm of the BOT: Towards market-oriented, risked-based supervision

According to a World Bank survey, Thailand did not comply with the BIS 25 core principles of consolidated supervision because of inadequate legislation in 1999. In line with BIS guidelines and global trends, the Bank of Thailand has prepared and adopted a new approach to overseeing financial institutions. The approach is gradual, and it is hoped that the Basel II guidelines will be adopted in the near future. Compared to traditional on-site and off-site supervision, risk-based and market oriented supervision is preventive, forward looking and comprehensive. It stresses the identification and

measurement of the likelihood of risk, and the ability of financial institutions to manage and sustain risk. Supervision is comprehensive, qualitative and quantitative, and looks at both internal and external sources of risk such as strategic risk, operational risk, credit risk, market risk, and liquidity risk, and how the institution is organised in terms of technology, human resources, and its ability to handle risk. The idea is not to eliminate risk but to face the risks realistically.

In moving towards such a system, good corporate governance and the commitment of the board of directors are essential. The board must have a certain percentage of independent directors. The Bank of Thailand has distributed guidance regarding the qualifications needed for bank directors and managers. The bank considers negligence on the part of a bank manager sufficient reason to refuse their appointment. The fact that Mr.Viroj Nualkair was not reappointed for a second term as president of Krung Thai Bank (the largest state-owned bank) lends support to the view that the Central Bank uses the stick rather than the carrot in its oversight. Viroj is suing the Central Bank governor for damages and improper use of power. Having authority or power is a necessary but not sufficient condition for the development of a risk management system; seven more conditions are usually required:

i. Clear objectives and strategies in both the short and long run in risk management;

ii. Restructuring the organisation so as to have an independent risk management unit as a check and balance;

iii. Development of the capabilities of the unit to meet the needs of growing banks;

iv. Modernisation of infrastructure such as IT, data systems and human resources;

v. Development of risk management tools focussed on both portfolios and individual securities;

vi. Back testing to test effectiveness; and

vii. Stress testing to test volatility.

The Bank of Thailand is providing guidance to help banks meet these conditions. Currently, most foreign banks and large local banks are making good progress. The Bank of Thailand has also reorganised internally for better risk-based supervision. What follow is a description of Bank of Thailand initiatives in laying these new foundations and commercial banks responses.

Strategic risk

Supervision will ensure that the long-term strategic plan and the short-term business plan cover risks that are consistent with the external environment and the internal organisation. Risk assessment requires estimating the risk level of the risk management system, the quality of management and human resources.

Credit risk

Credit risk is a major component of risk in the Thai banking system. Basic prudential rules as laid out in the Commercial Banking Act, such as large exposures, concentration of loans to single groups or borrowers, the prohibition of connected party lending or lending to legal entities in which the bank holds an equity share, continue to be strengthened after the crisis. For example, commercial

banks will be constrained in their lending and investment to connected persons or entities. Lending is not to exceed:

- 5% of bank Tier 1 capital; or
- 50% of shareholder equity; or
- 25% of total debt.

Nominee structures and indirect ownership have been used to circumvent the above regulations. The forthcoming Business Financial Institutions Act is expected to deal with this loophole. These rules do not apply to mutual funds or legal entities controlled by the Ministry of Finance. Commercial banks are not normally allowed to own the shares of other banks. Less than a simple majority of Thai ownership and directorship are not allowed without Minister of Finance approval. The government has relaxed this stipulation to permit the inflow of badly needed foreign capital for Thai banks.

As the banking system has stabilised and become profitable, the Bank of Thailand has adopted tougher standards for the enforcement of a good credit culture. For prudential reasons, loans may not exceed 70% of property values in order to prevent an asset bubble. In the area of asset classification and reserve provisioning (See Table 2. Non-performing loans) the provisioning of reserves for potential loan losses has been extended to the assessment of the probability of loan recovery. This is more in line with international standards of supervision.

Cash flow performance will provide early warnings on the quality of loans and an incentive for banks to screen and process loans carefully. According to a statement by Mr. Pridiyatorn Devakula, the governor of the Bank of Thailand, in August, some banks have been increased reserves because of cash flow problems at their borrowers. Cash flow testing is needed because many firms enjoy a grace period of interest free payments after debt restructuring. The conventional interest payment test does not reveal the non-performing nature of a loan.

Thai NPLs were highest among Asian economies hit by the 1997 banking crisis. NPLs peaked in mid 1999 at 47% of loans. Part of this problem was attributed to the closing of 56 finance companies, and the decentralised, market based, help yourself approach to restructuring banks. In retrospect, when one looks at the economic recovery, it is amazing that Thailand enjoyed positive growth for most of the time after crisis. The data below shows changes in NPLs among commercial banks since 1998.

Table 2. Non-performing loans

Year	NPLs (in million THB)	Percent of NPLs to Total Loans
1998	2 674 533	45.02
1999	2 094 424	38.93
2000	863 663	17.73
2001	477 405	10.41
2002	770 282	15.65
2003	641 350	15.69
2004(March)	617 142	12.02

The reduction over time was made possible by the continuing growth of the economy and by removing NPLs from the banking system and transferring them to the Thailand Asset Management Corp. (the state-owned AMC), and private AMCs. Finally, it was because of successful in and out-of-

court debt restructuring. Total NPLs are higher than shown above if NPLs from these institutions are added back. Nevertheless, Thailand's capacity for growth is high. After debt restructuring, firms were improved their financial condition and resumed normal business.

As banks became more profitable and better capitalised, the requirement for loan loss provisioning became stricter. Compared with the pre-crisis era, asset classification is now more detailed to capture the quality of loans measured by the duration of non-payment of interest and principal. Currently, six asset classifications ranging from pass, special mention, substandard, doubtful, doubtful of loss and loss are utilised. Required provisions range from 1% to 100%, with a write-off from the balance sheet in case of loss. The Bank of Thailand classifies substandard loans with no interest payment for three months as NPLs even if the bank establishes a 100% reserve. The provisioning requirements now go beyond aging factors. Other factors such as source of funds, nature of cash flow and use of borrowed funds are employed.

Credit risk transfer (CRT), market risk and liquidity risk

Thailand's banking system is mostly deposit based (92% of funding sources as of December 2003). The absence of a sophisticated market for financial instruments may give the impression of a relatively low liquidity risk for banks. During the 1997 crisis, the passage of unhedged exchange rate risk to firms by banks eventually hurt the banks anyway due to borrower defaults. With this experience, one should not jump to conclusions about low market or liquidity risk. On the liability side, Thai banks normally face a negative re-pricing gap risk or maturity mismatch since deposit terms are shorter than loan maturities. This mismatch increases when interest rates rise. This is the direction that Thailand will be moving from now on. However the change will be calculated and gradual so that the risk is manageable.

From 2003 onward, the Bank of Thailand authorised commercial banks to expand their scope of business to include many new financial products such as derivative instruments. Banks can expand their businesses and still be profitable if risk is better managed through various hedging opportunities. The credit risk transfer business is now regulated by the Bank of Thailand. The market will emerge in the near future. Thus, the market for credit linked notes (CLN), deposit linked notes (DLN), credit default swaps (CDS), forward bonds, bond options, and equity index linked notes has been authorised and is regulated by the BOT. These derivative instruments are subject to regulation as to their effects on capital, large exposures, net foreign positions, etc. For the first time, Thai financial institutions will be subject to capital rules. The same is true for liquidity risk. Many of these rules will be enforced by June 2005. Thailand is gradually moving towards a market disciplined, risk-based supervision.

Conclusions and recommendations

When crisis necessitates change, response will be forthcoming. This is the case of Thailand. Witness the bankruptcy law, which after a decade of futile discussion before the crisis was finally revised. It is fortunate that the employees of the Bank of Thailand have historically placed a high value on their reputation and integrity and are therefore amenable to positive changes. In some cases, legal infrastructure may be introduced while demand takes time to develop. This is the case of securitisation, special purpose vehicles and the secondary mortgage corporations. We should not be overly worried about the time it takes to complete the process.

The BOT spearheaded internal organisational restructuring and guided the financial sector in a professional manner in its policy and regulatory rule. Risk-based supervision of financial institutions together with sound monetary and fiscal policy should strengthen the financial sector over time and inure the economy to shocks, and market disruption or volatility. Though there are several aspects of

business and insolvency law that need change, an efficient police, state prosecutors, judges, and enforcement are equally important for Thai society. Thailand's economic criminals could have been put in jail had the enforcers been less corrupt. Long term concern should, however, be directed at the implementation of good governance at all levels of society especially for politicians, judges, civil servants, controlling or family owners of businesses, etc. The persistently low score of Thailand's standing on these matters should remind the Thai state and its citizens of badly needed reforms.

Table 3: Relative role of stock of debt restructured by different methods

Year	Financial Institution Debt Restructured	Informal Workout		Formal Corporate Reorganisation (Central Bankruptcy Court)	
		CDRAC	TAMC	Verified Debt	Plan Approval
1998	156 865	47 737	-	60 047	0
1999	1 072 095	495 519	-	215 688	38 504
2000	1 953 520	1 043 003	-	1 221 297	332 499
2001	2 429 093	1 275 313	28 138	1 523 006	636 311
2002	2 725 923	1 374 031	501 195	1 600 560	801 450
2003	2 961 244	1 443 622	732 332	n.a.	944 105

Note: Figures in millions of THB.

TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK MANAGEMENT: THE EXPERIENCE OF VIETNAM

by
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Introduction and summary

Vietnam's development continued to show a positive trend in 2003 and in the first ten months of 2004. Its GDP growth remains the second highest in South-East Asia after China. Commercial bank credits have also grown in recent years. However, problems with non-performing loans (NPLs) and distressed assets (NPAs)--largely related to state-owned enterprises (SOEs)--remain unresolved. The burden of NPLs and NPAs are causing a slowdown in the Vietnamese reform process and hampering the economy. NPL and NPA resolution are high on the government's reform agenda since they pose a serious problem for transforming (*i.e.* "equitising", selling, renting) SOEs.

Rooted in the centrally planned economy, insolvency and non-performing loans are mainly issues with SOEs and state-owned banks (SOBs). In addition to the Asset Management Companies (AMCs) of commercial banks, the government has established and put into operation a new special vehicle, the Debts and Assets Trading Company (DATC), which is a national AMC managed by the Ministry of Finance. Policy directives are issued for banks and the DATC to resolve the NPLs, but the achievements today are largely attributed to the sale of foreclosed assets.

Risk management practices at commercial banks in Vietnam are improving. All five State-Owned Banks (accounting for about 80% of the capital, lending and total assets of the banking sector) were required by the State Bank of Vietnam to design and implement a new credit manual.

Trends and developments in the insolvency and creditor rights framework and practices

Current legal and institutional developments

There is no comprehensive law dealing with corporate insolvency in Vietnam. Insolvency and creditor rights are regulated by the Law on Bankruptcy, civil law, the Ordinance on Economic Contracts, etc. However, these regulations are sometime unclear, inconsistent and might lead to differing interpretations and application. More important, the lack of enforceability lead to creditor rights not always being respected and long delays in resolving debts. Under the old Law on Bankruptcy, very few bankruptcy cases were realised. The Vietnamese National Assembly passed a new Law on Bankruptcy on 15 June 2004 that come into force on 15 October 2004.

More regulations were issued including those pertaining to:

- Equitisation of state-owned enterprises;

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- Selling state-owned enterprises;
- NPL resolution for commercial banks and state-owned enterprises; and
- Recapitalisation of state-owned commercial banks.

For the banking sector, efforts have been made to separate policy and directed lending from commercial lending. State-owned commercial banks (SOCBs) are now given more autonomy on extending loans. These banks are allowed to reject projects that they do not believe to be commercially viable. In recent months, this was evidenced by the SOCB's refusal to lend to some projects that were proposed by state-owned big business groups. This change is the sign of a more conservative credit policy that will help prevent bad debts from reccurring.

Institutional developments

Regarding intuitional aspects of insolvency, Vietnam is still in the beginning stage. Insolvency is being dealt with mainly through formal solutions, *i.e.* informal workout solutions have not been used.

New vehicles for resolving distressed loans and assets were put into operation but results are still limited. Currently, there are two type of AMCs in Vietnam: AMCs belonging to commercial banks and the national Debts and Assets Trading Company that belongs to the Ministry of Finance.

The Vietnamese government has studied different forms of AMCs since 1998 with technical assistance provided by international consultants. In 2000, the government issued regulations regarding the establishment and operation of AMCs that belong to commercial banks. At present, there are ten commercial banks that have established AMCs. AMCs belonging to commercial banks focus mainly on dealing with and managing the mortgaged assets transferred to them from their parent entities in order to recover long-outstanding NPLs.

In addition to these AMCs, the Vietnamese government also established the national Debts and Assets Trading Company (DATC) under the management of Ministry of Finance. The DATC was established in June 2003 and has chartered capital of VND 2 000 billion (about USD 127.4 million), much more than commercial banks. It is the government's ambition to use the DATC as an important means to help enterprises resolve their loan and distressed asset problems, and improve their financial health. At present, DATC focuses on resolving the NPLs and NPAs of SOEs. The lifetime of the DATC is undefined.

The DATC officially started its operation in the beginning of 2004. It will pilot the resolution of the distressed assets and loans of 20 companies determined by the government. DATC has been dealing with (receiving and selling) non-performing assets of SOEs with historical values of VND[1] 270 million (USD[2] 15.4 million) and net book values of VND 71 million (USD 4.5 million). The recovered amount after eight months of operation of the DATC was VND 17 billion (USD 1.1 million). This accounted for a very small portion of the total debts and non-performing assets of SOEs, currently estimated at VND 28 785 billion and VND 3 285 billion respectively.

The majority of SOE debt (72%) was borrowed from commercial banks and credit organisations, while the remainder is owed to the state, other enterprises and labourers.

[1] Vietnamese dong.
[2] US dollar.

A classification system and official definitions for distressed assets are needed. DATC will deal primarily with the distressed debts and assets of SOEs that have been outstanding for a long time. The company will purchase/receive debts and assets from SOEs or from other governmental agencies but not from banks. This means that a classification system for bank loans may not suitable for the purposes of evaluating and resolving the distressed debts and assets.

The involvement of foreign investors in NPA resolution is something being considered by the government. Although it was mentioned in some regulations, in practice there have been no cases where foreign investors purchased NPAs.

Previously, the role of professionals in insolvency was limited. The number of experts was small and know-how was limited. As a consequence, many creditors chose to resolve debts on their own. Recently, professionals (mainly qualified auditors and financial consultants) had more chances to involve themselves in the valuation of assets and corporations. Businesses and the markets are becoming more familiar with the involvement of professionals. However, the need to further develop the profession remains.

Still in the early stages of operation, the DATC needs to evaluate the distressed assets situation, enhance the skills of its staff, develop procedures and operating manuals, and develop a strategy for NPL and NPA resolution.

The DATC has dual and potentially conflicting purposes. Its charter specifies its objectives to be: (1) the social policy objective of cleaning up NPLs and helping SOEs get their financial problems sorted out; and (2) to make a profit, or at least be self-sustainable, by dealing in NPL-related transactions.

A new organisational structure to enable the DATC to meet both objectives, but in two separate entities, might need to be established. One entity should deal with advising, establishing plans on restructuring NPLs and helping SOEs get their financial situations sorted out as instructed by the government. This entity would be responsible for the purchase of NPLs under government mandate. The other entity should be broadly engaged in the purchase and sale of NPLs in market transactions and similar activities for the purpose of profit making. This entity would be responsible for the purchase and sale of outstanding debts and assets at market prices through negotiation, auction or bidding.

Current practices in various areas

Thanks to the government's efforts in undertaking reforms, the public's confidence in the Vietnamese financial system has been restored. The increasing number of players and types of financial services institutions on the market as well as the deepening monetisation of the whole economy best illustrate the growing confidence. The five State-Owned Commercial banks, in particular the four large ones, continue to dominate the market with 80% of total banking assets and lending market share. Joint-stock banks (JSBs) and foreign-invested credit institutions continue to be important players on the market, while insurance companies are gaining ground.

Banking reforms continue with the recapitalisation of the four large SOCBs and the JSBs as well as the resolution of non-performing loans. According to the State Bank of Vietnam (SBV), NPLs totalled USD 1.1 billion as of Dec 2002; foreign analysts however estimate this figure to be much higher. The number of JSBs has been reduced to a total of 36 banks currently in operations.

The four SOCBs principal weakness is their low Capital Adequacy Ratio (Equity/Risk Assets) of an average 3.5% compared to the international standard of 8%. Credit remains the key business and source of income for the banks, although they strive to diversify into other products. The convergence of the banks' business strategies might be an impediment to their competitiveness in the future.

There have been significant efforts by the government to resolve NPLs. Out of resolved NPLs from SOEs, 36% were paid out by state budget sources, 40% were dealt with by risk provision funds and only 24% by liquidation of the assets of the SOE debtor. There are still however very few NPL sale and purchase transactions taking place. Although they have made progress on the resolution of NPLs, further efforts are necessary to clear the NPLs from the banking system

Before the reforms in the early 1990s, banking in Vietnam was largely monopolised by the State Bank of Vietnam, which was the country's main institution for deposit taking and lending. Lending was carried out by what were effectively four SBV departments focused on borrowers in the areas of international trade (exporters and importers), infrastructure, industry and commerce, and agriculture. In 1988, these departments were converted into four separate, autonomous, SOCBs, wholly owned by the SBV, (currently the Bank for Foreign Trade or Vietcombank), the Industrial and Commercial Bank (Incombank), the Bank for Investment and Development (BIDV) and the Agriculture and Rural Development Bank (VBARD) to perform commercial banking activities.

Since the late 1980s, important changes have occurred in the structure, the regulation, and the operation of the Vietnamese banking sector. Four large SOCBs still account for over 80% of the total assets in the system but they are now complemented by a number of Joint-Stock Banks (JSBs), Joint Venture Banks, and branches and representative offices of foreign banks and, to a minimal extent, credit co-operatives/credit funds, microfinance institutions, and financing companies.

Over the past decade, the four SOCBs have evolved from specialised policy-driven lending vehicles to more commercially oriented financial intermediaries. However, policy-driven lending practices continued throughout the 1990s and limited credit assessment skills in the wake of rapid credit growth led to an accumulation of NPLs. In 2001, the Vietnamese government embarked on an important overhaul of the banking system through a multi-year restructuring and recapitalisation programme to address this concern. The main purpose of the restructuring programme is to enhance the health of local Vietnamese banks. The means by which this is achieved are: to increase the legal capital of the state-owned banks as committed with the IMF and World Bank; increase the registered capital of joint-stock banks; provide a correct NPL calculation and bring down NPLs; allocate sufficient loan loss provisions and close down problem joint-stock banks.

Currently, the ratio of bank credit to GDP is about 50%. The growth of the non-banking financial sector, and especially of the issuance business, has been remarkable, even if the size of the sector remains small in absolute terms.

Current risk assessment and management systems and policies

Risk assessment and management systems

There is a lack of transparency with respect to NPLs. Disclosure of NPLs in Vietnam is limited, and remains far behind international standards. Until recently, such information was considered a state secret.

Divergent classification criteria for NPLs lead to differing perceptions of the depth of the problem. Different definitions of non-performing loans and assets lead to an understatement of NPLs

compared to international standards. NPLs of banks have been variously reported to range from 3% (as reflected in official bank financial reports) to 30-75% of total outstanding loans (as reported by some foreign analysts). The figures of foreign analysts are higher than those of the SBV since their calculation is based on more stringent international accounting standards while the SBV's calculation is based on Vietnamese accounting standards.

Before 2002, the banks only counted missed payments in medium and long-term loans as overdue. Starting from January 2002, Vietnam adopted a more rational loan classification based on a new accounting method, which classified the whole principal as overdue if a portion of the loan becomes overdue. If a borrower fails to pay any amount of principal or interest and such amount is not extended or rescheduled, the total amount outstanding under the loan agreement (presumably including principal, interest, fees and any other amount payable) is classified as overdue debt. The new debt calculation methods will help bankers improve their risk management but will also drastically increase the ratio of overdue debts.

Loan loss allowances are not commensurate to credit risk. Banks are required by the SBV to classify their assets into four groups every quarter and make provisions to cover the risk. Currently, the four SOCBs are able to classify their assets but are unable to make the appropriate provisions. The reason is that a very number of NPLs was originated between 1995 and1998. If the banks were to make the required provisions, they would not have any profits or be able to pay any taxes, which neither the MOF or the SBV want. Banks need to have some profits in order to pay taxes. They also need to ensure that employee salaries increase marginally in order to maintain the morale of their human resources.

In October 2002, the SBV issued Decision 1154, which instructs the SOCBs to set aside loan loss provisions based on financial results. Early in the year, banks set a goal of a certain loan loss reserve (LLR), which must be approved by the SBV and the MOF. Then, by end of each year, the banks take out the reserve as a lump sum. In case the financial results are better than expected, the banks need to take further LLRs.

The four SOCBs hold the majority of NPLs in the banking system. Most of the bad loans that have accumulated are the result of soft policy loans to inefficient SOEs and occurred before 1998-1999. Since then, as the SBV applied stricter control and better risk management of commercial banks, new NPLs are about 2-3%.

According to the State Bank of Vietnam, a series of control measures resulted in a reduction of NPLs in the entire banking sector from an initial 14% (or from 8.5% in 2001 (USD 1.29 billion)) to 6% (USD 1.1 billion) in 2002, of which NPLs of the four SOCBs accounted for almost 80% (USD 865 million).

For the last three years, between 2001 and 2003, a significant number of bad loans were resolved by the four SOCBs via loan loss reserves, write-offs and realisation of foreclosed assets. Given the fortunate increase in real estate prices, the banks have been able to recover a large amount by selling foreclosed assets. In addition, the government allowed SOCBs to use previous soft loans to write off a large amount of bad debts that were extended to SOEs that were dissolved.

Vietnam is moving towards international standards of risk management. Vietnam continues the reform of its banking and finance sector with a number of achievements being made by both the supervisory agency and commercial banks. The State Bank of Vietnam is currently reviewing regulations pertaining to risk management in light of Basel II requirements. It has instructed SOCBs to develop credit manuals. With the support of consultants, SOCBs have developed comprehensive

credit manuals, which are sent to the SBV for approval for subsequent implementation. Joint-stock banks will also be requested to do so. These new credit manuals have been designed to take into account international practices in risk management.

Significant staff training and new information technology (IT) systems will be required to implement the credit manuals successfully. The development and implementation of credit manuals can contribute significantly to the risk assessment and management systems of the SOCBs if done in conjunction with other key activities such as the development of business strategy, asset and liability management, and internal audit.

More autonomy is being given to commercials banks. Government regulations were changed to allow SOCBs to reject projects that are not commercially viable. This allows banks to work on a commercial basis and reduce credit risk.

Credit information systems

The Credit Information Centre (CIC) was established under the State Bank of Vietnam to provide credit information on borrowers to creditors. This agency is being strengthened in order to become an important tool for banks to reduce risk in their future lending. Before 2004, the CIC received information from and provided access to credit institutions only. From 2004, the CIC started providing access to interested parties in all economic sectors for a fee. The type of information is diversified, and tailored to the needs of the interested parties. There is currently no credit rating agency in Vietnam.

The Vietnamese Financial Sector

Box 1: The Formal Financial System

Banking financial sector:

- 5 state-owned commercial banks
- 4 large state-owned commercial banks:
  - Bank for Foreign Trade (Vietcombank)
  - Industrial and Commercial Bank (Incombank)
  - Vietnam Bank for Agriculture and Rural Development (Agribank)
  - Bank for Investment and Development (BIDV)
- 1 small state-owned commercial bank: Housing Development Bank for the Mekong River Delta
- 1 social policy bank
- 25 foreign banks branches
- 6 foreign bank sub-branches
- 40 foreign credit institution representative offices
- 5 joint venture banks
- 36 domestic joint-stock commercial banks
- Central People's Credit Fund System and 23 branches
- 888 local credit funds
- 7 finance companies (of which 5 are affiliates of general corporations)

Non-banking financial sector:

- 18 insurance companies
- 8 finance leasing companies, 3 of which are joint ventures with foreign investors or wholly foreign owned. 5 are subsidiaries of state-owned commercial banks
- 1 postal savings system, the Vietnam Postal Savings Service Company (VPSC)
- 1 stock exchanges: Securities Trading Centre in Ho Chi Minh City, opened in July 2000
- 4 investment funds

Part III

TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK MANAGEMENT IN SOUTH ASIA

TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK MANAGEMENT IN SOUTH ASIA

by
Sumant Batra*

The frequent swings and the series of financial crises of the previous decade indicate the inevitable trend of a financially liberalised and globalised economic system. Expert analysis and institutional introspection in the aftermath of these crises have produced valuable efforts, initiatives and results to minimise the risks of failure of financial systems in critical times. Such financial crises are surmountable, and the architecture of a sound financial system can minimise the risk of failure in a crisis and promote a rapid recovery. Financial architectures require effective and efficient insolvency and risk management systems to mitigate risk, absorb the shocks of corporate failures and insolvencies, and maximise returns for stakeholders.

For South Asian countries, the necessity of creating healthy insolvency and risk management systems is linked with creating a sound climate for investment, maintaining public confidence in the corporate and financial sectors and promoting sustainable growth in the private sector. Having opened its markets in 1991, India faces the gigantic task of meeting the challenges of liberalisation and, in turn, modernising its laws. Bangladesh, Nepal and Pakistan initiated reforms in various areas to bring their legal and financial systems in step with modern times. More recently, Sri Lanka set out on the path of globalisation and the introduction of reforms in its systems. The last decade witnessed a slew of reforms in the banking and insolvency regimes in the region. There is an effort to transform the financial system by introducing financial sector reforms aimed at promoting an efficient, well-diversified and competitive financial system; evolving suitable and comprehensive models for risk-management by the banks; and integrating this new discipline into their working systems.

This paper provides an overview of the country systems, traces recent developments and makes key recommendations to enhance the efficiency of insolvency and creditor rights systems.

The legal and regulatory framework

The legal framework in most South Asian countries, particularly in Bangladesh, India, and Pakistan, is a British legacy. Though the common law system of Sri Lanka is derived from English law, the Roman Dutch laws remain the common law of Sri Lanka. While the law applicable to insolvency and banking in Sri Lanka is English law, Roman Dutch Law provisions apply to the mortgage of property. The legal system of Nepal is predominately influenced by common law system and also has elements of the continental legal system. The first codified law for a unified Nepal, the Muluki Ain (the Country Code), was introduced in 1853 and replaced by the existing Muluki Ain in 1963.[1] Commercial laws were introduced mainly in the 1930s and although the common law

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foundation remains, unlike other common law countries, Nepal did not keep up with the developments of common law. As a result, the legal framework for commercial law and the necessary legal mechanisms for the effective functioning of the corporate sector were not in place until the mid-1990s. Globalisation and the opening of trade have led the countries to consider laws that come from fundamentally different legal traditions as models.

Insolvency and reorganisation: Legal and institutional framework

In most countries, the liquidation of companies is carried out under the company law. In Bangladesh, India and Pakistan the liquidation process is carried out by liquidators who are government officials. In Nepal, the Office of the Company Registrar (OCR) conducts the liquidation. In Sri Lanka, however, an Official Receiver is appointed out of a panel of accountants. In Bangladesh, India and Pakistan, the jurisdiction for liquidation rests with the High Court; and in Sri Lanka, with the District Court. Nepal does not provide a role for the courts in the liquidation of companies (See Table 1).

Table 1. The liquidation framework

India	Pakistan	Nepal	Bangladesh	Sri Lanka
Governing Law				
Companies Act 1956	Companies Ordinance 1984	Companies Act 2053 (1997)	Companies Act (Bangladesh) 1994 Bankruptcy Act 1997	Companies Act, 1982
Institution				
Designated Company Court in High Court of Every State	High Court	No Role for Courts	High Court Designated Bankruptcy Court	District Courts
Regulator				
Ministry of Company Affairs	No specific Regulatory Authority	Office of the Company Registrar (OCR)	No Specific Regulatory Authority	Regulatory Powers Only With the Court and OCR, No Other Regulatory Framework

A formal law providing for the reorganisation of companies exists only in India in the form of the Sick Industrial Companies (Special Provisions) Act of 1985 (SICA) which deals with the revival and rehabilitation of sick industrial companies. In other countries, reorganisation is contemplated in the form of schemes of compromise and arrangement under the Companies Act (See Table 2).

Table 2. Restructuring law

India	Pakistan	Nepal	Bangladesh	Sri Lanka
SICA Composition & Scheme of Arrangement Under Companies Act of 1956	Under Part IX of Companies Ordinance 1984	No Law	No Law Composition & Scheme of Arrangement Under Companies Act.	No Law Composition & Scheme of Arrangement Under Companies Act.

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India

In India, the winding up of companies is a long drawn-out affair. Before a company is finally dissolved, it takes years to obtain the statement of affairs, the books of account, records and assets, realisation of debts and sale of assets, settlement of the list of creditors and contributories, the distribution of assets to creditors, members, etc. In the process, substantial corporate assets remain unrealised and undistributed. The inordinate delay in proceedings impedes the rapid use of productive assets which lie dormant throughout the country. This process has been found to be ineffective due to inefficient government-appointed liquidators. Debtors misuse SICA to seek protection and moratoriums from recovery proceedings initiated by creditors. The companies are able to enter into the reference (sometimes by manipulating their accounts to reflect net worth erosion) and are then able to enjoy immunity from the recovery actions of creditors. Registration of reference is dependent upon the erosion of net worth, which can be achieved by accounting manipulations. The provisions for the suspension of legal proceedings are misused and perpetuated. Unscrupulous promoters enter into the process of rehabilitation by manipulating sickness, and draw undue benefits from the delay in decision-making by the Board of Industrial and Financial Reconstruction (BIFR).

Pakistan

In Pakistan, the legal environment is uniquely complex owing to the imbalance between creditor and debtor rights. The creditor-friendly laws have impacted the financial landscape, particularly the investment climate in Pakistan. Some laws are regarded as being overly punitive on debtors and have frustrated attempts at restructuring. The National Accountability Ordinance of 1999, leading to the Creation of the National Accountability Bureau (the NAB) permitted the presumption of guilt, and shifted the burden of proof to the accused. The target of this law was corruption in all its forms including non-payment or delayed payment of bank debt. For borrowers, a new legal term/concept was introduced whereby any default to any government institution (even on a utility bill) of more than 30 days was defined as "wilful default". Wilful defaulters were subject to imprisonment, barred from holding any public office and put on the Exit Control List that barred them from foreign travel. The law carries the risk of highly selective and discriminatory use.

Liquidation law remains ineffective, and a formal restructuring law does not exist. The informal restructuring process has been attempted but failed to deliver satisfactory results. The Corporate and Industrial Restructuring Corporation (CIRC), a public sector asset management company (AMC), was created in September 2000 under broad legislation. Its mandate was "to make provisions for the acquisitions, restructuring, rehabilitation, management, disposition and realisation of non-performing loans" of public sector banks and financial institutions. All public sector financial institutions have to offer their non-performing loans (NPLs) to CIRC, which retains the right to cherry-pick for acquisition and "return" others to the parent bank(s). Each High Court in Pakistan has nominated judges with a mandate to handle CIRC and related litigation. CIRC concentrated only on auctioning NPLs acquired by it. Acquiring assets at a purchase price well below the forced sale values established by the banks had a negative effect on the secondary market price of industrial assets. This pricing methodology resulted in the AMC generating large profits on asset sales leaving the parent bank(s) with a larger write-off. CIRC had limited success in cleaning up the balance sheets of financial institutions, having acquired 233 NPAs involving NPLs of PKR[2] 34 billion at an acquisition price of PKR 6 billion in the last four years. So far, it has managed to sell/auction only 87 units/NPAs for slightly less than PKR 3 billion. The Committee for the Rehabilitation of Sick Industrial Units (CIRSU) claims that it has revived 172 industrial units involving outstanding NPLs of PKR 46 billion. It is very difficult to comment on this claim, as CIRSU does not maintain any record with respect to the post-revival status of these industrial units.[3] It was created with a specific "sunset clause" to be wound up in six years (by September 2006).

The Committee for the Rehabilitation of Sick Industrial Units was created through a notification of the Ministry of Finance in May 2000. The body does not operate under an enabling law. It comprises representatives from large public sector financial institutions and senior industrialists. The design objective was to create an entity that would probe the root causes of industrial sickness and come up with long-term solutions for sustainable growth in the major industrial clusters and segments. In practice, CIRSU has chosen to act was an "arbitration window" on NPLs between the banks and the borrowers. Periodic meetings are held in which very basic data is considered. Data is not maintained by CIRSU in terms of revival defined as a closed unit coming back into production.

Sri Lanka

The legal framework for corporate insolvency is dated and provides only for liquidation with no reorganisation regime. There are some provisions for compromise and schemes of arrangement under the Companies Act but they are neither directed at nor facilitate the rehabilitation of companies. Creditors do not use these provisions for restructuring of debts or the settlement of dues with debtors. The key features of a sound insolvency system are absent, and no material aspects of the law or process are observed.

The law does not provide for the needs of a modern industry. The process of seizure of assets is cumbersome. Sales are carried out by public auction, which typically attract significantly lower values than if businesses were sold as going concerns. The absence of effective tools and instruments to supervise and manage the insolvency process renders the liquidation process an insignificant part of market dynamics. Very few cases of winding up are filed (See Table 3) and rarely are winding-up cases filed in the outstations, if the registered office of the company is situated in those areas. However, from statistics available from the Registrar of Companies, since 1977, 551 companies were struck-off (in the case of about 100 more companies steps have been taken to strike-off, but the process is not completed), 122 companies were wound-up voluntarily, 10 companies were wound-up by creditors and 38 companies were wound-up by the court. Secured creditors prefer to remain outside the winding up process. Only ten companies were wound up on creditor petition since 1977.

Table 3: Number of Bankruptcy Cases

Type of Proceedings	1999	2000	2001	2002	2003	April 2004
Winding up	20	31	33	24	30	12

Source: District courts

The District Court has the jurisdiction to make orders in respect of winding-up. They are not specialised bankruptcy courts and deal with a variety of jurisdictions. Judges promoted from the subordinate judiciary preside over these courts. No specialised qualifications are required for a district judge to oversee the liquidation proceedings. There is a need to make the training and continuing education system more broad-based with regular interaction with experts and professionals from developed systems and countries like India that serve as a sound and acceptable model in the region. The implementation framework is weak and materially non-observant with respect to the courts, and non-observant concerning regulations pertaining to insolvency practitioners. The participation of professionals is absent in the liquidation process. Only a very few accountants offer their services for appointments as official receivers.

Under the insolvency law and procedures, there is little opportunity to preserve the business as a going concern with the prospect of maximising the ultimate value and recovery for creditors. There is

no supervisory body responsible for regulating the conduct of official receivers and liquidators. This role is left to the courts, which oversee the liquidation process. The Registrar of Companies has a limited supervisory role over the liquidators. The professionals do not find enough incentives in the liquidation process. A regulatory framework is required to ensure that receivers and administrators are competent and duly licensed, and supervised in carrying their functions. There is also a general consensus in favour of an additional supervisory body.

Nepal

There is no law of reorganisation in Nepal. The liquidation of limited liability companies is governed by the Companies Act 2053 (1997). While the law of rehabilitation is absent, the provisions relating to the liquidation of companies do not comply with the key objectives and policies of a legal framework for corporate insolvency. Liquidation is a long drawn-out process, which is inefficient, ambiguous, uncertain and disorganised. The law prohibits any action pertaining to the business of company after an order of winding up is made, but creditors are not stayed from initiating recovery or enforcement proceedings. The law has little synergy with the other laws, which establish rights for enforcement of security interest and recovery of dues.

Secured creditors rank fourth in priority of claim. The cost of liquidations ranks first in priority followed by payment of wages, remuneration, provident fund, gratuity and other amounts due to workers/employees. Unsecured creditors have priority only against the shareholders. Government dues rank third in priority. There is no definite requirement, time frame, procedure or process for submitting claims and their adjudication. About 170 companies are to have been liquidated by OCR though most were voluntary liquidations.[4] There is no attempt to save the business. The scheme of the law is to liquidate the assets without maximising the value of assets and recovery. Stakeholders have not owned the liquidation process and prefer to stand out. Creditors prefer to enforce security through the "self-help"[5] mechanisms. They have not initiated a single liquidation in the last ten years. One reasons for this is the high floor limit set for creditors to invoke the liquidation process.[6] Claim is not defined. No appropriate provisions for the determination of priorities exist, though similarly situated foreign and domestic creditors are treated at par. The law does not establish a framework for cross-border insolvencies with recognition of foreign proceedings. There is no law to recognise foreign judgements and orders.

Bangladesh

In Bangladesh, the Bankruptcy Act of 1997, which deals with the insolvency of individuals, came into force on 1 August 1997. It re-enacted the law on insolvency using the expression "bankruptcy" in place of "insolvency". The law substantially follows the scheme and pattern of the two earlier acts it repealed. The act provides a detailed procedure for dealing with bankruptcy cases including appeal and review. The court either adjudges a debtor as bankrupt or rejects the case within 60 days of filing the plaint with the court. After declaring a debtor as bankrupt, all property and assets (excluding the property described in Section 32 shall vest either with the receiver of the court or, if there is no receiver, with the court. The receiver or the court (as the case may be) shall take the necessary steps to sell the property of the bankrupt for realisation of the debt of the creditor. The act also provides procedures to prevent the multiplicity of suits. After a debtor is adjudged as bankrupt, no person can file any case against the bankrupt without approval of the bankruptcy court. The law also provides a strong procedure and time frame for appeal. Prior to filing an appeal, the bankrupt must deposit money equivalent to 10% of the creditors' claim in the court. Appeal against the decision lies with the High Court.

The law has some inadequacies which make banks reluctant to use it frequently. Although the law prescribes a time limit for adjudication of a case and appeal, there is no consequence for non-completion of the case (or appeal) within the stipulated period. In absence of this clarification, the Supreme Court declared the said provision as declaratory not mandatory. Section 54 of the act is inadequate for protecting a secured creditor over an unsecured lender. After adjudging the debtor as bankrupt, the security of the secured creditor falls in the hands of the receiver although Section 31(4) gives protection to the secured creditor. The secured lender cannot deal with the property on its own and is likely to be equal to an unsecured creditor. This provision is opposed to the general principles of law and banking that a secured creditor gets preference over other creditors.

Recent legal and institutional developments

The existing laws have failed to meet the dynamics of changed economic systems. The cumbersome provisions obstruct expeditious liquidation of companies and vast national resources in liquidation proceedings. The banks in the region are weighed down with large non-performing assets and lack effective systems for enforcement. These laws do not postulate a role for professionals causing a serious impediment to their effective and efficient implementation. Globalisation, backed by the desire to bring the laws into harmony with international benchmarks, triggered a series of reforms to strengthen the insolvency and creditors' rights framework in most of the countries in the region.

India

The Justice Eradi Committee:

In 1999, alarmed by the large amount of assets lying blocked in liquidation and restructuring proceedings, the government of India set up a High Level Committee headed by Justice V. B. Eradi, a superannuated Judge of the Indian Supreme Court to examine and make recommendations with regard to the desirability of changes in existing law relating to the winding up of companies and the need for a self-contained law for reorganisation and liquidation of companies, with a view to creating confidence in the minds of investors, creditors, labour and shareholders.

Companies (Second Amendment) Act, 2002:

Based on selected recommendations of the Eradi Committee, Parliament passed the Companies (Second Amendment) Act, 2002 (Second Amendment) to significantly restructure the 1956 act and to create a new regime for tackling corporate rescue and insolvency. The provisions of the Second Amendment are, however, yet to be notified and SICA has still to close as the Sick Industrial Companies (Special Provisions) Repeal Bill, 2002, passed by Parliament, awaits notification. Till then, while the Board for Industrial and Financial Reconstruction (BIFR) sets up, SICA continues to deal with the revival and rehabilitation of companies, and the High Court retains its jurisdiction as the liquidation court under the 1956 Act. The main features of the Second Amendment are:

- It amends the provisions of the 1956 act for the setting up of a National Company Law Tribunal (NCLT) and its Appellate Tribunal. NCLT will have the power to consider the revival and rehabilitation of companies, and the jurisdiction and power relating to the winding up of companies. The winding up proceeding pending in the High Courts shall stand transferred to NCLT.

- The Second Amendment seeks to provide easy, convenient, inexpensive and quick access to the restructuring of companies and requires the board of directors of an industrial company

which has become a sick industrial company[7] to refer to the NCLT, prepare a scheme for its revival and rehabilitation, and submit the same to NCLT for the determination of the measures which may be adopted with respect to the company.

- The Second Amendment introduces a new time frame for restructuring proceedings.[8]

- It does away with the infamous provision of automatic protection from creditors under SICA.

- The Second Amendment introduces a provision for levy and collection of cess for the purposes of rehabilitation or revival or protection of assets of the sick industrial company at a rate not less than 0.005% and not more than 0.1% of the value of turnover of every company or its annual gross receipts whichever is more. It also requires the creation and setting up of a Rehabilitation and Revival Fund. The sources from which amounts will be credited to the fund have also been specified. This fund will be transferred to the Consolidated Fund of India and amounts will be released to NCLT from time to time for the purposes specified in the Second Amendment.

- Apart from the existing grounds,[9] additional grounds for winding up of a company have been added by way of the Second Amendment: if the company has acted against the interest of the sovereignty and integrity of India, the security of the state, friendly relations with foreign states, public order, decency or morality; if the company has defaulted in filing with the Registrar its balance sheets and profit and loss account or annual returns for five consecutive financial years; if the NCLT comes to the conclusion that the sick industrial company is not likely to make its net worth exceed the accumulated losses within a reasonable time while meeting all its financial obligations and that it is not possible to revive the company in the future, and that it is just and equitable that the company should be wound up.

- The Second Amendment provides for appointment of court appointed professionals as liquidators who are capable and competent of handling insolvency proceedings much more efficiently. It provides for liquidators to be appointed from a panel of chartered accountants, cost accountants, lawyers and company secretaries. This is a key feature of the Second Amendment.

The insolvency reform process suffered a setback when earlier this year the Madras High Court set aside certain provisions of the Second Amendment, on a challenge made by the Bar Association of that court, bringing the implementation of the new law to a grinding halt. The matter is currently before the Supreme Court in an appeal proffered by the government of India.

Concept Paper on Company & Insolvency Law:

Recently, the Ministry of Company Affairs introduced a concept paper with the objectives of simplifying the company law and tune it to international developments. The concept paper is a commendable initiative of the Ministry of Company Affairs and a superb approach to the law making/reform process. It invites a public debate and stakeholder participation before the drafting of the bill and taking it to Parliament. This will certainly enhance the value of the end product and its acceptability and ownership by stakeholders.

Unfortunately, the concept paper does not propose any significant change from the provisions of the Second Amendment in the chapters relating to the restructuring and liquidation. At the same time, the paper commissions a debate on the provisions of these chapters. This is demonstrative of the

ministry's intent to review the Second Amendment. The concept paper is nevertheless timely as far as insolvency reforms are concerned. It offers a wonderful opportunity to plug the gaps in the Second Amendment, deal with the Madras High Court decision, and incorporate the features of the UNCITRAL Guide and the World Bank Principles.

Dr. J. J. Irani Expert Committee:

In December 2004, the government of India set up a High Level Committee of Experts chaired by Dr. J. J. Irani to make recommendations on the Company Law including the Insolvency Law. The committee is expected to submit is report in May 2005 and make significant recommendations on insolvency law.

Pakistan

New Corporate Rehabilitation Act in the offing:

Pakistan has been struggling to pass its new insolvency law. At present, a bill is being debated whose object is to amend and consolidate the law regarding corporate insolvency and financial rehabilitation. The bill, if enacted, would replace the existing corporate insolvency regime. The rehabilitation aspects of the proposed legislation bear similarity to Chapter 11 provisions of the United States code relating to bankruptcy. The first chapter covers general provisions which describe the jurisdiction of the court, the entities covered by the legislation, and the main role players. It visualises the creation of the office of an "official administrator", and the constitution of "advisory committees". The second chapter relates to case administration and contains sub-chapters covering the commencement and prosecution of the cases, the role of officers such as the administrator (who may also engage services of professionals), administration matters relating to committees and the examination of the debtor, and a sub-chapter relating to administrative powers. The third chapter relates to creditors, debtors and the estate, while the fourth covers rehabilitation. The final chapter refers to provisions of existing law that stand repealed.

A distinctive feature of the new legislation is that commencement of the case operates as a stay regarding all legal proceeding, attempts to collect or recover claims against the debtor that arose before the commencement of the case, exercise of right of set-offs, and also any acts aimed at creating, perfecting or enforcing any lien against the property of the estate or taking possession or control of the same. In the existing law, a petition for corporate re-organisation does not operate as automatic stay. The court has the power, if it sees fit, to grant a stay. In the proposed legislation, commencement of a case would at least ensure breathing room for the debtor while the rehabilitation plan is in the process of approval, and the debtor would not be harassed by the creditors or persons laying claim to the debtor's estate. The office of the liquidator would stand substituted by that of the "Official Administrator".

Sri Lanka

The legal framework for corporate insolvency is dated and imbalanced providing only for liquidation with no reorganisation regime. The government set up a committee to propose a new company law. The recommendations of the committee were not accepted. Recently, the government of Sri Lanka invited the World Bank to undertake an assessment of Insolvency and Creditors Rights Systems in the country under the World Bank's Reports on Observance of Standards and Codes assessment project and make suitable recommendations. The Central Bank of Sri Lanka and the Business Recovery and Insolvency Practitioners Association of Sri Lanka, along with the Ministry of Commerce, have set up a committee to propose a suitable law of corporate restructuring.

Bangladesh

Bangladesh has yet to initiate any major reform to improve its insolvency regime. The current status of legislation in Bangladesh is inadequate to facilitate efficient corporate recovery and restructuring processes. It is imperative that a comprehensive review of the Bankruptcy Procedures and Corporate Restructuring methodology is conducted not only in the legislative arena but also amongst practitioners.

Nepal

Nepal initiated the process of economic liberalisation in the mid-1980s leading to significant developments in the Nepalese financial system. The banking sector, in particular, required urgent treatment to deal with high levels of NPA that were around 29% in 2003. A new Banking and Financial Institutions Ordinance was passed in February 2004. The drafts of the Secured Transactions Ordinance, Insolvency Ordinance, and Securities Ordinance have been approved by the cabinet and are awaiting the royal seal for enactment, and the Asset Management Company and Company Ordinance is under consideration of the cabinet. The drafts of the Fiscal Transparency Ordinance and the Anti-Money Laundering Ordinance are also under active consideration of the government. The Asian Development Bank is currently assisting in the drafting of the new law to govern the micro financial sector.

Insolvency Ordinance, 2003:

The Insolvency Ordinance of 2003 (IO) is presently under consideration in Nepal. The proposed IO provides for the liquidation and restructuring of companies. It covers companies with limited liability, banks, financial companies (with prior approval of NRB) and insurance companies (with the prior approval of Beema Samiti, the regulatory authority for insurance companies). The government may define any state-owned limited liability corporation as a company for the purposes of the IO. The provisions of the Company Act would only apply to voluntary liquidation.

The proposed IO does not provide easy access to creditors and debtors. Creditors representing 5% of debt may serve a 35 days demand notice and initiate liquidation proceedings if the debt is not serviced or a petition against the notice of demand is not preferred. If a petition is preferred, the court may order or refuse to commence insolvency proceedings in case there is a dispute over the debt or no debt is found to be due and payable. If commenced, an insolvency practitioner will be appointed who will take over the supervision of the company and investigate if the company should be restructured or liquidated. There will be an automatic stay against the transfer of assets, shares, etc. and the making of any payments out of company funds.

The IO provides for the formation of a creditors committee. Under the IO, the sovereign debt is treated as unsecured and ranks only prior to shareholders. The secured property does not form part of the reorganisation estate. After the adoption of the plan by creditors and its approval by the court, the secured creditors may enforce/foreclose their security if they have not voted or consented to the plan. It provides for notice of claim but does not define claim. Setting off of mutual debts will be possible, provided the transaction was not entered into with the knowledge of imminent insolvency. Directors and officers can be made liable for losses caused to the company.

The proposed IO provides for a time-bound reorganisation process. The reorganisation manager will prepare the reorganisation scheme and put it to the vote of creditors. The creditors are required to vote in favour of such scheme. If reorganisation is not completed on time, the court may, on

recommendation of reorganisation officer, terminate the scheme and order liquidation. During the reorganisation period, the management of the company is entrusted to the reorganisation officer.

The proposed IO, if enacted in its present form, would create a satisfactory framework for corporate insolvency as a starting point, though the law requires a review to make it compliant with the World Bank Principles. The amendments are needed to provide easy access to law for creditors and debtors, streamline the process of voting on plans, determine appropriate priority rules, etc. The implementation framework will need support from international institutions to build capacity for the Office of the Insolvency Administrator for discharging its functions efficiently. A specialised court dealing with insolvency matters, with judges appointed with suitable qualifications and experience, is a considerable advantage in enhancing efficiency and maintaining consistency in the process. The district courts do not possess the skills and capacity to deal with specialised insolvency work. The profession of insolvency practitioners needs to be institutionalised. There is a pressing need to train judges and practitioners on a continuous basis, and to conduct exchanges between judges and international experts.

The dissolution of Parliament affected the progress of legal and regulatory reform. Progress has suffered during the past two years. All laws are currently passed by the cabinet and receive royal assent. These laws are called ordinances and are only valid for six months, unless renewed by royal assent at intervals of six months. The real fate of these ordinances is uncertain as the Parliament, once it comes into session, has to ratify them. In the recent past several laws, largely affecting the corporate and private sectors, were either drafted, or passed by the cabinet or are in the final stages of enactment.

Out-of-court and informal workouts

Informal workout procedures and techniques require improvement in the region. The Corporate Debt Restructuring (CDR) Scheme sponsored by the Reserve Bank of India (RBI) is a success story (See Table 4) and offers a role model for the region. Non-bankruptcy workout on a voluntary basis between the debtor and the creditor exists as a matter of private agreement.

Table 4: Formal out-of-court restructuring mechanisms

India	Pakistan	Nepal	Bangladesh	Sri Lanka
Corporate Debt Restructuring (CDR) Scheme	The Committee for the Rehabilitation of Sick Industrial Units (CIRSU)	None	None	None

The CDR scheme was framed with the objective of creating a timely and transparent mechanism for restructuring corporate debts of viable corporate entities affected by internal and external factors (outside the purview of the BIFR, the Debt Recovery Tribunal or other legal proceedings) for the benefit of all concerned. The legal basis for the mechanism is provided by the Inter-Creditor Agreement (ICA). All participants in the CDR mechanism have to enter into a legally binding ICA with necessary enforcement and penal clauses. It is a voluntary system based on debtor-creditor and inter-creditor agreements. The scheme does not apply to accounts involving only one financial institution or one bank. Instead, it will cover multiple banking/syndication/consortium accounts with outstanding exposures of INR[10] 20 crore[11] and above by banks and institutions. The CDR system is applicable to standard and substandard accounts, with potential cases of NPAs getting a priority. Banks and financial institutions have been gripped by CDR frenzy.

The federal government of Pakistan set up the Task Force for the Revival of Sick Industrial Units under the Companies (Rehabilitation of Sick Industrial Units) Rules, 1999 (1999 Rules) to identify sick industrial companies. The 1999 Rules provide for a "Bankers Committee" (constituted by the State Bank of Pakistan, and comprising the heads of banks and financial institutions) to implement the recommendations of the State Bank of Pakistan co-ordination committee relating to the revival of sick units. If the Bankers Committee is of the opinion that a company owning an industrial unit is facing financial or operational problems, it must report this to the task force.

If, after considering the Bankers Committee's report and other evidence, the task force is of the opinion that the company is a sick company, it is required to make a reference to the federal government which may declare it to be a sick company and ask the task force to prepare a plan for its rehabilitation. This must be submitted to the federal government for approval. Once a rehabilitation plan is approved it becomes valid, binding and enforceable in all respects, notwithstanding anything to the contrary contained elsewhere. Implementation is supervised by the federal government or any authority or person authorised by the federal government in this regard.

Contrary to the practices in India and Pakistan, which employ a wide range of approaches to rescue viable business with a view to ensuring debt recovery, informal workout procedures and techniques are rarely applied by Sri Lankan or Nepalese banks except for the rescheduling of loans in a *post parate* execution or self-help action. Stakeholders recognised the need for developing the informal out-of-court work out mechanism, which balances the necessity of keeping potential businesses alive while ensuring the recover of debt. Successful models exist in India in the form of the CDR, in addition to the INSOL Global Principles, which can be considered by the countries in the region for adoption.

Current risk assessment and management systems and policies

Risk assessment and management systems

While many banks have good credit risk management systems and procedures in place, others are in the process of doing so. Even though credit marketing and credit risk functions are segregated in the leading banks, they are yet to take root, mainly because of the lack of trained professional personnel and the prevailing mindset. There is a general lack of use of effective tools and techniques for credit risk management and credit information collection, collating and sharing in the region. The banks (except large banks in India, Pakistan and Sri Lanka and the foreign banks in all the countries) do not employ effective and efficient internal procedures for managing credit defaults, recovery and resolution. Most banks have well-established legal departments, but the staffs do not possess a strong working knowledge of a wide range of recovery and resolution techniques. Sufficient attention is not paid to managing credit default and there is a tendency to rush to enforce security. The credit recovery departments, wherever they exist, do not possess the knowledge and skills required for balancing the need for keeping the business alive while ensuring timely and adequate recovery.

India

The government of India, the RBI and other related agencies have been frantically engaged in introducing banking and financial sector reforms. RBI has been making serious efforts to create suitable and comprehensive models for risk-management by banks and to integrate this new discipline into their working systems. There has been a systemic dismantling of controls and deregulation of commercial banks. Entry of new private sector banks is being encouraged and permission is being granted to foreign banks to open further branches, leading to the opening of banking to global standards by making them function efficiently in a competitive environment. The process of

deregulation freed the banks from the control of the Finance Ministry and the RBI. Banks now operate independently in a competitive financial market, but have to comply with prudential norms and safeguards essential for their wellbeing.

Implementation of Basel II norms is on the way. There is a larger emphasis on good corporate governance by banks. The RBI has identified risk-prone areas in asset-liability management, credit management, changes in market conditions and counter-party and country risks and has evolved suitable models for managing such risks. The RBI has also created a system of risk-based bank supervision. It advised banks on a parallel scheme for carrying out internal audit based on risk perception. The RBI has put in place a system for periodic circulation of details of wilful defaults of borrowers of banks and financial institutions. This serves as a caution list while considering requests for new or additional credit limits from defaulting borrowing units and also from the directors, proprietors or partners of these entities. The RBI also publishes a list of borrowers (with aggregate outstandings of INR 1 crore and above) against whom suits have been filed by banks and financial institutions for the recovery of their funds, as on 31 March every year. These measures serve to dissuade fresh lending to defaulters.[12]

The RBI has suggested to the banks to create a new asset category (special mention accounts) for early identification of bad debts. This would be strictly for internal monitoring. Loans and advances overdue for less than one quarter and two quarters would fall under this category. Data regarding such accounts will have to be submitted by banks to the RBI. However, special mention assets would not require provisioning, as they are not classified as NPAs. An asset may be transferred to this category once the earliest signs of sickness/irregularities are identified to help banks look at accounts with potential problems in a focused manner right from the onset of the problem, so that monitoring and remedial actions can be more effective. Once these accounts are categorised and reported as such, proper top management attention would also be ensured. Borrowers having genuine problems, due to a temporary mismatch in funds flow or sudden additional funding requirements, may be considered at the branch level. For this purpose, a special limit to tide over such contingencies may be built into the sanction process itself. RBI has issued revised guidelines on provisioning requirements with respect to bank advances.

Pakistan

Recent years have seen several major changes in the Pakistani financial system. Significant improvements across a wide spectrum of risk management and banking regulation have taken place. The banking system is healthier and has a greater capacity to absorb shocks. NPLs are declining. The macroeconomic environment is supportive. New areas of lending are opening up rapidly. Regulation for a sizeable chunk of the financial system, comprising leasing companies, investment banks, mutual funds and insurance companies, has been moved to the Securities and Exchange Commission (SECP).

The banking system is consolidating by successively raising the minimum (paid-up) capital requirements in a phased manner.[13] The State Bank of Pakistan and the SECP have issued codes of corporate governance. Disclosure standards have improved, though the quality of financial statements continues to be marginal. Substantial progress has been made in banking audit and supervision. Compliance with the Basle Core Principles is generally high. The SBP now conducts comprehensive on-site inspections using a standardised CAMELSS (Capital, Assets, Management, Earnings, Liquidity, Sensitivity to Market Risk, Systems) framework for rating the overall condition of a bank.

There are many issues which continue to hamper the efficiency of secured lending procedures. There is no central register of land title and, outside the main urban centres, land title is determined from the revenue record *i.e.* it is based on the assumption that the person who is liable for taxes is the

owner of the land. There is no concept of a will in Pakistan (Islamic laws of inheritance in which the share of each relative is specified). Execution (by a bank) on any mortgaged land/property can be thwarted by litigation from a female relative on the grounds that she had not received her due share in inheritance. Under current law, there is no statute of limitations on claims by women and their heirs. Oral gifts, Benami transactions and pre-emption laws are other challenges. The cumulative effect of these laws and social practices is that banks are extremely reluctant to lend against real estate outside the main urban centres. Furthermore, even in the main cities, banks are (understandably) very cautious in approving housing finance transactions. The debt/equity ratio they often apply is around 50/50, as opposed to 80% debt financing, which is the norm in countries like the UK. Therefore, the removal of these impediments is crucial to the development and broadening of the banking sector in Pakistan.

There is a need to expedite the enactment of the CRA (the pending corporate insolvency bill). There is also a need to address the major deficiencies in the legal system (including the repeal of out-dated laws and practices), identified in several sections of this paper.

Sri Lanka

The Sri Lankan financial sector has performed well in recent years and the commercial banking sector continues to grow reflecting the recovery in the economy. An increase was seen in the utilisation of banking sector resources by the private sector, particularly towards the end of the year, while the dependence of the public sector on banking resources has decreased. However, unsatisfactory lending practices and inefficiencies in the banking sector have kept interest rate spreads high and restrained further growth in credit to the private sector. The banking sector, which dominates the financial system, provides the lowest level of credit to the private sector as a ratio to GDP among South Asian neighbours and far less than that in East Asia.[14] NPLs for the industry are estimated by the Central Bank at 15.3% which translates to around LKR[15] 90 billion for 2002.

Considerable reforms have been implemented in Sri Lanka during the last two decades, which have made the financial sector vastly more efficient and resilient. The institutions have adapted themselves creditably to the competitive market-oriented economic reforms initiated by the government. They are adopting standard international norms of prudential conduct and disclosure. In keeping with the adoption of best practices and codes, the Central Bank of Sri Lanka (CBSL) led a task force on corporate governance for the financial sector, which issued specific guidelines for banks, which are expected to be adopted by consensus rather than coercion. The Central Bank has embarked on a systematic upgrading of bank supervision aided by a close and confidential consulting process.

CBSL is an efficient and independent regulator and effectively oversees the implementation of its guidelines and instructions on capital adequacy, prudential norms, provisioning requirements, implementation of Basel norms and others. However, sophisticated methods for tracking and monitoring default levels; tracking of data and statistics; and collecting, compiling and analysing credit information do not exist. The Banking Supervision Division of the CBSL continues to monitor compliance by banks with regulatory requirements introduced from time to time under the provisions of the Banking Act and other prudential directions applicable to capital, liquidity, large exposures, share ownership in banks, investments in shares by banks, asset quality, income recognition, provisioning for bad and doubtful debts, related party transactions, acquisition of immovable property, disclosure of quarterly and annual financial statements and the audit of banks.

Nepal

Nepal has a fairly significant financial system. As of April 2004, the financial system consisted of 17 commercial banks, 19 development banks, 5 regional rural development banks (RRDBs), 116 postal saving banks, 58 finance companies, 33 saving and credit co-operative societies involved in limited banking activity, 44 non-government micro-credit institutions, 1 stock exchange with a network of brokers and securities dealers, 18 insurance companies, 1 employees' provident fund, 1 credit guarantee and deposit insurance corporation, and 1 Citizen Investment Trust. Of these institutions, the commercial banks, development banks, RRDBs, finance companies, financial co-operatives and NGOs are under the regulatory framework of Nepal Rastra Bank (NRB).

The NRB is playing a very active role with technical assistance and support from international experts in improving the overall control and supervision of the financial system. It has paved the way for financial sector reforms and de-regulation to some extent. These measures have improved the liquidity in the financial system and enhanced the degree of competitiveness. NRB laid out various prudential norms; set up the Asset Liability Management Committee to meet periodically to review market risks (interest rate, liquidity and forex risk); established audit committees to meet periodically to review audit inspection reports, etc.; required banks to make various disclosures while presenting the financial statements to the annual general meeting for approval; and introduced disclosure norms that are in compliance with international standards. The accounting policies of banks and financial institutions are required to be stated in the annual financials relating to income/expense recognition, the translation of foreign currency transactions, provisions for possible loan losses, write-off, fixed asset depreciation and amortisation, details of investments along with the basis of valuation, etc. It is mandatory for commercial banks to comply with directives of the regulator with regard to lending to productive and priority sectors.

However, the banks in Nepal continue to suffer from a lack of credit risk management. Financial statements (including audited statements) do not reflect a "true and fair" view of the business entity due to creative accounting. The audited financials statements do not reflect details relating to: (a) encumbrances of the company's current/fixed assets, plus to whom they are charged; (b) details of group lending/borrowings; (c) contingent liabilities; (d) accounting policies; (e) status of income tax assessments, etc. The delegation of lending authority is based on seniority and not on the competence of the concerned officials. There is no exchange of credit information that leads to a lack of transparency among competing banks, which, in turn gives rise to multiple banking (the same customer having facilities with different banks), excessive financing, double financing, diversion of funds, capital flight, asset coverage shortfalls, etc.

There is an absence of risk-based pricing methodologies, customer risk rating models, and facility risk rating models. There is lack of appreciation of the need to staff operations with skilled professionals since most of banks are set up by promoters who are traders. Pronounced name lending, and collateral-based lending instead of need-based/cash flow-based lending are the other problem areas. The blacklisting guidelines contribute to new NPAs due to the spread of contamination. Other problems are overbanking, political instability, a slow growing economy, a small domestic market, an ineffective judiciary, cross-border risk, inadequate law for dealing with financial crimes, etc.

The NRB needs to strengthen its supervision and control of the financial system and ensure compliance with its directives to a greater degree. Though NRB has issued various directives on capital adequacy, prudential norms, provisioning requirements and risk management methods, banks do not comply with them. Nor does the NRB have the capacity to effectively supervise their observance and implementation. The banks do not possess adequate skills to evaluate borrower's loan

requests and assess collateral requirements to cover risk. The Nepal Banker's Association lacks the capacity to help in the development and implementation of policies in conjunction with the NRB.

One of the major problems in the banking system is the high level of NPAs, which has remained at around 29% in 2003. An asset management corporation has been proposed to help the banks to improve their loan recovery and their asset portfolios, and reduce the level of NPAs. A draft AMC Ordinance is under the consideration of the cabinet. The initial draft–which was commented upon by the World Bank–highlighted a number of structural, administrative and legal issues. Adequate powers, skilled staff, sufficient resources and sufficient autonomy are main prerequisites for the success of AMCs. The law ought to contain procedural details and objective criteria wherever needed. In addition, there is a clear need for the autonomy of the AMC and for its staff to act independently. Given the closed nature of the Nepali financial sector (and the business community in general), as well as the inevitable close ties to government, it is almost a prerequisite that the management of the AMC be from outside Nepal.

Bangladesh

The Bangladesh banking sector is comparatively larger than many economies of a similar level of development and per capita income relative to the size of its economy.[16] The total size of the sector at 26.54% of GDP dominates the financial system, which is proportionately large for a country with a per capita income of only about USD[17] 370. The non-bank financial sector, including capital market institutions is only 3.2% of GDP, which is much smaller than the banking sector. The financial system also embraces insurance companies, stock exchanges and the co-operative banks. The Bangladesh Bank (BB), as the central bank, has the legal authority to supervise and regulate all the banks. While there are sound banks, the banking sub-sector is technically insolvent. Consolidated data tend to understate provisions significantly. Adjusting for the understatements, the financials of the banking sub-sector are characterised by a 32% NPL ratio, a USD 720 million shortfall in provisions, a USD 1 billion shortfall in provisions and capital combined, and losses of USD 685 million after adjusting for the shortfall in provisions in mid-2001. The adjustments could possibly be larger if provisioning as followed by major international auditors were applied.

Bangladesh like many other developing countries, started financial sector reforms since 1990 as a part of its overall economic stabilisation programme. Defaults on loans in 1990 by industrial and nationalised commercial banks[18] in Bangladesh stood at USD 1.1 billion, when the World Bank stepped into the banking sector with its Financial Sector Reform Programme. Nevertheless, by the end of the 1990s, the total bad debt had grown to USD 4.3 billion. The government started with a five-year financial sector reform project under the supervision of a foreign expert and adopted a good number of measures to restore discipline in the financial sector, particularly in the banking sector. The five-year financial sector reforms programme was ended in 1996 and commercial banks a restructuring project was established in 1997 with a view to improving the recovery of classified and overdue loans. A revised policy for loan classification and provisioning was introduced as of 1 January 1999. As a part of these reform measures, the government enacted a good number of laws concerning the financial sector, with a view to salvaging the NCBs, particularly through improving their bad loan portfolios. The most significant step taken by the government was the enactment of the new Artha Rin Adalat Act of 2003, which set up separate courts for speedy recovery of defaulted loans. The Bankruptcy Act was also enacted in 1997 to deal with the cases of large defaults.

The ongoing reform drive in the banking sector entered into a new phase with the government's decision to appoint financial advisers for each of the four nationalised commercial banks to help improve their management and financial health. The operations of the commercial banks, particularly the NCBs, are now carried out in a more disciplined and efficient way leading to a decline in defaults.

Credit information systems

The credit information systems in all the countries in the region need urgent attention. Traditionally, banks and financial institutions have been reluctant to share credit information about their constituents owing to a perception that information received from and relating to clients is confidential. Over a period of time, the principle was embedded in the form of substantive provision in the banking laws.

In India, the laws require banking companies and lending institutions to maintain secrecy in respect of the affairs of their constituents as a matter of legal obligation.[19] In 1962, the Reserve Bank of India Act, 1934 (RBI Act) was amended vesting with it the power to collect and furnish credit information from banking companies. The RBI could collect information and furnish it to those banks that applied for it, without disclosing the name of the banking company. The information provided has to be treated as confidential and cannot be published or otherwise disclosed except for the purposes specified. In 1994, the RBI announced a scheme to collect details about borrowers with outstanding liabilities classified as doubtful, loss and suit filed.[20] In 1999, the RBI introduced a scheme requiring banks and notified financial institutions to report cases of wilful default on a quarterly basis.[21] The lists are consolidated and circulated to banks and financial institutions. In 2000, the RBI advised banks to obtain consent from borrowers to publicise the names of those who default on repayments.[22] Based on the information submitted under the different schemes, the RBI publishes a list of suits filed and cases of wilful defaults on its website.

The efforts of the RBI allow only limited negative information to be collected and furnished to the requesting banking company. The information has certainly helped banks observe caution in respect of lending to defaulters. But since the list does not provide information on first-time borrowers or borrowers who have not defaulted (though they are likely to default in future), it does not serve the overall objectives of credit information. There is no satisfactory mechanism that could act as a repository of credit information (both current and historical data on existing and potential borrowers) and a database of credit information (both positive and negative), which could be accessed by the lending institution.

The Sri Lankan banking industry functions in a restrictive information-sharing environment. The banks are required to observe secrecy in respect of all transactions, customers, the state of accounts and matters relating thereto. The Banking Act of 1988, which deals with the licensing, regulation and control of banking businesses requires every director, manager, officer or other person employed in the business of a licensed commercial or specialised bank to pledge himself not to reveal any matter except "in the performance of his duty" or when required to do so "by a court of law" or "by the person to whom such matters relate" or "to comply with the provisions" of the Banking Act. These restrictions hamper the development of a credit information collection and dissemination culture and obstruct the emergence and development of an efficient credit information system. The Central Bank of Sri Lanka performs a function in the collection of credit information, compliance and implementation of prudential norms and other requirements by receiving quarterly reports from banks. However, this information does not contain details and other information on borrowers and, in any case, is kept confidential and not shared with other banks.

The financial systems in Bangladesh, Nepal, and Pakistan function under a severe handicap due to the lack of exchange of information about the business entities availing themselves of credit facilities. Thus, the system is exposed to high degree of credit risk.

Credit information bureaus

Sri Lanka has a fairly well developing body to collect and disseminate credit information. Bangladesh and Nepal have bureaus though their effectiveness leaves much to be desired. India is on its way to providing a statutory backing to its Credit Information Bureau (India) Ltd., currently a limited company (See Table 4).

Table 4: Credit information systems

	India	**Pakistan**	**Sri Lanka**	**Bangladesh**	**Nepal**
Credit Information Bureaus	Credit Information Bureau (India) Ltd.		Credit Information Bureau of Sri Lanka	Credit Information Bureau	Credit Information Bureau
Legal Status	Not Statutory		Statutory	Departmental	Department of Central Bank
Promoters	State Bank of India, HDFC and Private Sector.[23]		State, Central Bank and Financial Institutions		Managed by Financial Institutions and Banks

The Credit Information Bureau (India) Ltd.

The Credit Information Bureau (India) Ltd. (CIBIL) was set up in January 2001 to collect positive and negative credit information on retail and corporate borrowers to help creditors make informed decisions. Since the existing banking legislation does not allow banks and financial institutions to share credit information with the bureau, information is confined to transactions where banks have filed suit to recover their dues and in respect of which the consent of the client has been obtained to disclose the information. India is introducing legislation to provide statutory backing to the Credit Information Bureau. The law is expected to be enacted shortly. This will provide for ownership/protection of data and the accuracy thereof, permissible purpose for the usage of data, rights of customers and service providers, and protection available to the bureau and the credit institutions sharing the data. The RBI has advised all scheduled commercial banks to become members of one or more credit information bureaus in order to maintain the selectivity of customers in their credit card businesses.

The Credit Information Bureau of Sri Lanka

Sri Lanka set up the Credit Information Bureau of Sri Lanka (CRIB) "to collect and collate, trade, credit and financial information on borrowers and prospective lending institutions; to provide credit information, on request, to lending institutions who are shareholders of the Bureau and simultaneously to borrowers and prospective borrowers to whom such information relates; to establish a credit rating system in Sri Lanka; to undertake credit rating and to sell such credit ratings to any foreign and local agencies, or to any person making a request for such ratings; and to undertake research projects for lending institutions who are shareholders of the Bureau with a view to facilitating the distribution of credit to all sectors of the economy and to the informal sector, in particular."

Although the bureau has performed reasonably well operationally and financially during the past few years, it continues to suffer from many deficiencies and problems affecting its overall efficiency and performance. The CRIB has confined its functions to collecting and providing information to its

members. It does not undertake credit scoring or rating though it is one of its objectives. Its operations are narrow, and restricted to furnishing information on the request of the lender in receipt of a request for borrowing, and not otherwise. CRIB does not undertake all the functions envisaged under its charter. The development and sharing of credit information continues to be hindered by secrecy laws. The CRIB and banks are reluctant to expand the scope of information dissemination fearing the violation of these laws in the process. CRIB faces legal actions against it in court for damages, restraining orders from furnishing information, and other problems that create further reticence to information sharing.

CRIB faces infrastructure and resource constraints that affect the timely receipt of credit reports, and the reporting and updating of information. With the assistance of the World Bank, a project is now underway to upgrade the information and technology system of the CRIB to a web-enabled system. Institutions like courts, the Securities and Exchange Commission, the Registrar of Companies, the Registrar of Persons, and the Registrar of Businesses (that hold valuable information about companies, promoters, financial health, activities and assets, pending disputes, etc.) do not share such information with the CRIB, thus depriving it of expanding its database of information.

There are many other difficulties faced by CRIB such as: the inability to collect important data (national identity card number, full name and address, etc.); failure to report advances that fall within the reporting criteria; reporting of advances only when they become irregular; failure to update information properly and on a timely basis; balances outstanding not reported/correctly written off; updating of information with ambiguous remarks; duplication of records; reporting of advances as legal actions before initiating legal action in a court of law; request forms with inadequate/incorrect data, etc. The number of advances reported by some lending institutions is far below what actually occurs. These factors also affect the efficiency of CRIB.

The restrictive provisions in Banking Law create ambiguity in the system and require modification to facilitate the exchange of information. Sufficient safeguards should simultaneously be provided for data protection. The privacy principles, supervision of the CRIB, and grievance redress mechanisms would increase the participation of the private sector. There is a need to expand the functions and areas of activities of the CRIB. It should make comprehensive reports available that provide: basic company data such as date of incorporation; authorised and paid up capital; location and address of different offices; directors and major shareholders along with their shareholdings; background and history of the company; information about the activities of the company; number of employees; sales and purchase terms and operating premises; name and address of bankers; information about key partners or the chief executive of the company; financial data; name and involvement with subsidiaries, affiliates and parent company; any event, incident or activity of the company; disputes and pending litigation and all other relevant information. The networking between banks needs strengthening through the creation of effective means and channels of communications and information sharing. The CRIB could create a database and provide the type of comprehensive credit information necessary for credit scoring. The membership network could become broader based and its areas of activity expanded.

The Credit Information Bureau of Nepal

The Credit Information Bureau (CIB) of Nepal is promoted by banks and is used primarily to ascertain "blacklisting" status. CIB was established in 1989 under the Nepal Banker's Association and finds it legal basis in the Nepal Rastra Bank Act, 2012 (1955), which requires the NRB to establish a CIB to obtain and exchange information on the flow of credit from commercial banks and financial institutions in order to ensure fairness and appropriateness in credit flows, and to blacklist debtors not repaying loans on time or misusing loans. CIB currently collects information from both

banks and finance companies. It operates as a department of NRB and implements the blacklisting directives of the NRB. The input and database of the CIB have been computerised. In the absence of other legal provisions to back a credit information bureau, Section 88 may be utilised to form a bureau in the form of a company owned by the NRB and other financial institutions. Nevertheless, it is necessary to ensure that the bureau has sufficient legal powers to ensure compliance with the submission of credit information by participants.

It is mandatory for banks, before sanctioning, enhancing or reviewing any credit facilities beyond NPR[24] 1 million per party, to seek information from the CIB as to the borrowings from the system. CIB is expected to provide the data within a specified time frame to the applicant bank. The response provided by the CIB merely indicates the aggregate amount of borrowings by the business without any further inputs as to the terms of the borrowings, the security offered or the names of lending institutions. Such a response is not of great assistance. The information contained in the responses is not updated and may be four to six months old.

The Credit Information Bureau (CIB) of Bangladesh Bank

The Credit Information Bureau (CIB) of Bangladesh Bank provides credit details on all borrowers. It is now mandatory for lenders to obtain a CIB report prior to providing any credit facilities. However, the system remains inadequate and is limited to information provided by other banks. This does not allow for an independent credit rating of the borrower as is available in most developed countries.

The Credit Information Bureau of Pakistan

The Credit Information Bureau of Pakistan is a confidential database maintained by the State Bank of Pakistan (SBP). The Bureau does not have statutory backing and can only be accessed by persons authorised by the SBP.

Credit rating

There are some well-developed credit rating agencies in India. Credit Rating Information Services of India Limited (CRISIL) is one of the leading agencies in the region. There are a few others, namely, Investment Information and Credit Rating Agency of India (ICRA), Credit Analysis & Research Limited (CARE) and Duff & Phelps Credit Rating India Private Ltd. (DCR India). In Sri Lanka, Fitch Ratings Lanka Ltd. is the only rating company operating at present. Deposit taking institutions are required to obtain a credit rating and publish the rating obtained as per the 2003 budget. By the end of February 2004, Fitch Ratings Lanka Ltd. had published ten entity ratings for financial institutions. It had also published three entity ratings given to companies. It is now also mandatory to obtain a credit rating for issues of all varieties of debt instruments, except for those issued by the government, where the value exceeds LKR 100 million. Amongst the issue ratings published up to February 2004, were the five-year debentures of Sri Lanka Telecom Ltd. issued in 2000 and listed on the CSE (SL AA+), the issue of 100 million preference shares of LKR 10 of the Commercial Bank of Ceylon Ltd. issued in 2003 and listed on the CSE (SL AA-), the five-year debentures of Commercial Bank of Ceylon Ltd. issued in 2003 and listed on the CSE (SL AA), LKR 400 million in debentures of Aitken Spence & Company Ltd. issued in 2002 and listed on the CSE (SL AA), and the three-year debentures of Singer Sri Lanka Ltd. issued in 2002 (SL A).

There is no comprehensive credit rating and reporting agency. There are two approved credit rating companies in Pakistan: the Pakistan Credit Rating Agency Limited and JCR-VIS Credit

Rating Co. Ltd. (JCR-VIS). In Bangladesh and Nepal, efforts are on to develop credit rating systems. The issue has also engaged the attention of Pakistan.

Credit risk transfer

These techniques are relatively underdeveloped and unused in the region. However, a series of initiatives are underway in some countries to develop them as a part of credit risk management. In India, impressive progress has been made, and many housing finance companies, banks and financial institutions undertake securitisation transactions by setting up special purpose vehicles (SPVs) using trust structures and acting themselves as trustees. The debt instruments issued by such special purpose vehicles are rated by rating agencies and have very low default rates.

One major constraint in undertaking securitisation transactions in India is the multiple stamp duty laws applicable in various states. In transactions where the secured loan is transferred by a bank to an SVP, the transfer is coupled with the benefit of the underlying securities. Under the provisions of the stamp laws, any assignment of mortgage or other securities attracts *ad valorem* stamp duties which make the transaction unviable. Realising the various difficulties faced by the banks and financial institutions, certain states have reduced the rate of stamp duty to 0.1% and in these states (like Maharashtra, Gujarat, Karnataka, Tamil Nadu and West Bengal) securitisation transactions are being undertaken.

Statutory provisions for securitisation have been made under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act of 2002 (SRFAESI) for securitisation transactions to be undertaken by a securitisation company, which should have a minimum capital of INR 200 lakhs[25] and a capital adequacy of 15%. It is also provided that securitisation companies should register with the RBI. A proposal to segregate securitisation from the provisions of the SRFAESI and enact a separate law for securitisation with enabling provisions for setting up a trust (which is a bankruptcy proof, pass-through structures), is under consideration by the RBI and the government. After enactment, it is expected that the market for debt instruments will grow further.

Credit risk transfer instruments and institutions are absent in Bangladesh and Nepal. Pakistan and Sri Lanka have some experience in factoring, and the development of the securitisation market is under active consideration. The market or instruments for performing credit risk transfers are underdeveloped. The basic concept of securitisation is still at the developmental stage, even for the best assets. It will probably be some time before a proper credit transfer mechanism is developed in Bangladesh. The Asian Development Bank is providing technical assistance to India and Sri Lanka in mortgage-backed securitisation in the housing sector.

Conclusions and recommendations

The countries in the region lack a comprehensive insolvency code and roadmap to deal with corporate bankruptcy. The existing legislation requires a comprehensive review to bring in elements of a modern insolvency framework. The biggest challenge faced by the winding up proceedings is lengthy process. There is a pressing need to provide a definite and meaningful time frame to conclude proceedings in a reasonable period of time so that the process becomes attractive for its users and so that stakeholders recover maximum value from assets. The legal framework for corporate insolvency in, Bangladesh, Nepal and Sri Lanka does not provide for any formal reorganisation regime. There is a pressing need to provide a mechanism to revive potentially viable businesses.

The trend, in general, appears to be in favour of special courts within or outside the existing framework. India decided in favour of setting up of the NCLT as part of the tribunalisation of justice and to bring in the multi-disciplinary knowledge necessary for restructuring, reorganisation and the conduct of bankruptcy proceedings. There is a need to minimise the role of the court in insolvency and restructuring processes by delegating the functions to the two key players–creditors and insolvency practitioners. Excessive court involvement in the process leads to delays.

The UNCITRAL Legislative Guide on Insolvency recommends that the role of the court should be supervisory and its participation should not be sought on day-to-day procedural matters. Its intervention should be confined to matters of interpretation, resolution of disputes, deadlock and ensuring fair and judicious process. The insolvency courts/bench should be provided with an adequate and modern infrastructure, with access to technology and information, so that they can handle the specialised work of liquidation and restructuring. They should be institutionalised and professionally managed. Government interference and control should be kept at a minimum, and dependence on the government to run the tribunals should be reduced.

More care and transparency is required in the appointment of judges handling insolvency cases, in order to ensure the selection of candidates who have both qualifications and practical experience in this field of law. Appropriate continuing training could reinforce the quality and skills of judges, whether newly appointed or existing. Administrative and technical staff should be qualified and trained, and receive continuing training. Appropriate procedures and standards should be devised to evaluate judicial performance.

Policy makers need to take the initiative in institutionalising and regulating the insolvency profession. Some substantive provisions for such institutionalisation need insertion in the law. There is a need to build capacity among insolvency practitioners, provide continuous training, and encourage best practices. While the laws are being strengthened and professionals are being involved in the process, stakeholders obviously need to be reassured that the professionals are adequately qualified and sufficiently experienced to deal with complex business situations. In particular, stakeholders would want to have clarity on their qualifications, experience, appointment, training and knowledge, credibility and accountability, fees and disqualifications. There is a need to create a self-regulating body that is supported by the government, existing bodies of professionals, industry and similar associations in other countries. The Indian Society of Insolvency Practitioners (ISIP) is an initiative with these characteristics that helps develop and institutionalise the profession in India. The Nepal Insolvency Practitioners Association (NIPA) and the Business Recovery and Insolvency Practitioners Association of Sri Lanka (BRIPASL) can be developed into self-regulatory organisations.

There are no sophisticated methods for tracking and monitoring default levels, data and statistics, or for the collection, compilation and analysis of credit information. Banks do not oversee client businesses nor follow the usual techniques of risk management. There is scarce use of effective tools and techniques for credit risk management and credit information collection, collation and sharing. Insufficient attention is paid to managing credit defaults and there is a tendency to rush to enforce security. Credit recovery departments need to enhance their knowledge and skills in order to balance the need for keeping businesses alive with ensuring timely and adequate recovery. There is a need to review relevant laws and regulations in the enabling framework to: maximise incentives for corporate restructuring; develop informal rules and guidelines for addressing credit risk management practices; and building capacity for credit risk management, and credit information sharing and application. The government should encourage the development of credit rating agencies.

The implementation framework is weak and is not observed with respect to the courts, and regulations pertaining to insolvency practitioners. The effectiveness and efficiency of the system

requires substantial enhancement to create incentives for stakeholders to participate. There is an urgent need for greater implementation. Even a well-intended law, if not properly implemented, can fail to serve its purpose, however good the law may be.

The essential features governing a model formal restructuring process are common if not alike in any part of the world. Then why do they fail in one country and succeed in others? South Asian countries need to focus and improve their implementation. There is a need for a more creative and commercial approach to corporate entities in financial distress and attempts need to be made to revive them rather than applying the more traditional and conservative approach of liquidation or bankruptcy.

The banks in Bangladesh, Nepal and Sri Lanka need to improve informal out-of-court workout procedures. The absence of a framework for informal restructuring in these countries creates a pressing need for legislation or a mechanism for out-of-court restructuring. The Corporate Debt Restructuring Scheme of the Reserve Bank of India or the Malaysian CDRC can be considered as models.

There is a lack of dependable credit and status information about potential business connections that creates a pressing need to build a sound legal framework for the provision of credit information, references and ratings. None of the CIBs provide the type of comprehensive credit information necessary for credit scoring. Since credit information is vital for taking lending decisions, an appropriate regulatory authority is required to have control over the CIBs. Experience shows that CIBs are either set up as divisions of central banks or in the private sector where they lack statutory backing.

There is a need to make available basic company data such as: the date of incorporation; authorised and paid up capital; location and addresses of different offices; directors and major shareholders along with their shareholdings; background and history of the company; information about the activities of the company, number of employees, sales and purchase terms and operating premises; names and addresses of bankers; information about the key partners or persons of the company; financial data; names of and involvement with subsidiaries, affiliates and parent companies; and any event, incident or activity of the company because of which it was recently in the news. Banking laws could be amended to facilitate the collection and exchange of credit-related information.

The banks have to remain focused on recovering bad loans or non-performing assets to sustain the trend of improving asset quality. The lack of research and academic activity in the banking sector is also felt and needs attention at the institutional level. Better risk management techniques, compliance with the core principles for effective banking supervision, skill building and training, and transparency in transactions could be the solutions. Removal of non-performing loans from the banking system (even through government or quasi government funds) is, at times, essential. Official assistance should be structured to avoid moral hazard. While NPAs cannot be eliminated, and can only be contained, it must not be done at the heavy cost of provisioning and increasing the credit portfolio. Fresh NPAs should be brought down to levels that are lower than their resolution. If this goal is reached, there is an eventual solution to this problem. In-house efforts are needed to pull out of in-house quandaries. Risk management and threat containment is an in-house obligation. In a competitive global environment, only the efficient and alert survive.

It is important to recognise that bankruptcy reform can not be seen in isolation. It may be necessary to combine it with legal and other reforms, improvements in corporate governance, strengthening of investor rights, and so on. The ability of any nation to provide greater certainty, efficiency and fairness in insolvency depends upon: the environment provided by its laws, culture and markets; the availability of trained professionals (bankers, supervisors, lawyers, accountants and

others); government competence and economic depth. A functioning insolvency system must have well-designed insolvency laws. It must also have laws that provide a basis for commercial activity, grant creditor and debtor rights, and otherwise promote predictable commercial outcomes.

Beyond legal issues, the maturity of market mechanisms will determine whether certain insolvency processes, such as auctions, bulk asset sales or others, will be effective and maximise value. Such processes will be affected by the reliability and transparency of prices and financial data, which are, in turn, dependent on the legal infrastructure and the presence of a trained cadre of financial and legal professionals. This does not mean that all of these elements must or should exist to permit an effective insolvency system. It does, however, indicate that the more a nation moves toward these mutually interdependent features, the more likely it is that the insolvency system will be successful in providing certainty, efficiency, and equitable resolutions.

Much is happening in South Asian countries to introduce reforms in insolvency, risk management systems and related areas. The ultimate impact of these actions will be reflective of the degree of effective enforcement by the regulators.

Notes

1 The Muluki Ain is a general law and contains both substantive and procedural laws covering both criminal and civil matters. Specific law overrides the provisions of the Muluki Ain.

2 Pakistan rupees (PKR).

3 World Bank Report (2003) on the functioning of CIRC.

4 As disclosed by Registrar of Companies from the register of liquidated/under liquidation companies maintained by OCR.

5 Sale of assets outside the court process under BFI Ordinance 2003.

6 Section 101(1)(c) of the Company act provides that creditors may invoke the liquidation proceedings if the loan is outstanding for more than a year and such creditors represent atleast 50% of the total outstanding loan.

7 Section 46aa the companies (Second Amendment) Act, 2002 defines sick industrial company as an industrial company which has at the end of any financial year accumulated losses equal to 50% or more of its average net worth during four years immediately preceding such financial year or failed to pay its debts within any three consecutive quarters on demand for its repayment by a creditor or creditors of such company.

8 Reference to be filed within 180 days from the date on which the board of directors has come to know the causes of making a reference or within 60 days of adoption of final accounts; enquiry by oa to determine whether the company is a sick industrial company in 21 days, which is extendable to 40 days; time for oa to prepare the scheme - 60 days extendable by 90 days; sanction of scheme within 60

days from receipt of suggestions/objections to draft scheme; and consent of creditors required to give financial assistance in any form in 60 days.

9 The court may wind up a company if the company has by special resolution resolved that it be wound up; if the company does not commence its business within a year from its incorporation, or suspends its business for a whole year; if it is unable to pay its debts. a company shall be deemed to be unable to pay its debts - if a creditor to whom the company is indebted in a sum exceeding one lakh, has served on the company a demand by registered post at its registered office requiring it to pay the sum so due and the company has for three weeks thereafter neglected to pay the sum; or if execution or other process issued on a decree or order of any court in favour of a creditor of the company is returned unsatisfied; or if it is proved to the satisfaction of the court that the company is unable to pay its debt; if a default is made in delivering the statutory report to the registrar or in holding the statutory meeting; if the number of members is reduced in the case of a public company below seven and in the case of a private company below two; if the court is of the opinion that it is just and equitable that the company should be wound up.

10 Indian rupees (INR).

11 Indian numbers covert to international numbers as follows: 1 crore = 10 million; 10 crores = 100 million; and 100 crores = 1 billion.

12 RBI circular on wilful defaulters numbered DBOD. No. D1(w).BC. /110 /20.16.003(1)/2001-02), May 30, 2002.

13 There have been 17 mergers and acquisitions during the past two years, and several are in the pipeline. The average capital base (of a commercial bank) has risen from Rs. 1.8 billion (2000) to Rs. 3.7 billion (2003). Habib Bank Limited, United Bank Limited and Allied Bank Limited have been privatized. Over 80% of the total assets of the banking system are now privately managed.

14 Association of Professional Bankers of Sri Lanka, 15th Anniversary Convention, Address by A S Jayawardena, Governor, Central Bank of Sri Lanka, Colombo, July 26, 2003

15 Sri Lankan rupees (LKR).

16 The financial sector of Bangladesh is comprised of 86 members including 50 schedule banks and 36 non-banking financial institutions. The financial system of Bangladesh consists of Bangladesh Bank as the central bank, 4 nationalized commercial banks, 5 government owned specialized banks, 30 domestic private banks, 12 foreign banks and 22 non-bank financial institutions.

17 United States dollar (USD).

18 Default but no reform: financial sector issues in Bangladesh, at March 2002 Insights Issue #40, by Willem van der Geest, European Institute for Asian Studies, Rue des Deux Eglises 35, 1000 Brussels, Belgium.

19 Section 3 of *the Public Financial Institution (Obligations as to Fidelity and Secrecy)* Act, 1983 provides that a public financial institution shall not except as other wise provided in this Act or in other law divulge any information relating to or to the affairs of its constituents except in circumstances in which it is, in accordance with the law or practice and usage customary among bankers, necessary or appropriate for the public financial institutions to divulge such information.

Section 44 of the *State Bank of India Act, 1955* provides that State Bank shall not divulge any information relating to or to the affairs of its constituents except in circumstances in which it is, in

accordance with the law or practice and usage customary among bankers, necessary or appropriate for State Bank to divulge such information.

Section 52 of the *State Bank of India (Subsidiary Banks) Act, 1959* provides that a subsidiary bank shall not divulge any information relating to, or to the affairs of its constituents except in circumstances in which it is, in accordance with the law or practice and usage customary among bankers, necessary or appropriate for that bank to divulge such information.

Section 13 of the *Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/80* provides that every corresponding new bank (i.e. nationalised bank) shall not divulge any information relating to, or to the affairs of its constituents except in circumstances in which it is, in accordance with the law or practices and usages customary among bankers, necessary or appropriate for the corresponding new bank to divulge such information.

20 Circular No. DBOD No.BC.CIS/47/ 20.16.002/94 dated 23rd April 1994.

21 Circular No. DBOD No. BC.Dl (W) 12.16.002 (1) 98-99 dated 20th February, 1999.

22 Circular No. DBOD No.BC.DL.4/20.16.002/99-2000.

23 Housing Development Finance Corporation Ltd. (HDFC), State Bank of India (SBI), Dun & Bradstreet Information Services (India) Pvt. Ltd., and Trans Union International Inc., U.S.A. signed a shareholders agreement to subscribe to the equity of CIBIL. HDFC and SBI participated 40 per cent each and two foreign technology partners viz., M/s. Dun & Bradstreet Information Services (India) Pvt. Ltd., and Trans Union International Inc., U.S.A. shared the remaining 20 per cent equity stake.

24 Nepal rupees (NPR).

25 1 lakh = 100 thousand, 10 lakhs = 1 million.

TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK MANAGEMENT: THE EXPERIENCE OF INDIA

by
M.R. Umarji

The legal system in India is based on English common law. It operates based on statutory laws and the constitution of India, which provide the basic structure of the judiciary and the powers of judicial review to the High Courts and the Supreme Court.

With the judicial system well-entrenched, professional expertise in the fields of law, accounting, costing and valuations are also well developed. Each category of professional has a self-regulatory organisation and professionals are subject to the codes of conduct prescribed by such SROs.

After India embarked upon the process of liberalisation and deregulation, reforms were undertaken in all sectors of the economy including the financial sector. Certain specific measures include:

- In the matter of exchange control, a number of relaxations have been introduced. The Foreign Exchange Regulation Act was replaced by the Foreign Exchange Management Act. In other words, the focus of exchange control, which was strict regulation and punishment of any violation of regulation, has been changed to the management of foreign exchange transactions.
- The control, regulation and supervision of the banking system has also been liberalised with full freedom being granted to banks to conduct business subject to the prudential norms and regulatory requirements of the Reserve Bank of India. Controls on credit have also been relaxed except certain requirements of lending to priority sector. Interest rates are deregulated.
- Private mutual funds are allowed to operate in the market subject to regulation by the Securities and Exchange Board of India (SEBI).
- The insurance sector, which was totally government owned, was liberalised and the private sector is allowed to undertake both general insurance and life insurance business.
- Reforms have been undertaken in the judicial system for the purpose of eliminating delays. The Civil Procedure Code was amended and there are many areas for which specialised tribunals were established.
- In the financial sector, special tribunals were set up for recovery of defaulted loans of banks and financial institutions.
- Creditor rights were further strengthened by giving powers of enforcement of securities to banks and financial institutions.
- The law relating to the winding up of companies contained in the Companies Act of 1956 was also amended for the purpose of setting up the National Company Law Tribunals

(NCLTs) with powers of amalgamations and mergers, restructuring and winding up of companies.

- In the amended provisions of the Companies Act of 1956, it is permissible for professionals to be appointed as administrators, managers and liquidators which was not permissible under the earlier law.
- The information Technology Act was enacted for E-commerce.
- The Negotiable Instruments Act was amended for the purpose of providing Truncation of Cheques.
- Foreign direct investments and foreign institutional investments were categorised and various ceilings were laid down for the purpose of permitting such investments in various sectors of the economy.
- The Capital Market Regulation was widened by providing regulations for merchant bankers, debenture trustees, mutual funds, venture capital funds, etc.

As can be seen from this list, India is progressing on the path of liberalisation and deregulation, and is adopting market economy features at a faster pace. Proposals for further reforms are already under consideration in respect of the following:

- A new law for Credit Information Bureaus;
- A new law for Payment and Settlement Systems; and
- An amendment to the Banking Regulation Law to strengthen the regulation of the co-operative banking sector.

Coupled with the above changes, corporate governance norms are also being prescribed for participants in the financial markets, and disclosure and accounting norms have been revised to make the functioning of entities doing business with public money more transparent.

Labour policy and insolvency laws

For any economy, the generation of employment and the prevention of unemployment are major policy considerations and India is no exception. In India industrial policy tilted towards the protection of labour and many measures, including statutory provisions, aimed to ensure that an industrial undertaking not close down and render the labour force jobless. Some important steps taken in this direction were:

- An industrial establishment employing not less than 100 workers is required to obtain the permission of the government before closing down (Section 25-0 of the Industrial Disputes Act of 1947).
- The Industries (Development and Regulation) Act of 1951 empowered the central government to take over management or control of any industrial undertaking.
- In cases where action could not be taken under the Industries (Development and Regulation) Act of 1951, management takeovers were done by passing an act of Parliament.
- In certain cases where such management takeovers could not solve the problems of the ailing industry, industrial undertakings were nationalised and the government ran the industry

itself. This was done in respect of certain large engineering units and composite textile mills with large workforces.

- Some state governments enacted laws for declaring any industrial undertaking a Relief Undertaking. On such declaration a standstill provision became operative and no recovery of money or any other proceeding could be taken against the undertaking.
- For the purpose of rehabilitation of any ailing industrial unit, a special law was enacted called the Sick Industrial Companies (Special Provisions) Act of 1985, which prescribes a detailed procedure for preparing schemes for the revival of sick industrial undertakings. Since most of the banks and financial institutions are public sector undertakings controlled by the government, the rehabilitation of sick industrial undertakings was facilitated by the grant of further financial assistance.

Implications for the insolvency law

A policy heavily favouring the protection of employment has implications for the insolvency law. Hence, in India the process of winding up of companies is regulated by the Companies Act and is under the supervision of the court. Since Article 19(1)(g) of the constitution gives freedom to practice any profession or to carry out any occupation, trade or business to the citizens of India, there are restrictions on closures of industrial undertakings. Such restrictions are justified on the grounds that it is in the public interest to prevent unemployment. As a result, there is a freedom to undertake any industrial activity, but no freedom to exit.

In the process of deregulation and liberalisation, a number of restrictions on industrial activities were withdrawn and relaxed. There is a need to take the process of liberalisation a step further and recognise that so long as a company is acting in the interest of shareholders and otherwise observing the law of the land, it should be free to manage its affairs, merge, amalgamate, restructure and reorganise or otherwise plan its affairs as it considers in the best interest of the stakeholders. Interference by the government, court or any tribunal should only be in the event of any detriment to the shareholders or, under the Competition Act, to prevent monopolies or restrictive trade practices. While undertaking reforms in insolvency law, there is a need to change the focus from strict regulation of companies to granting freedom to industry in conducting its activities and laying down norms for the protection of stakeholder interests.

Risk assessment and management systems

The mismatch between assets and liabilities has serious implications for interest rate risk, liquidity risk, foreign exchange risk, credit risk, etc. To manage these risks properly, risk management skills on the part of the banks need to be enhanced. For this purpose, there is a need to put in place clear asset-liability management (ALM) practices. The RBI issued ALM guidelines and complementary guidelines on risk management on 21 October 1999. It is expected that these two guidelines will help banks establish integrated risk management systems.

The RBI guidelines on risk management place the primary responsibility of laying down risk parameters and establishing risk management and control systems on the board of directors. The guidelines require that top management give priority to credit risk. The banks should put in place a loan policy, approved by the board of directors, covering the methodologies for measurement, monitoring and the control of credit risk. Banks are expected to evolve comprehensive risk rating system that serve as single point indicators of diverse risk factors of counterparties in relation to credit and investment decisions.

Taking into consideration the diversity and varying size of balance sheet items between banks, the RBI also indicated that it would be difficult to develop uniform risk management systems for all banks. Hence it was suggested that banks design their risk management framework according to the bank's requirements dictated by the size and complexity of the business, risk philosophy, market perception and the existing level of capital. In other words, banks can evolve their own systems compatible with the type and size of operation as well as risk perception.

With regard to credit risk, the guidance note covers areas pertaining to the policy framework, the types of credit risk models, managing credit risk in inter-bank and off-balance sheet exposures and implications for credit risk management arising from the New Capital Accord.

With regard to market risk, the guidance note encompasses areas of liquidity, interest rate risk and foreign exchange risk management as well as the treatment of market risk in the proposed New Capital Accord. The systems, procedures and tools prescribed in the guidance notes for effective management of credit risk and market risk are merely indicative in nature. The risk management systems in banks should be adaptable to changes in business size, market dynamics and the introduction of innovative products by banks in the future.

Many banks are now focusing on improving their existing MIS to: enhance their risk management capabilities; prepare contingency plans to measure the bank's ability to withstand liquidity crises; conduct stress tests to estimate future volatility in the value of securities; create operational risk management policies; stipulate prudential limits based on operational risk; and develop internal systems for quantifying and monitoring operational risk. The RBI is yet to issue guidelines for operational risk management for banks.

Disclosures in the balance sheets of banks

Since transparency and disclosure are accepted as areas which need to be aligned with international best practices, Indian banks are required to disclose in their balance sheets information such as ownership patterns, NPA ratios, capital adequacy ratios, return on assets, business per employee, profit per employee, movement of NPA, movement in the depreciation of non-performing assets, depreciation in investments, movement in provision of non-performing non-SLR investments, issuer composition of non-SLR investments, maturity profiles of assets and liabilities, segment reporting, etc.

Deposit insurance

Deposit insurance is designed to protect small depositors who cannot be expected to monitor the soundness of the bank's asset portfolio. In India deposits up to INR[1] 100 000 are covered under the Deposit Insurance Credit and Guarantee Corporation (DICGC) scheme. A uniform risk premium is charged to all banks irrespective of their size and soundness. With a view to reforming existing practice, the 2002-03 budget announced the conversion of the DICGC into the Bank Deposit Insurance Corporation (BDIC). Appropriate legislative changes will be proposed for this purpose. The BDIC is expected to be an effective instrument for dealing with depositor risks and for dealing with distressed banks. Efforts are being made to align the present deposit insurance scheme with that of the Federal Deposit Insurance Corporation model. Major difference between the Indian deposit insurance scheme and that of the developed nations is the lack of re-insurance and the absence of risk-adjusted premiums.

[1] Indian rupee (INR).

Text Box I on the Financial Sector

Types and number of banks and financial institutions	There are 90 scheduled commercial banks operating in the country: 27 public sector banks, 30 private sector banks and 33 foreign banks. There are 196 regional rural banks located in the rural areas of the country. There are 9 development financial institutions, 13 671 non-bank finance companies (of which 584 NBFCs are permitted to accept/hold public deposits) operating in the country. There are also co-operative banks who have limited geographical presence in their respective areas of operations.
Financial health of major lenders and potential sources of systemic risk	Immediately after the introduction of prudential norms based on income recognition principles, the balance sheets of some banks went into red. But RBI has adopted a policy to benchmark Indian norms against international best practices and align them with international standards over a period of time. The Indian banking system is now aligned with international best practices except one or two norms on provisioning if default continues beyond 365 days. The financial health of major lenders continues to be sound. As in any other market, there have been cases of distressed small banks where the RBI has stepped in and taken measures to merge the stressed bank with a healthy bank without systemic repercussions. A few failures of co-operative banks have adversely affected the business of some other co-operative banks. RBI is aware of the need for strengthening the co-operative bank supervisory framework and various steps including legislation were initiated. (Challenges: large number of banks to be regulated, regulatory overlap between several regulators and high levels of loan delinquency).
Prudential supervision and regulatory capacity	The RBI regulates commercial and urban co-operative banks, development finance institutions (DFIs) and NBFCs. Life insurance corporations and mutual funds are regulated by the Insurance Regulatory and Development Authority (IRDA) and the Securities and Exchange Board of India (SEBI). The main objective of regulation and supervision has been to maintain confidence in the financial system by enhancing its soundness and efficiency. For this purpose RBI evaluates system-wide risks and promotes sound business and financial practices. The Reserve Bank of India is fully aware and participates in the formulation of international norms through the Basel Committee. As far as implementation of such norms in India is concerned, RBI is adopting a prudent policy of introducing the changes in a phased manner after assessing the preparedness of the Indian system for the new norms.
Financial institutions suspended or closed recently	Three private sector banks were amalgamated with public sector banks over the last two years and two co-operative banks were put under moratorium during 2004-05.
Ownership structures of banks, if majority privately owned or not	Twenty-seven banks are state-owned. Thirty banks are privately owned. Thirty-three foreign banks are working as branches of foreign banks. All development financial institutions are government owned. All regional rural banks are jointly sponsored by state-owned commercial banks, the central government and concerned state governments.
Ownership and control of banks and firms by the same shareholder	The major shareholder in 27 public sector banks is the government of India. The RBI regulates these banks. Although government is the owner, the RBI has the full freedom to point out any regulatory lapses and force corrections. As far as the government is concerned, the Reserve Bank is always consulted before taking any measures, including appointment of government nominees to their boards.

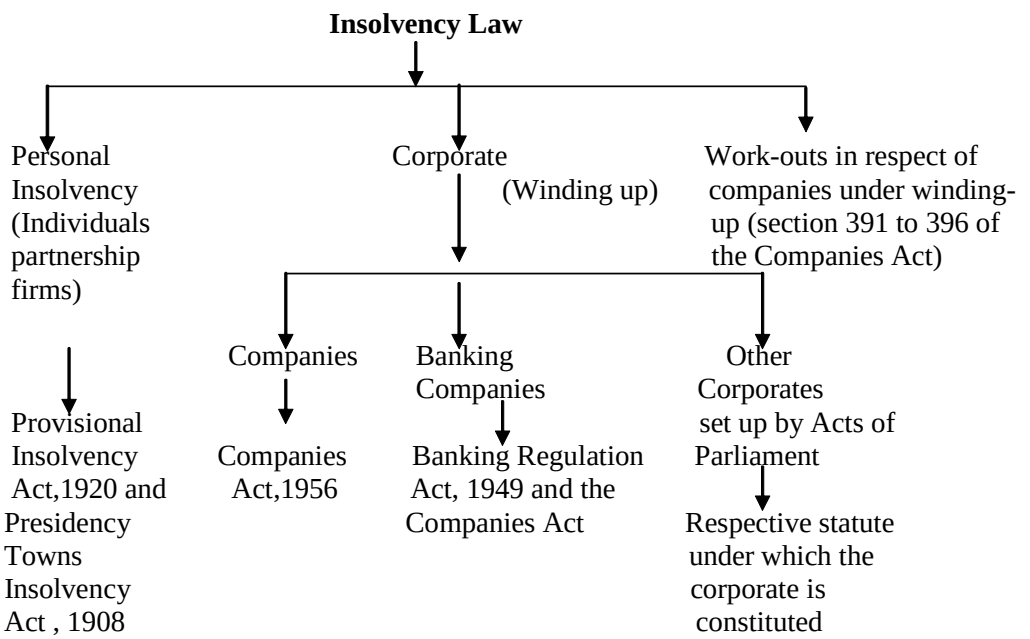
State bailouts of banks, state subsidies to state banks and interference in management of banks	Government has occasionally infused capital to the extent of INR 20 000 crore[2] in public sector banks to improve their financial strength. Government has also permitted such banks to raise capital from public investors ensuring that government's stake remains 51% of the total capital.
Types of collateral, directed lending and their percentage	Banks are expected to provide 40% of the net bank credit to priority sectors comprising agriculture, SSI and other weak sectors. Such directed lending is more in the form of policy directions. Banks are free to take their own loan decisions and there are no penalties for not achieving targets for such lending.
Risk management capacity, financial market characteristics and role in risk management	Risk management is recognised as one of the important requirements for a sound banking system. Detailed guidelines have been issued to the banks for asset liability management and risk management five years ago. RBI has also started risk-based supervision of banks. RBI has issued directions for mitigating risks in the money, debt securities, equities and foreign exchange markets.

Current Legal and Institutional Developments:

The insolvency laws in India can be segregated into three parts:

- Pre-insolvency workouts;
- Personal insolvencies; and
- Corporate insolvencies.

The laws applicable to various insolvencies are illustrated in the following chart:



[2] Indian numbers covert to international numbers as follows: 1 crore = 10 million; 10 crores = 100 million; and 100 crores = 1 billion.

Pre-insolvency workout schemes:

- The Companies Act of 1956 (Sections 391 to 396);
- The Sick Industrial Companies (Special Provisions) Act of 1985;
- The Corporate Debt Restructuring Scheme;
- The Asset Reconstruction under Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act of 2002 (SARFAESI); and
- The RBI Guidelines on Special Mention Accounts.

As far as the laws relating to personal insolvencies are concerned, they are relevant only in the context of certain basic principles of insolvency proceedings which are applicable even to the winding up of companies. In the process of liberalisation, deregulation and adopting a market economy, India is experiencing massive growth in retail loans, housing loans and credit card users. On account of the phenomenal rise in retail lending, it will be necessary in the near future to review personal insolvency laws to ensure that any proceedings against individuals are also expeditiously decided.

Although the statutory provisions in regard to various commercial laws are well-defined, there is a problem of delays of the judicial system in the matter of implementation or enforcement of contractual rights and other claims. Here again the trial and decision of any suit for enforcement of contract or for a recovery of money or compensation/damages for breach of contract are to be decided by filing a civil suit in the civil court. There is no jury system applicable in civil suits. But, the Civil Procedure Code and the law of evidence have detailed provisions which are very time consuming and prone to delays on account of appeals. In the matter of recovery of loans and advances granted by the banks and financial institutions from the defaulting borrowers, lenders faced delays in the enforcement and realisation of securities and the recovery of the loans. Unsecured lenders and other claimants against any person or company continue to face the same delays if the recovery of the defaulted loans or claims is to be made in insolvency proceedings. In fact, in regard to the winding up proceedings against any company registered under the Companies Act of 1956, the delays are more pronounced on account of the rigid system of sale of assets by the official liquidator appointed by the court. As a result of inordinate delays, lenders do not consider proceedings for insolvency as a viable mode for the recovery of defaulted loans.

The insolvency of a borrower and the consequent default in repayment of a loan is a risk which every lender takes. The mitigation of such risk is achieved by promoting secured lending and recognising the rights of secured lenders to take possession of securities and sell them in the event of default. As far as India is concerned, the commercial laws in India recognise the rights of the secured creditor to remain outside the winding up/insolvency proceedings against a borrower and to enforce the securities taken for the loan outside such insolvency proceedings. The reforms required in the insolvency laws in India need to be directed towards eliminating delays in concluding such proceedings. There is also a need to streamline statutory provisions in regard to the rehabilitation of sick industrial companies and workout schemes for revival of such companies.

Another aspect of insolvency law which is related to the expeditious completion of insolvency proceedings relates to the claims of unsecured creditors and other claimants. In many cases there are no assets available for satisfying the claims of unsecured creditors even partially on account of the strong recognition of rights of secured creditors and statutory provisions for certain preferential payments due to the government and labour. Reforms are urgently needed for expediting decisions in insolvency proceeding to prevent the deterioration of the assets to be sold, for ensuring better

realisation of the assets, and also the possibility of selling the business as a going concern, which can take care of the claims of unsecured creditors to a certain extent.

Recent changes in corporate insolvency laws

The government has appointed a committee to consider reforms in the provisions relating to winding up of companies in the Companies Act of 1956 under the Chairmanship of Justice V.B. Balakrishana Eradi, retired judge of the Supreme Court. Based on the recommendations of the Committee, the relevant provisions of the Companies Act of 1956 have been amended as follows:

- The jurisdiction for winding up of companies belongs to the National Company Law Tribunals (NCLTs) to be set up under the amended provisions. Proceedings will no longer need to be filed before the high courts.
- Provision has been made for the appointment of professionals as liquidators which was not permissible earlier. Remuneration of liquidators is also statutorily prescribed subject to a maximum of 5% of the value of the debt recovered and the realisation of the sale of assets.
- The amended provisions propose that the National Company Law Tribunals (NCLTs) shall replace the Board for Industrial and Financial Reconstruction (BIFR) constituted under the Sick Industrial Companies (Special Provisions) Act of 1985 (SICA) for the purpose of preparing workout schemes for sick industrial companies.
- The amended provisions of the Companies Act are the same as the SICA except that there is no standstill provision as under Section 22 of SICA and the definition of sick industrial companies has been revised.
- An act for the repeal of the SICA has also been passed by the parliament. The abolition of BIFR has yet to take place. It is expected that the new NCLTs will be set up with a simultaneous order for the abolition of BIFR.
- The constitutional validity of the Companies Amendment Act in regard to setting up of NCLTs was challenged before the Madras High Court. The Madras High Court has held that certain provisions in the Companies Amendment Act relating to the terms of the office of the NCLT and the powers given to the administrative member of its tribunal are invalid. It is understood that the issue relating to correcting the objected provisions is under consideration of the government and the stalemate with the Madras High Court is expected to be resolved shortly.

Pending amendment of the provisions found to be objectionable by the Madras High Court, the *status quo* relating to the rehabilitation of sick industrial companies by the BIFR continues, and the amended provisions of the Companies Act of 1956 are yet to become effective and operational. As a result of the Madras High Court judgement there is a vacuum which needs to be cleared urgently.

Further reforms

The process of workout or closure of an industrial company is tightly regulated and is done under the supervision of the courts or tribunals. There is a need for deregulation in this area to permit the company and its creditors to agree on the reorganisation, restructuring or closure of the company with the assistance of expert professionals. The law should provide an environment conducive to such workouts and access to the courts or tribunals in the event a stakeholder has a grievance.

Further reform measures that could be considered are:

- Repeal provisions relating to the rehabilitation of sick industrial companies;
- Any scheme for rehabilitation should be made in accordance with the provisions contained in Sections 391 to 396 of the Companies Act;
- The law may be amended to facilitate workouts if the shareholders and other stakeholders with a three-fourths majority approve the workout scheme; and
- A suitable provision can be made for protecting the interests of minority stakeholders.

Developments in creditor rights

The judicial system in India has traditionally functioned in a debtor friendly manner; lenders are treated as having deep pockets, who can absorb any losses and suffer any delay. The scene has undergone a change as a result of the adoption of prudential norms based on income recognition principles for the loans and advances of banks and financial institutions. With the need for provisioning for non-performing assets and the non-recognition of income unless actually realised, debtors are now under pressure for prompt payments of loans on due dates. Creditor rights have been strengthened by the enactment of following laws:

- The Recovery of Debts Due to Banks and Financial Institutions Act of 1993 (DRT Act); and
- The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act of 2002 (SARFAESI Act).

One of the major problems faced by lenders in recovering defaulted loans was delays in the judicial system which resulted in the deterioration of the securities and other assets of the defaulting borrower. Since the sale of securities or other assets of the borrower took a very long time, lenders rarely recovered the full loan amount. Under the DRT Act the government set up specialised Debt Recovery Tribunals to recover the loans of banks and financial institutions. Such provisions are not required to follow the civil procedure code which is applicable to suits filed in the civil courts and tribunals are free to determine their own procedures for dealing with the claims of the banks. The tribunals have adopted a summary procedure for the purpose of enabling speedy recovery of the defaulted loans.

The constitutional validity of the DRT Act was challenged before the high courts and in appeal to the Supreme Court. With certain changes suggested by the Supreme Court, the law was further amended and has been declared to be constitutionally valid. The government has increased the number of DRTs. Twenty-two such tribunals are functioning and the process of recovery of bank loans has now stabilised. The tribunals are deciding cases of recovery in about one year compared to an average of five to seven years for decisions in civil suits. As of 30 June 2003, out of 57 915 cases (involving INR 82 266 crore filed by banks with the DRTs), 22 163 cases (involving INR 19 633 crore have been adjudicated and the amount recovered is INR 5 787 crore.[3,4]

In the Indian legal system, secured lenders do not have a power of foreclosure. It was not permissible for a secured creditor to take possession of the securities in the event of default and sell

3 RBI Report on Trends and Progress of Banking 2002-03.

4 1 crore = 10 million; 10 crores = 100 million; and 100 crores = 1 billion.

the securities to recover the loan. This power has been conferred on the secured creditors by the SARFAESI Act of 2002. Enactment of the SARFAESI Act has changed the entire environment with regard to the recovery of non-performing loans. With the power of taking possession of secured assets, the fear of dispossession has resulted in fewer defaults and, in cases where there are defaults, more and more defaulters approach banks for the purpose of out-of-court settlements. In the report of the Reserve Bank of India on Trends and Progress of Banking in India 2002-2003 the following is observed:

> The decline in NPAs has also been evidenced across bank groups, except in 2000-01. In line with this declining trend, NPAs declined sharply in 2002-03, reflecting, *inter alia*, the salutary impact of earlier measures towards NPA reduction and the enactment of the SARFAESI Act ensuring prompter recovery without intervention of court or tribunal. The progress under this Act has been significant, as evidenced by the fact that during 2002-03, reductions outpaced additions, especially for PSBs and reflected in an overall reduction of non-performing loans to 9.4 percent of gross advances from 14.0 percent in 1999-2000.

The constitutional validity of the SARFAESI Act of 2002 was also challenged before the Supreme Court. On 8 April 2004, the Supreme Court declared the act to be constitutionally valid in the case of Mardia Chemicals versus Union of India except for one provision which required the deposit of 75% of the claim amount by the borrower if it files an appeal against the action of the bank in taking possession of the securities. This judgement is a significant landmark in banking law for India because it recognises the contractual right of the secured creditor to take possession of securities in the event of default and sell them for realisation of the loan.

Under the law, prior to the enactment of the SARFAESI Act of 2002, the borrower community used a system whereby claims of the lenders were adjudicated by courts and the recovery process by attachment and sale of securities and other assets could only be done after such adjudication. Under the provisions of the act, the system was replaced by a procedure whereby banks can serve notice on the defaulting borrower for payment of the defaulted loan. In the event of non-compliance, they may proceed with actions for taking possession and selling securities. The Supreme Court read into the existing provisions of the requirement of secured creditors acting in a fair and reasonable manner. With the declaration of the SARFAESI Act of 2002 as constitutionally valid, the rights of secured creditors have been strengthened. They are now in a much better position to recover on defaulted loans. Such recognition of security rights mitigates the risk of insolvency.

NPA management by banks

Prudential norms

In India, prudential norms, including classification of loan accounts based on income recognition principles, were introduced in 1991. Although, the norms initially prescribed by the RBI were not in conformity with international standards, RBI adopted a policy of benchmarking Indian standards against international norms and gradually aligning Indian with international standards. This was done taking into consideration the impact of international norms on the banking system and the ability of the banking system to absorb new stringent provisioning requirements. The process of alignment with international norms has almost been completed.

Concept and definition of NPAs

With the introduction of income recognition and asset classification, the concept of non-performing assets came into being in India. In 1993, a non-performing asset was defined as a credit

facility in respect of which interest has remained past due for a period of four quarters ending 31 March 1993, three quarters ending 31 March 1994 and two quarters ending 31 March and onwards. Banks were not permitted to charge and take to the income account interest on non-performing assets. Banks were required to classify their assets into four broad groups: a) standard assets; b) sub-standard assets; c) doubtful assets; and) loss assets. With effect from 31 March 2001, the concept of "past due" was withdrawn and an advance has to be classified as an NPA if interest and/or the instalment payment of principal remain overdue for a period of more than 180 days. With a view to moving towards international best practices and greater transparency, the 90 day norm for recognition of loan impairment was introduced with effect from 31 March 2004.

Provisioning requirements

Banks have to make 100% provisions in respect of loss assets and not less than 30% in respect of sub-standard and doubtful advances. For standard assets, a general provision of 0.25% is to be made for global as well as domestic advances effective from October 2000. Effective from 31 March 2005, RBI directed banks to classify assets as doubtful if they remain in the substandard category for 12 months. Additional provisions would be phased in over a four-year period commencing 31 March 2005 with a minimum of 20% per year. Recently, banks were asked to introduce graded higher provisioning according to the age of NPAs in the "doubtful" category for more than three years with effect from 31 March 2005.

Policy support to deal with NPAs

During 1995-2000, the non-performing assets of banks were very high. Of late, they have come down both in absolute terms and as a percentage of advances. Various government and RBI policies played a critical role in containing the growth of stressed assets along with bank initiatives to curtail their growth through efficient risk and recovery management practices. Important policy initiatives to check the growth of non-performing assets include: the One-time Settlement/Compromise Schemes announced in July 2000; the Special One-time Settlement Scheme for loans of up to INR 50 000 for small and marginal farmers; Lok Adalats; Debt Recovery Tribunals; CDR mechanisms; formation of the Credit Information Bureau and the Securitisation and the Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act of 2002 (which helps banks realise dues without the intervention of courts or tribunals). Asset reconstruction companies (ARCs) have also become operational. ARCs help banks dispose of stressed assets and clean up their balance sheets.

As per the balance sheet data of banks for the year ended 31 March 2004, all the groups, *viz* public, private and foreign banks, showed declines in non-performing assets as a percentage of advances. The following table gives data pertaining to NPAs of SCBs over the last five years.

Table 1. NPAs of SCBs over the last five years

Year (1)	Gross Adv (2)	Gross NPA (3)	(3) as % (2)	Net Adv. (4)	Net NPA (5)	(5) as % (4)
2000	475 113	60 408	12.7	444 292	30 073	6.8
2001	558 766	63 741	11.4	526 328	32 461	6.2
2002	680 958	70 861	10.4	645 859	35 554	5.5
2003	778 043	68 714	8.8	740 473	32 764	4.4
2004	-	64 811	7.3	864 146	24 554	3.0

Note: Figures in INR crore: 1 crore = 10 million; 10 crores = 100 million; and 100 crores = 1 billion.

Additions to non-performing assets during 2003-04 were INR 24 026 crore as against INR 21 863 crore during 2002-03 (an increase of INR 2 163 crore). Due to good recovery efforts, the reduction of NPAs from the system was approximately INR 27 835 crore during 2003-04 (higher than the INR 23 302 crore of the previous year). The following table gives the recovery and incremental NPA positions of SCBS from 2000 to 2004

Table 2. Recovery and incremental NPA position of SCBS from 2000 to 2004

Year	Additions	Recovery
2000	16 234	12 376
2001	19 118	15 668
2002	24 826	17 515
2003	21 863	23 302
2004	24 026	27 835

Note: Figures in INR crore: 1 crore = 10 million; 10 crores = 100 million; and 100 crores = 1 billion.

Though recovery improved over the previous year from 2000 to 2002, incremental non-performing assets were higher than recovery leading to an increase in NPAs. 2003 saw a decline in additions and strong recovery performance which resulted in a reduction in non-performing assets. For 2004, additions were higher than before owing to good recovery and higher provisioning made by banks due largely to treasury profits. The NPA level was lower than the previous year.

Informal workouts for industrial undertakings

Corporate debt restructuring schemes

The salient features of the revised CDR scheme issued in February 2003 are as follows:

- It will cover multiple banking/syndication/consortium accounts with outstanding exposures of INR 20 crore and above;
- It will be a voluntary system based on Debtor-Creditor Agreement (DCA) and Inter-Creditor Agreement (ICA);
- CDR will have a three-tier structure consisting of: (a) the CDR Standing Forum and its Core Group (the policy-making body); (b) the CDR Empowered Group (the functional group deciding on the restructuring of cases referred to the CDR mechanism); and (c) the CDR Cell (the secretariat to the CDR system);
- The revised guidelines provide exit options for lenders who do not wish to commit additional financing or wish to sell their existing stake; and
- Standstill agreements binding for 90 days or 180 days for debtors and creditors respectively, under which both sides commit themselves not to take recourse to any legal action.

The CDR scheme contemplates a workout in respect of accounts which are classified as sub-standard. It is a scheme which is being used extensively by the industry for the purpose of restructuring debts and retaining a performing asset in terms of the revised repayment schedules. The progress under the scheme up to 30 June 2003 is as follows:

Table 3. Progress under the CDR scheme

Particulars	No. of cases	Amount involved
1	2	3
Cases referred to CDR Forum	71	53 736
Final schemes approved	41	38 638
Rejected	18	7 252
Pending	12	7 846

Source: RBI Report on Trends and Progress of Banking, 2002-2003
Note: Figures in INR crore: 1 crore = 10 million; 10 crores = 100 million; and 100 crores = 1 billion.

Recourse to reorganisation procedures and out-of-court workouts

As far as reorganisation procedures for industrial companies are concerned, a special law was enacted *viz* the Sick Industrial Companies (Special Provisions) Act of 1985 (SICA). This law contains an automatic standstill provision which operates on registration of a reference by a sick industrial company with the Board for Industrial and Financial Reconstruction (BIFR). Many industrial units abuse the standstill provision for the purpose of stalling action against the company for recovery of secured and unsecured loans, and other claims. Such abuse was noted by the BIFR as well as the courts before whom such matters were brought. Since the success rate of proceedings filed before BIFR for reorganisation or workout was very low, government finally decided to repeal the special law and abolish BIFR. Necessary legislation for the repeal of SICA has been passed but the date for its coming into force is yet to be notified. The BIFR is to be replaced by the National Company Law Tribunals, which are to be set up under the amended provisions of the Companies Act of 1956. The amended provisions do not contain a standstill provision along the lines of Section 22 of SICA, and a stay on any proceeding or action against a company is left to the discretion of the National Company Law Tribunals.

One other reason for the very low success rate of workouts under SICA is the criterion of total erosion of net worth by accumulated losses needed to classify a company as a sick industrial company. In most cases, companies having lost their entire net worth are not capable of being reorganised or restructured. Inordinate delays in working out such reorganisations also made workout schemes unviable.

The amended provisions of the Companies Act have changed the criteria for making an application for workout to erosion of net worth to the extent of 50%, or failure to repay debts within any three consecutive quarters. It is expected that the process of preparing a workout scheme, under the changed classification criteria, will start at a much earlier stage making it possible for companies to be reorganised or rehabilitated.

Workouts for non-industrial business enterprises

The statutory provisions contained in the SICA relating to reorganisation do not apply to small-scale industrial undertakings or any other non-industrial business enterprise. However, the RBI guidelines prescribing the prudential norms on asset classification and income recognition contain detailed guidelines for the prevention of, and measures to correct such accounts from becoming non-performing. The guidelines provide for the classification of accounts showing signs of default and becoming NPAs as Special Mention Accounts. They provide a strategy for early alerts and initiate special corrective measures to prevent the account from becoming non-performing. For any restructuring, Companies Act provisions are applicable to companies that are non-industrial enterprises.

Other measures for the settlement of defaulted accounts: Asset reconstruction

Under the provisions of the SARFAESI Act of 2002, asset reconstruction activities for the impaired loan accounts of banks and financial institutions can be undertaken by any company after registering with the Reserve Bank of India. Asset reconstruction companies must have a minimum capital of INR 2 crores and capital adequacy of 15%. The law provides for the acquisition of loans and advances of the banks and financial institutions and the issue of debt instruments (security receipts) by such asset reconstruction companies to the investors. The unique feature of this law is that the entire exercise of asset reconstruction is thrown open to the market. There is no government support to the activity by way of either equity participation or government guarantee for the debt instruments issued by the asset reconstruction companies.

This new concept has been successful and three asset reconstruction companies have been registered by the RBI and are functional. Foreign investors have evinced interest in setting up asset reconstruction companies and issues relating to the permissible limit of foreign investment in such activities are to be clarified by the government. Once the clarifications are issued, it is expected that more asset reconstruction companies will be registered with foreign investment. With this development, banks and financial institutions will have additional options of disposal of their financial assets.

One-time settlements

The Reserve Bank of India has also formulated one-time settlement schemes for settlement of chronic non-performing assets. Originally, such schemes were applicable to small loans. They have now been extended to loans up to INR 10 crores. Such schemes also provide yardsticks for deciding proposals for the settlement of defaulted loans.

Secured lending procedures

In the matter of control over the lending activities of banks, the process of deregulation is complete. Banks enjoy full freedom in matters of the quantum of credit, interest rates, securities and repayment schedules, subject to the observance of prudential norms based on income recognition principles. Each bank is directed to formulate its own credit policy and permit deviations only with the approval of the board of directors. The systems and procedures with respect to credit appraisal and the assessment of the viability of projects are done by the banks themselves and by outside experts for large value accounts. Most of the banks have their own niche areas where they have developed expertise in meeting credit needs of a specific business, industrial, trading or agricultural activity. Broadly, the lending procedures observed by banks are:

- Lending without security is normally done for Triple A rated borrowers having a very good balance sheet. Hence, chances of defaults in such type of lending are very low.

- As far as secured lending is concerned, it can be divided into two parts namely, working capital finance and term lending.

- Working capital finance is given against non-possessory security of hypothecation of movables. Indian law recognises such non-possessory securities by way of hypothecation or floating charge. The recent enactment of the SARFAESI Act of 2002 gives further recognition to such securities by introducing the concept of comprehensive security interest, which covers all categories of securities given for due repayment of any loan to a bank or financial institution.

- In respect of non-possessory securities, the borrowers are permitted to dispose of such securities during the course of business without the approval or consent of the bank. Working capital financing also includes financing against receivables. Such finance is normally given in running accounts called cash credit or overdraft accounts and the borrowers are required to furnish periodic statements containing the list of movable properties which are hypothecated to the bank. Based on the value of the hypothecated movables, which are called stock statements, the banks fix the drawing power in the cash credit account and the borrower accounts are accordingly operated subject to such drawing power. Working capital financing is also given by way of discounting or purchase of bills of exchange.

Margins for working capital

The banks stipulate a margin of 20-25% for working capital finance. Depending on the nature of the business, margins may be higher. Lending against possessory securities is normally restricted to pledge of valuables, pledge of shares and securities, and holding of documents of title to goods such as bills of lading, motor transport receipts, etc.

Term lending

Banks are also engaged in financing land purchases, building construction, and the purchase of plant and machinery. Such loans are usually payable in instalments and are sanctioned after assessment of the viability of the borrower's project. In respect of small scale industries, whether set up by individuals, partnership firms or corporates, the loan component ranges between 60-80%. The balance comes from the borrower. In respect of large projects where corporates are in a position to access funds from the capital market, the loan component is lower than with small and medium enterprises.

- In the past, enforcement of securities was a time-consuming process on account of delays in the judicial system.

- As a measure of reform, the rights of secured creditors were strengthened by providing remedies for expeditious recovery through the Debt Recovery Tribunals and by strengthening secured creditors rights by giving them powers to enforce securities in the event of default.

Credit information systems

Under existing law, the collection, sharing and dissemination of credit information is limited to the RBI. RBI's use of credit information is restricted to statistical purposes on account of the enormity of the task of collection and dissemination to prospective lenders. The practice amongst bankers is, therefore, to call other banks for credit information on persons making loan applications (provided the prospective borrower discloses the existence of the other bank account). In order to develop a credit information system, RBI decided to enact new legislation. Pending such legislation, the Reserve Bank of India directed banks to obtain borrower and account holder consent for information sharing. Based on the consent obtained from the constituents, banks have started furnishing credit information to the Credit Information Bureau which was set up by a group of banks and financial institutions as a company.

The bureau has started collecting credit information from member banks and financial institutions. The RBI has also directed banks to furnish information relating to defaulted accounts and

suit-filed accounts to the Central Information Bureau. It is expected that the necessary legislation for will be in place shortly giving such bureaus the statutory power to collect information. Credit information bureaus will also be taking up credit ratings and scorings.

Credit risk transfer and new financial instruments

In the Indian financial market, certain housing finance companies, banks and financial institutions have started securitising transactions by setting up special purpose vehicles (SPVs). SPVs have trust structures and act as trustees. The debt instruments issued by SPVs are rated by agencies and have, in respect of loan assets, very low default rates. One major constraint in undertaking securitisation transactions in India is the multiple stamp duty laws applicable in various states of the country. In transactions where a secured loan is transferred by a bank to an SVP, the transfer is coupled with the benefit of the underlying securities. Under the provisions of the stamp laws, any assignment of mortgage or other securities attracts *ad valorem* stamp duties which make securitisation transactions unviable. Realising the various difficulties faced by the banks and financial institutions, certain states have reduced the stamp duty to 0.1%. In such states (Maharashtra, Gujarat, Karnataka, Tamil Nadu and West Bengal) securitisation transactions are being undertaken.

An attempt was also made to make statutory provisions for securitisation under the SARFAESI Act. Under the said law, provisions were made for securitisation transactions to be undertaken by securitisation companies with a minimum capital of INR 200 lakhs[5] and a capital adequacy of 15%. It also provided that such securitisation companies register with the RBI. On account of these requirements no securitisation transactions have yet taken place. A proposal to segregate securitisation from the provisions of the SARFAESI Act and enact a separate law for securitisation is under consideration by the RBI and the government. It is expected that the market for debt instruments will grow after enactment.

Conclusions and recommendations

- Recent reforms in the legal system in India have been particularly directed at delays and new legislation has been enacted to facilitate the rapid recovery of defaulted loans by banks and financial institutions. Special mention needs to be made of two laws enacted for dealing with recovery cases of banks and financial institutions: 1) the Recovery of Debts Due to Banks and Financial Institutions Act of 1993; and 2) the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI).

- The Recovery of Debts Due to Banks and Financial Institutions Act does not apply to non-banking financial companies and other lenders who are not banks. It will be necessary to carry the reform process further to ensure that the benefits of speedy recovery are available to all categories of lenders.

- There is a need to reform the laws for workout schemes for industrial companies in order to facilitate the formulation of workouts by creditors and other stakeholders with the assistance of professionals. The supervision and the role of the court or tribunal may be restricted to grievance redress and, perhaps, final approval of the workout scheme. In order to achieve this objective, provisions relating to the rehabilitation of sick units may be repealed and any

[5] 1 lakh = 100 thousand, 10 lakhs = 1 million.

such schemes should be brought under the provisions of Sections 391 to 396 of the Companies Act (Compromise and Arrangement Schemes).

- Restrictions on the closure of industrial units contained in Section 25-0 of the Industrial Disputes Act of 1947 need to be repealed.

- It is necessary to devise a system for workouts of sick units in which professionals can be appointed as liquidators, administrative receivers or managers. The goal would be to turn around stressed industrial units or the speedy disposal of company assets and the completion of winding-up proceedings within a specified timeframe not exceeding one year.

- The CDR scheme, which is at present applicable to large industrial undertakings with borrowings from the banking system of INR 20 crores and above, needs to be extended to lower-level industrial undertakings.

- In the matter of CDR, there is a need to provide super priority to any lender who provides post-workout credit. In other words, in case a lender provides further finance for the revival of a stressed or impaired account, such financing should have priority over all other existing secured lenders. Such a statutory provision would encourage lending to stressed accounts and improve the prospects of turning around sick industrial units.

- The SARFAESI Act of 2002 provides for the establishment of a central registry for the purchase of movable and immovable properties. These provisions have not yet been brought into force. A new registration system may have to be devised on the lines of the notice filing system prevalent in the US and some other countries. In addition, the registry may have to adopt the principle of first-to-file to get priority. It will also be necessary to decide how the existing registry systems are to be integrated with the new registry.

- Although banks are lending against the security of commodities, there is no formal recognition of warehouse receipts as negotiable instruments. A law needs to be enacted to give warehouse receipts the status of negotiable instruments. This needs to be coupled with a system of grading and valuation of commodities so that the entire system of lending against warehouse receipts can develop.

- The securitisation of financial assets has already been provided in the SARFAESI Act of 2002, but there are hardly any securitisation transactions being undertaken under the new law. This is on account of the inability to use pass through trust structures, capital requirements, and other regulations of the Reserve Bank of India. There is a need to segregate the concept of securitisation from the security enforcement law and enact a separate securitisation law with provisions to enhance the growth of the market in debt instruments.

- There is a need to enact a law on the Payment and Settlement System for recognition and protection of set-off or netting rights, notwithstanding the commencement of insolvency proceedings.

INDIAN INSOLVENCY REFORMS: AN UPDATE

by
Sumant Batra*

Effective and efficient insolvency systems are essential parts of the national and international financial architecture. They are needed to encourage enterprise, underpin investment and economic growth, and to create wealth. For the developing economies, in particular, effective insolvency systems are vital to stabilise commercial relationships and financial systems, advance the important social objective of maintaining public confidence in the corporate and financial sectors, and promote sustainable growth in the private sector. They help create a sound investment climate, enable market participants to more accurately price, manage and control default risks and corporate failure, and encourage sound credit practices. Efficient exit laws promote responsible corporate behaviour by encouraging higher standards of corporate governance, including the financial discipline needed to avoid the consequences of insolvency, and preserve employment through an effective system for rehabilitating financially distressed but viable enterprises, while assuring maximum play in a fair reallocation of assets to more efficient market users through efficient liquidation systems.

Background

India does not have a composite law dealing with the insolvency of companies. While the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) deals with the revival and rehabilitation of corporate entities, the Companies Act, 1956 (1956 Act) deals with their winding up. SICA failed to turn around sick companies. The Board for Industrial and Financial Reconstruction (BIFR) turned into a haven for defaulting borrowers that rushed to BIFR only to get statutory protection from creditors wanting to recover their funds. The bureaucratic and cumbersome provisions of the 1956 act obstruct expeditious liquidation, resulting in the locking up of an enormous amount of national resources in liquidation proceedings.

The last decade witnessed a large number of reforms in India. Various financial sector reforms were aimed at promoting an efficient, well-diversified and competitive financial system with the ultimate objective of improving the allocative efficiency of resources so as to accelerate economic development. In the year 1999, a high level committee headed by Justice V.B. Eradi was set up to make recommendations with regard to the desirability of changes in existing law relating to the winding up of companies and for having a self-contained law for reorganisation and liquidation of companies, with a view to creating confidence in the minds of investors, creditors, labour and shareholders.

In December 2002, the Indian Parliament passed the Companies (Second Amendment) Act, 2002 to restructure the 1956 Act leading to a new regime dealing with corporate rescue and insolvency. The

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act was the legislative product of the recommendations of the Eradi Committee. The provisions of the Second Amendment are, however, yet to be notified. SICA, which presently deals with the revival and rehabilitation of companies, has still to cease operation, as the Sick Industrial Companies (Special Provisions) Repeal Act, 2003, passed by the Parliament, awaits notification. Until then, while BIFR continues to deal with the revival and rehabilitation of companies, the High Court retains its jurisdiction as the liquidation court under the 1956 Act.

The insolvency reform process suffered a setback earlier this year, when the Madras High Court set aside certain provisions of the Second Amendment on a challenge made by the Bar Association of that court, bringing the implementation of the new law to a grinding halt. The matter is currently before the Supreme Court in an appeal proffered by the government of India.

The Companies (Second Amendment) Act, 2002

The Second Amendment provides for the setting up of the National Company Law Tribunal (NCLT) and its Appellate Tribunal to consider the revival and rehabilitation of companies. A composite law is, therefore, now proposed to deal with the reorganisation and liquidation of companies. The Second Amendment seeks to improve upon the standards to be adopted to measure the competence, performance and services of a bankruptcy court by specifying the qualifications necessary for appointment of members to the NCLT, and a transparent process for their selection and appointment. In addition, it seeks to provide quicker access to the restructuring process, as opposed to SICA (where the trigger point is based on the erosion of 100% of net worth) and BIFR (where the companies are virtually dead and beyond revival). It provides a new time frame for various stages of the restructuring process. The Second Amendment also does away with the infamous provision of automatic stay.[1] This provision is one of the major causes for the failure of SICA as legislation.

The Second Amendment provides for the appointment of a liquidator from a panel of firms of chartered accountants, cost and work accountants, advocates, company secretaries or others as may be prescribed. This is a welcome feature of the Second Amendment. However, the role of professionals is restricted to liquidation proceedings. In rehabilitation proceedings, the debtor remains in possession and administers the company. There is no role for insolvency practitioners in rehabilitation proceedings.

On the whole, the Second Amendment has been received with caution. The alternative mechanism under the Second Amendment is being perceived as an old tablet in a new foil. It does little to expedite and simplify liquidation procedures. Much more needs to be done to make the laws predictable, transparent and affordable by efficient mechanisms.

Concept paper on the Company Law and the review of the Second Amendment

Insolvency reforms are an ongoing process. Today, the financial world works quickly and globally, generating a market place that is both versatile and vulnerable to multi-jurisdictional economic tremors because of its exposure to different territories and systems.

Many internationally significant developments have taken place recently in the area of insolvency reform. Some of the key developments are:

[1] Section 22 of the Sick Industrial Company (Special Provisions) Act, 1985.

- In June 2004, the UNCITRAL finalised its Legislative Guide on Insolvency[2], which will soon be sent to member countries, including India, to assist in reviewing existing laws.
- The World Bank, in collaboration with and assistance from international experts and the financial community, developed Global Principles for Effective Insolvency & Creditors Rights Systems[3]. The principles contain international benchmarks and best practices. Currently, the World Bank is conducting a Report on Observance of Standards and Codes (ROSC) assessment in India to evaluate the Indian insolvency and creditor rights systems based on the Principles.
- Many countries have adopted the UNCITRAL Model Law on Cross Border Insolvency and others are considering its adoption.
- INSOL International developed its INSOL Global Principles for Multi-Creditor Workouts.
- Recently, the Ministry of Company Affairs introduced a concept paper with the objectives of simplifying the company law and bringing it in tune with international developments. The concept paper is a commendable and inclusive lawmaking/reform initiative. It invites public debate and stakeholder participation before the drafting of the bill and its submission to Parliament. This will certainly enhance its value and acceptability, and ownership by stakeholders.

Unfortunately, the concept paper does not propose any significant changes in Chapters XVI to XVIII relating to the restructuring and liquidation provisions of the Second Amendment. At the same time, the paper commissions a debate on the provisions of these chapters; this demonstrates the Ministry's intent to review the Second Amendment.

The concept paper is timely, as far as insolvency reforms are concerned. It offers an excellent opportunity to plug the gaps in the Second Amendment, deal with the Madras High Court decision, and incorporate the features of the UNCITRAL Guide and the World Bank Principles. The following issues need to be addressed under the concept paper:

Comprehensive bankruptcy code and road map

The concept paper stops short of providing a comprehensive insolvency code and road map to deal with corporate bankruptcy. In the fast-changing scenario of growing cross-border investment, trade and commerce, domestic and trans-border insolvency problems are bound to increase and only a comprehensive insolvency code can address such issues taking into consideration international practices. The provisions of the concept paper require a comprehensive review to make the insolvency law efficient and effective, maximise value of assets, increase its ownership among stakeholders, preserve estate, re-circulate the assets in the economy and bring the provisions in tune with international developments. A clear road map of the bankruptcy proceedings is required providing for:

- Application for initiating bankruptcy proceedings;
- Appointment, role and empowerment of the administrator;
- Operational and functional independence;

[2] The finalised text of the guide is available at www.uncitral.org.

[3] Refer to: www.worldbank.org\gild

- Fees of the administrator and accountability to the court, including the power of the court to remove the administrator in case of mismanagement;
- Relationship with current management;
- Monitoring or substitution;
- Day-to-day operation;
- Time-bound restructuring/recognition plan;
- Who should submit and procedure of acceptance;
- Mechanism to sell off;
- Proactive initiative of the administrator;
- Number of time-bound attempts for restructuring;
- Protection and disposal of assets, refinancing, role of creditors, voting on the plan, decision to opt for insolvency and winding up; and
- Strategies for realisation and distribution.

A part of this road map can be implemented through statutory provisions. Clear and predictable rules and procedures can make up for the rest.

Time frame for liquidation process

The concept paper does not provide a definite period for the various stages of liquidation proceedings. The biggest challenge faced by the winding up proceedings is the long, drawn-out process without any time management. There is a pressing need to provide a definite and meaningful time frame to conclude the proceedings so that the process becomes attractive for its users and stakeholders, and so that they can recover the maximum value out of the assets in a reasonable time.

Role of the court

The role of the court in the insolvency and restructuring process should be minimised and delegated to the two key stakeholders and players: creditors and insolvency practitioners (read: liquidators). Excessive court involvement in the process leads to delays. The UNCITRAL guide recommends that the role of the court be supervisory and its participation should not be sought on day-to-day procedural matters. Its intervention should be confined to matters of interpretation, resolution of disputes and deadlock, and ensuring fair and judicious process.

Decompartmentalisation of restructuring and insolvency proceedings

The restructuring provisions have been transplanted from SICA to the Company Law without any effort to reconcile them with the liquidation process. This results in a serious inconsistency. There is a lack of balance and reconciliation between the liquidation and restructuring regimes. Though under one legislation, the two processes still appear independent of each other with little synergy between them.

Different standards and approaches exist for the two. Insolvency practitioners (IPs) have no role in the restructuring regime. The services of professionals would be confined only to the liquidation process. The debtor remains in possession. Experience under SICA shows that the OA cannot substitute for IPs. The OAs do not have the capacity to discharge such functions as it in not their main

area of business. The restructuring process has to be carried out with assistance from administrators who are insolvency practitioners. There is no provision for remanding the matter for restructuring from liquidation. It is critical that both processes be reconstructed to achieve reconciliation and balance.

Creditors committee and voting rights

The concept paper does not provide for a committee of creditors. The creditors are the largest stakeholders in insolvency and need an organised representation and participation in the process through a committee. Every secured creditor has been provided with a veto right on the plan. Even a small secured creditor can hold the large secured creditors to ransom to extract the best deal for itself. Committees of creditors, secured and unsecured should be provided. The approval of the plan should be based on a majority vote, preferably three-fourths of secured creditors in value voting in its favour. Unsecured creditors should be provided with representation and perhaps a right to vote on the plan.

Role and participation of professionals

One of the key recommendations of the Eradi Committee was to involve professionals such as chartered accountants, cost accountants, company secretaries and lawyers in the process of insolvency in the form of IPs. While the concept paper permits appointment of professional firms of advocates, chartered accountants and others as liquidators, the role of IPs does not extend to restructuring proceedings. The concept paper does not currently recognise this fundamental requirement to ensure a smooth, unbiased restructuring process. It continues to require that the restructuring proposal be the responsibility of the Operating Agency, as is the case in SICA. Lenders believe that the operating agencies, which are typically the lead lenders themselves, are not equipped to deal with restructuring or insolvency. Clearly, there is a much larger role that professionals can play beyond that of just liquidators. In all developed economies, creditors have rights to come together, and to choose the professionals to whom they wish to entrust the job of facilitate the restructuring process.

Institutionalisation of the profession of liquidators/administrators

The government needs to take the initiative in institutionalising and regulating the profession of IPs *i.e.* liquidators and administrators (assuming they are introduced in the framework). Some substantive provisions for institutionalising and regulating the liquidation profession need insertion in the law. The government should support initiatives like the Indian Society of Professional Liquidators, which was formed recently by leading professionals in India as a self-regulatory body. There is a need to built capacity among IPs, provide continuous training and knowledge, and encourage best practices. While the laws are being strengthened and professionals are being involved in the process, stakeholders would obviously need comfort that professionals are adequately qualified and experienced to deal with complex business situations. In particular, stakeholders would want to have clarity on:

- Qualification of the professionals;
- Experience;
- Appointment;
- Training and knowledge;
- Credibility and accountability;
- Fees; and
- Disqualification.

As such, there is a need to institutionalise the restructuring and insolvency profession through the creation of a self-regulatory body that is supported by the government, existing bodies of professionals, industry, and similar associations in other countries. The Indian Society of Insolvency Practitioners (ISIP) is an initiative in this direction to help develop and institutionalise the profession of insolvency in the country. ISIP is currently in the process of evaluating the structure of the profession in other key economies and expects to submit feasible options to the government in key areas such as entry requirements, training, regulation of the profession, codes of ethics, dealing with complaints, remuneration of practitioners and so on.

Appointment of the administrator

The Indian restructuring law is based on the concept of "debtor-in-possession". In spite of serious allegations of mismanagement, the debtor remains in possession of assets and enjoys the freedom to use and deal with the assets. In cases where the creditors have lost confidence in management, they are reluctant to deal with promoters and discuss rehabilitation proposals. The promoters delay the process to buy time, to tire out creditors or take out good assets. Meanwhile, restructuring prospects suffer. On filing of a reference, an administrator (read: IP) should be appointed to take over the assets, control the management, get the plan prepared and negotiate with the creditors.

Suspension of proceedings

It is difficult to conceive a restructuring law without providing the debtor with some temporary relief from creditors. Section 22 of SICA was abused to avoid payment of legitimate dues and seek undue protection from creditors. However, the solution does not lie in taking away the provision of stay altogether. The problem can be addressed by providing for a time-bound stay on filing of reference, which can only be extended in agreement with creditors or under extraordinary circumstances by the court. It is hoped that there will be a rethinking and that a brief moratorium would be provided to give *bona fide* debtors time to negotiate a consensual business solution.

Stay against debtor's assets

There is a need for providing a stay against use and disposal of assets before and from the time of the filing of the reference. The existing provisions provide for powers to grant a stay at a later stage of proceedings by the NCLT.

International insolvency in India

Unfortunately, the Second Amendment ignores the recommendation of the Eradi Committee and fails to provide a framework for cross-border insolvencies with recognition of foreign proceedings. If a foreign company is taken into liquidation outside India, its Indian business will be treated separately and will not automatically be affected unless an application is filed before an insolvency court in India. The government should consider the adoption of the UNCITRAL Model Law on Cross-Border Insolvency, with suitable changes to reconcile the needs of the Indian market, to meet the demands of globalisation and deal with international insolvency.

Tribunalisation of justice and an overburdened tribunal

Though tribunalisation of justice is now a recognised trend, the Indian experiment with tribunals has been nothing to boast about. Flowing from such diverse dimensions of judicial functions, the NCLT would be burdened with a workload of enormous magnitude and in the process would likely

lose focus on the revival and rehabilitation of sick entities. In the process, the objective of expedient disposal of the matter may become a casualty. Though the number of members has been fixed at 62, past experience shows that the BIFR has never worked with a full contingent of members. The government should provide adequate resources, and build capacity in the NCLT on a self-sustainable basis. The NCLT should be built as a modern and well-equipped institution with effective use of technology and little dependence on government for resources.

Training of judges and staff of the NCLT

The quality and skills of judges, newly appointed or existing, will need to be reinforced by continuing training. Provision should be made for appropriate procedures to evaluate the performance of judges and staff based on established standards.

Conclusion

The essential features governing a model formal restructuring process in any part of the world are common though they may be structured differently. Indian laws are structured, more or less, on these principles. However, any sound legislative framework is dependent upon predictable and effective judicial processes coupled with effective enforcement mechanisms for its success. There is a pressing need to focus and improve upon our implementation mechanism. There is a need for a more creative and commercial approach to corporate entities in financial distress and a greater focus on reviving them rather than applying the more traditional and conservative approach of liquidation. The NCLT should function like a commercial and professional institute (rather than a judicial forum) with adequate mechanisms to ensure fair play, accountability and judicial review.

TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEM AND RISK MANAGEMENT: THE EXPERIENCE OF NEPAL[*]

by
C.B. Ramamurthy[***]

Summary

Nepal, the birth place of Lord Buddha, the home for exotic biodiversity, the tallest mountain in the World – Everest, a landlocked agro-based economy with a low industrial base, the most preferred tourist destination in Southeast Asia, is an underdeveloped country plagued by a Maoist insurgency that is causing the economy to stagnate.

Legal system

There is a three tier legal system in Nepal. The Supreme Court is the highest court followed by appellate and district courts. In terms of the provisions enshrined in the constitution of Nepal, the judiciary is an independent functional body whose task is to dispense justice in an effective manner.

The functioning of the judiciary in relation to the financial system is not compatible due to the:

- Absence of commercial benches with competent/trained manpower for deciding commercial cases;
- Inordinate delays in deciding commercial cases;
- Grant of *ex parte* restraint orders against banks/financial institutions (FIs) blocking disposal of the securities for realisation of their dues;
- Lack of transparency; and
- Absence of legislation: (a) for registration of security transactions for determination of priority of the "charges" amongst various lenders; and (b) relating to asset reconstruction companies for credit risk transfer etc.

While, to some extent, legal reforms have taken place, there is much to be done with particular reference to enacting insolvency law and professionalising insolvency practice. Due to want of a meaningful insolvency law, there is no interface between the insolvency system and the credit risk management system. Concepts like reorganisation or rehabilitation of business entities through the vehicle of insolvency law are unknown.

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[*] Sources: 1. Economy Survey, 2061 (HMG Finance Ministry); 2. banking and Financial Statistics Vol. 42 (Nepal Rastra bank); 3. Nepal Rastra bank-Other Publications; 4. Various Laws of Nepal; 5. Discussions with Senior Executives in banks and financial institutions, Senior Lawyers and Accountants.

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The credit risk management system

The financial system comprises commercial, development and co-operative banks, and FIs, the functioning of which are overseen by the Nepal Rastra Bank–the regulator.

Credit risk management *per se*, is impacted by a host of factors:

- Lack of transparency in financial statements;
- Permissive banking practices (such as multiple banking contributing to diversion of funds, flight of capital, over financing etc.);
- Absence of risk-based pricing methodologies;
- Absence of customer risk rating models;
- Absence of credit rating agencies, absence of an independent credit information bureau;
- Absence of credit risk transfer instruments; and
- Lack of transparency among the banks and FIs in exchange of information on the business entities etc.

These factors contribute to a high level of impaired debt specifically in the banking sector.

The regulator has the formidable task of pursuing financial sector reform, and deregulation and introducing regulation in critical areas relating to credit risk management. It has a catalyst role, among other things, for transforming the financial system by co-ordinating with government agencies, introducing required legislation, setting up credit rating agencies, and for setting up institutions for imparting banking education.

The judicial system and the financial sector in Nepal have to pass several milestones by carrying out meaningful reforms, and enacting legislation. Government, regulators banks and financial institutions all have to roles play in this difficult task.

Nepal at a glance

Nepal

Nepal is situated between China in the north and India in the south. It is a landlocked country shaped roughly like a rectangle and extending approximately 885 kilometres east to west and 145 to 241 kilometres north to south.

Nepal is one of the richest countries in the world in terms of bio-diversity due to its unique geographical position and latitudinal variation. It has the world's deepest gorge "Kali Gandaki". The elevation of the country ranges from 70 metres above sea level to the highest point on earth--Mt. Everest at 8 848 metres--all within a distance of 150 km, with climatic conditions ranging from subtropical to arctic. This wild variation fosters an incredible variety of ecosystems, the greatest mountain range on earth, thick tropical jungles teeming with a wealth of wildlife, thundering rivers, forested hills and frozen valleys.

Summary country data

Area: 147 181 square kilometres
Capital: Kathmandu
Population: 24.7 million
People: Nepal has more than 60 ethnic groups and 70 spoken languages
Language: Nepali is the national language though most educated people speak English as well
Currency: The Nepal rupee (NPR) (USD[1] 1 equalled NPR 74.25 as of October 2004)
Political system: Multi-party democracy with a constitutional monarchy

Nepal is home to:

8 out of 14 of the highest summits in the world exceeding an altitude of 8 000 M including Mt. Everest, Annapurna, and Dhaulagiri;
2% of all the flowering plants in the world;
8% of the world's population of birds (more than 848 species);
4% of the mammals on earth;
11 of the world's 15 families of butterflies (more than 500 species);
600 indigenous plant families; and
319 species of exotic orchids.

Foreign investment

Despite being a rich country in terms of natural gifts, Nepal's resources are underutilised. It is a neighbour to the world's most populous countries, China and India and, thus, has a huge potential for investment opportunities in several sectors of the economy. The government has adopted a market economy and has a liberal policy towards foreign investors.

Major potential investment areas

Major potential investment areas include hydro-electric power (Average annual flow = 225 billion QM, generation capacity = 83 million KW), tourism, agro and forest-based industries, flower seeds, vegetable production for export, fruit processing, tea development, sericulture, integrated dairy industries, floriculture, processing of spices, mushroom cultivation, coffee processing, mineral exploration and exploitation, textile, electrical and electronic industries, pharmaceutical industries, leather goods industries, air services, computer software development, adventure sports and so on.

Nepal is a preferred tourist destination centre in South Asia offering various attractions in the fields of nature, culture and adventure.

[1] United States dollar (USD).

Key Economic Indicators of Nepal

Financial Year 2003-2004 (*)

1	GNP at Market Price (USD)	6.88 billion
2	GDP Growth (based on constant 1994/95 factor cost)	3.70%
3	Gross Domestic Investment/GDP	26.70%
4	Gross Domestic Savings/GDP	12.20%
5	Inflation Rate	4%
6	Volume of Money Supply (m2 in USD)	3.78 billion
7	Money Supply (m2) Growth	13.50%
8	Volume of Merchandise Export (USD)	0.71 billion
9	Merchandise Export Growth	5.60%
10	Volume of Merchandise Import (USD)	1.88 billion
11	Merchandise Import Growth	11.90%
12	Current Account Surplus (USD)	0.2 billion
13	Overall Balance of Payment Surplus (USD)	0.2 billion
14	Foreign Exchange Reserve as at mid - July 2004 (USD) *(The reserve covers 11.2 months' merchandise import)*	1.76 billion
15	Exchange Rate	USD 1=NPR73.8

(*) FY in Nepal starts from mid-July

GDP at Factor Cost

F/Y 2003-2004

S.N.	Sector	Share %
A	**Agriculture**	**38.8**
1	Agriculture, Fisheries & Forestry	38.8
B	**Non-Agriculture**	**61.2**
1	Mining & Quarrying	0.5
2	Manufacturing	7.7
3	Electricity, Gas & Water	2.2
4	Construction	10.1
5	Trade, Restaurants & Hotels	10.4
6	Transport, Communications and Storages	9.5
7	Financial & Real Estate	10.9
8	Community & Social Services	10.0

Evolution of the financial sector in Nepal

Commercial banks

Commercial banking in Nepal started with the establishment of Nepal Bank Limited (NBL) in 1937. Government and the private sector held 51% and 49% of the shares respectively. Rastriya Banijya bank was set up in 1966 with 100% government investment, with the objective of expanding banking services throughout the country. In early the 80s, the government opened the Nepalese banking sector to foreign investment. As a result, Nepal Arab Bank Limited (renamed Nabil Bank Limited on 1 January 2002) was established in 1984 with a joint venture between Dubai Bank

Limited, Nepalese financial institutions (Rastriya Beema Sansthan, the Nepal Industrial Development Corporation and the Security Exchange Centre) and the Nepalese public. In 1986 and 1987, Nepal Indosuez Bank Limited and Nepal Grindlays Bank Limited began operations with a 50% holding by Banque Indosuez and ANZ Grindlays Bank Limited.

With the restoration of multi-party democracy in 1990, the government pursued a liberal economic policy that paved the way for the establishment of commercial banks by the private sector with or without foreign investment. Presently, there are 17 commercial banks in the country. Commercial banks are major players in the financial market as they have the lion's share in the country's deposits (81%) and credit (72%).

The central bank

Nepal Rastra Bank has been carrying out the functions of a central bank since 1956.

Development banks

Nepal Industrial Development Corporation (NIDC) was setup in 1959 by the government under a special charter with the objective of promoting the private industrial sector. Similarly, Agricultural Development Bank was established in 1968 under a special act with the objective of providing institutional credit for the agricultural sector. With the introduction of the Development Bank Act of 1996, the number of development banks increased. Currently, there are 25 development banks (including rural development banks) with an 11% and 18% share in the country's deposits and advances respectively.

Finance companies

Though the Finance Company Act was enacted in 1985, the Nepal Housing Development Finance Company, the first Nepalese finance company, only came into operations in 1992. Currently, there are 59 finance companies with a 7 % share in the country's deposits and a 9% share in advances.

Co-operatives

Despite the concept of the co-operative being very old in Nepal, the first formal working co-operative under NRB regulation and supervision was established only in 1993. Nabajeeban Co-operative Society is the first of its kind. Currently, there are 21 co-operatives working under NRB with around 1% of market share in both the deposits and advances.

- In the last 12 years, a large number of commercial banks, development banks, finance companies and co-operatives have been established. To expand their business, they have aggressively expanded branch networks (especially in urban areas). The number of banks and financial institutions, and their branches has increased at a time when the country is going through a turbulent period due to the Maoist insurgency. The insurgency has affected economic growth significantly.

- Establishment of these institutions triggered competition in the market. As a result, customers got better and new services at competitive prices. However, the number of professionals and the size of the economy did not grow to keep up with the increase in the number of banks and financial institutions. It gave rise to reckless lending that contributed to the high level of non-performing loans (NPLs) in the industry.

- In sum, the overall health of the financial sector, with particular reference to banking sector, is not good due to a host of factors such as: lack of transparency; permissive banking practices; weak legal system; weak regulatory environment; high level of impaired debt; and a dearth of skilled manpower/specialists/professionals, etc. These issues are dealt with separately.

Financial institutions (As at mid-July 2004)

The number of different financial institutions in Nepal are detailed as follows:

Commercial banks	17
Development banks	20
Finance companies	59
Insurance companies	17
Employees' provident funds	1
Stock exchanges	1
Co-operatives	21
Micro-finance NGOs	44
Rural development banks	5
Citizen investment trusts	1

Ownership structure of existing major commercial banks

The ownership structure of various commercial banks is as follows:

Nepal Bank Limited	Government 41%, others 59%
Rastriya Banijya Bank	Government 100%
Agricultural Development Bank	Government
Nabil Bank Limited	Foreigners 50%, 30% general public, 20% Nepalese financial institutions
Standard Chartered Bank Nepal	Foreigners 75%, general public 25%
Himalayan Bank Limited	Foreigners 20%, Nepalese promoters 51%, Employee's PF 4%, general public 15%

Statistical information

What follows is some statistical information on the Nepalese financial sector in tabular and graphic form:

TABLE 1

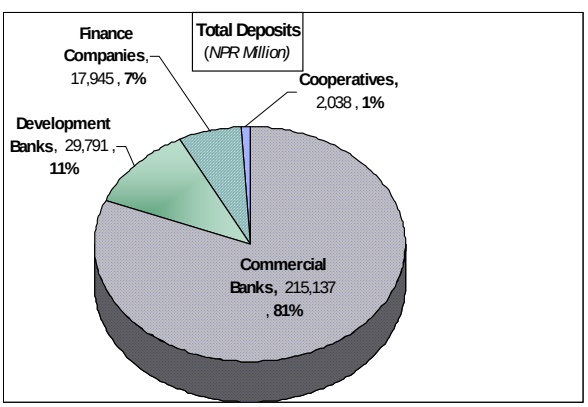
(Summary of Assets & Liabilities)

as at mid-January 2004

NPR mil.

S.N.	Capital & Liabilities	Commercial banks	Development banks	Finance Companies	Co-operatives	Country Total
1	Capital Fund	12 229	4 804	3 600	287	**20 921**
2	**Deposits:**	**215 137**	**29 791**	**17 945**	**2 038**	**264 910**
a	*Current*	*27 386*				*27 386*
b	*Savings*	*105 781*	*479*		*1 045*	*107 306*
c	*Fixed*	*64 658*	*27 793*		*828*	*93 279*
d	*Call*	*14 558*				*14 558*
e	*Others*	*2 754*	*1 518*		*164*	*4 436*
3	Borrowings	4 324	8 260	797	42	**13 423**
4	Others	87 344	8 993	2 339	497	**99 173**
5	**Total (1+2+3+4+5)**	**319 034**	**51 848**	**24 681**	**2 864**	**398 427**
	Assets	**Commercial banks**	**Development banks**	**Finance Companies**	**Co-operatives**	**Country Total**
6	Cash & Bank Balance	30 763	4 340	2 779	370	38 251
7	Investments	53 682	3 482	2 576	279	60 019
8	Loans & Advances	133 437	34 077	16 366	1 575	185 456
9	Others	101 151	9 949	2 960	640	114 700
10	**Total (6+7+8+9+10)**	**319 034**	**51 848**	**24 681**	**2 864**	**398 427**

	CD Ratio (8/(2+3))%	**61**	**90**	**87**	**76**	**67**
	ID Ratio (7/(2+3))%	**24**	**9**	**14**	**13**	**22**
	LD Ratio ((6+7)/(2+3))%	**38**	**21**	**29**	**31**	**35**
	Market Share (%)					
	Deposit	**81**	**11**	**7**	**1**	**100**
	Credit	**72**	**18**	**9**	**1**	**100**



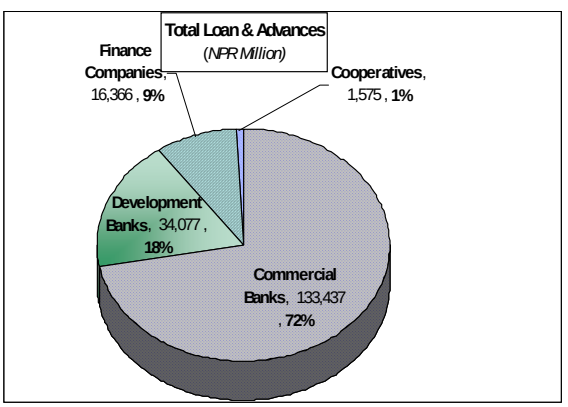


TABLE 2

Types and Volumes of Credit

As at Mid-January 2004

(A) Commercial	NPR Million	(B) Development	NPR Million
Agriculture	4 153	Agriculture	412
Mining	366	Industrial	2 919
Productions	44 622	Housing and Real Estate	443
Construction	3 688	Business Sector	682
Metal Productions, Machinary & Elec. Tools and Fittings	1 303	Service Sector	1 653
Transportation Equipment Production & Fitting	1 530	Against Fixed Deposit (FDR)	3
Transportation, Communications & Public Services	7 054	Others	27 965
Wholesaler & Retailers	27 074		
Finance, Insurance & Fixed Assets	4 383		
Service Industries	12 473		
Consumable Loan	3 554		
Local Government	3		
Others	23 235		
Sub Total (A)	**133 437**	**Sub Total (B)**	**34 077**

(C) Finance	NPR Million	(D)	NPR Million
Hire purchase	2 855	Commercial	617
Housing Loan	4 759	Production	49
Term Loan	7 670	Against FDR & Security	32
Lease Finance	144	Others	877
Merchant Banking	64		
Fixed Dep and Govt. Security	612		
Others	263		
Sub Total (C)	**16 366**	**Sub Total (D)**	**1 575**
		Country Total (A+B+C+D)	**185 456**

TABLE 3

Types of Collateral of Commercial Banks

As at Mid-January 2004

Collateral	Credit Volume (NPR Million)
Gold/Silver	1 385
Government Securities	2 798
Non Government Securities	911
Fixed Deposit	2 171
Asset Guarantee	**87 042**
Fixed Asset	64 877
Current Asset	22 164
Bills Guarantee	10 147
Personal Guarantee	6 431
Credit Card	53
Earthquake Victim Loan	114
Others	22 387
Total	**133 437**

CREDIT RISK AND CREDIT ACCESS IN ASIA – ISBN-92-64-03597-4 © OECD 2006

Major laws relating to the financial system

Some of the major laws relating to the financial system are:

- Nepal Rastra Bank Act of 2002
- Bank and Financial Institutions Ordinance 2004 (The ordinance replaced the Agricultural Development Bank Act of 1967, the Commercial Bank Act of 1974, the Finance Company Act of 1985, the Nepal Industrial Development Corporation Act 1990 and the Development Bank Act of 1996).
- Co-operative Bank Act
- Foreign Exchange Regulation Act of 1962
- Financial Intermediary Act of 1998
- International Financial Transactions Act of 1998
- Insurance Act
- Debt Recovery Tribunal Act

Trends and developments in insolvency and creditor rights frame work and practices

The legal system in Nepal: An outline

The constitution of Nepal of 1990 accorded significant status to the judiciary in order to render it an independent functional body capable of dispensing justice in an effective manner. The services of Supreme Court judges cannot be terminated unless parliament impeaches them with a two-thirds majority on grounds of incompetence, dishonesty, misconduct. Impeachment must be upheld by His Majesty the King. Similarly, the services of the judges of courts of appeal and district courts may be terminated, or legal action may be initiated against them on recommendation of the Judicial Council and approval by His Majesty the King.

The judiciary is divided into three parts and the courts are divided according to the geographical divisions of the country. There are 75 district courts, each in a district of Nepal, as the court of first instance. There are 16 courts of appeals as the appellate courts. A court of appeal also has original jurisdiction in certain judicial review cases and can issue writs of *habeas corpus* and *mandamus*, and injunction orders.

The Supreme Court is the apex court and is situated in the capital, Kathmandu. The Chief Justice, who is also the head of the judiciary, heads the Supreme Court. There are 15 permanent judges including the Chief Justice. The King, on the recommendations of the Constitutional Council and the Judicial Council, appoints the Chief Justice and the judges to the Supreme Court. The Constitution of Nepal lays down the qualifications for judges. Apart from these ordinary courts, a special court could be established to hear cases of corruption, drug-related matters etc.

The role of the Judicial Council

The Judicial Council is set up to oversee the functioning of the judiciary. It consists of:

- The Chief Justice;
- The Law Minister;

- Two senior judges of the Supreme Court; and
- Senior legal experts appointed by His Majesty the King to:
  - Recommend the appointment of judges to the Supreme Court to the King (Supreme Court, appeals courts); and
  - Instil discipline, efficiency and transparency in the system.

Current legal and institutional developments

Need for insolvency legislation

Personal bankruptcy law was first introduced in Nepal as early as 1853. However, there has been no reported case pursued under the said law. Even today, personal bankruptcies are not very much in vogue.

Laws relating to insolvencies of partnerships, limited companies, banking and financial institutions, insurance companies, etc. are embodied in different legislations. The Partnership Act deals with the dissolution of partnerships, winding up of limited companies is governed under the Company Act, The Banks and Financial Institution Ordinance of 2004 deals with the dissolution and insolvency of the banks and financial institutions licensed under the said ordinance. Thus, the law relating to insolvency is scattered in different acts. Further, invocation of insolvency proceedings is yet to take roots in Nepalese society.

i. Even though Company Act deals with liquidation of limited companies (other than banks, financial institutions, insurance companies and state-sponsored companies), the same has not gained popularity due to the following reasons:

ii. Creditors holding at least 50% of the total loan outstanding of the company, which is outstanding for more than one year, could alone apply for liquidation of the company, on the grounds of failure to pay. This is too stringent. The Law does not permit appointment of liquidator by creditors and as such, the office of company Registrar oversees the liquidation of the companies. This has a dampening effect.

The relevant statistics reveal that during the last 10 years, the voluntary liquidation of 130 private limited companies and 19 public limited companies were carried out. There has not been a single liquidation initiated by a creditor. This, ostensibly, necessitates the need for comprehensive legislation on insolvency.

The proposed insolvency legislation

The Insolvency Ordinance of 2004 has been drafted and is reported to be pending awaiting the King's assent. A study of the draft ordinance reveals the following key aspects that are not addressed in the extant legislation:

- The ordinance is applicable to all companies incorporated with limited liability under the Companies Act including banks, financial institutions, insurance companies and companies set up by the government (approval of the Nepal Rastra Bank, the Insurance Board and concerned government departments is needed for the insolvency of banks, financial institutions, insurance companies and government companies).

- It deals with voluntary liquidation and involuntary liquidation that may be prompted by creditors holding more than 5% of debt outstanding, or shareholders holding 5% of equity or 5% debenture holders. However, voluntary liquidation will continue to be under the purview of Company Act.
- Focuses on time bound completion of the proceedings indicating the timetable at each stage.
- Deals with issues like "fraudulent preference"' and the "doctrine of relation back".
- Jurisdiction is vested with the court as opposed to the company registrar. No insolvency proceeding can be initiated unless ordered by the court on examination of relevant factors.
- Provides for investigation of the factors leading to insolvency and reorganisation/rehabilitation of the company in appropriate cases (Section 13 (I)).
- Upholds the right of secured creditors to be paid out of security charged.
- Provides for issue of interim orders prohibiting transfer of shares, encumbering/alienating, transferring etc. of the company's assets. (Section C (11)).
- Facilitates the professionalisation of insolvency proceedings by directing the appointment of an investigation officer (Section 10), and a reorganisation manager (Section 13(4)) who is an insolvency practitioner. The official liquidator alone should conduct insolvency proceedings.
- Automatic suspension of specified transactions (Section 19) such as transfer/sales of assets, transfer of shares etc. Legislation allows creditor committees be associated with the liquidation proceedings (Sections 44 and 45). The liquidator must call for a meeting of creditors before compiling his report.
- Permits setoff of mutual debts between the company in liquidation and creditors (Section 53)
- Deals with insolvency related crimes, *i.e.* deliberate concealment of the facts that the company's solvency is under threat, forgery, fraud, cheating, misleading etc. (Section 72 (1) C).
- Setting up of the Insolvency Administration Office (Section 65) to administer the practice of insolvency, maintain a roster of insolvency practitioners and to set in motion their code of conduct.

Upon the assent of His Majesty the King, the ordinance will be promulgated and become the law of the land.

Limitations of the proposed ordinance

Given that 90% of the companies incorporated in Nepal are private limited companies closely held by family members, the prospects of insolvency law gaining a foothold is debatable. Due to pronounced lack of transparency in financial statements, the application of the solvency test, (*i.e.* liabilities exceeding the value of assets) may not be an easy task. Furthermore, due to the availability of self-help remedies to banks and financial institutions (under the law for realising dues by disposal of the securities charged) and, taking into account the time lag for getting court decisions through formal insolvency proceedings, the prospects for the banking community (including financial institutions) invoking the insolvency proceedings appear, for the present, to be very limited. As a corollary, the threat of insolvency may not usher an era of accelerating recoveries in the financial system. Finally, the success of the proposed ordinance hinges largely upon the availability of professionals and experts to be insolvency practitioners. An acute dearth of professionals in different fields could be a non-starter for the proposed law.

Legal reform milestones

Contextual to the need for legal reforms and for updating the various laws, the following were enacted during the past few years:

- *The Bank and Financial Institution Ordinance of 2004:* The ordinance consolidated the legislation governing banks and financial institutions. Public debate on the ordinance, which is receiving the attention of the government, highlighted the need for drastic changes. A fresh ordinance on banks and financial institutions is in draft form.
- *The Security Transaction Registration Act:* This is an important piece of legislation for mandatory registration of the "charges" created on the movable assets of companies by banks and financial institutions. It is expected to facilitate the determination of the priority of charges of different lenders from the banking and financial sectors. The act is in the process of finalisation for promulgation.
- *The Debt Recovery Tribunal Act:* This is an exclusive forum for banks and financial institutions to lodge their claims for recovery of dues exceeding NPR 500 000 each. It began functioning in October 2003. However, as the number of recovery cases filed with it is quite large, decisions are bound to take time. Further, the lack of experience and expertise in dealing with commercial cases by the judiciary could pose a serious threat to the efficiency of the DRT.
- *The Anti-Money Laundering Law:* The law is proposed and in draft form.
- *The Company Act of 1996:* The act is being repealed and re-written incorporating changes, including a chapter on liquidation.

i) The Asset Management Company

To date, there is no asset management company (AMC) to acquire impaired debt. The government is proposing to set up an AMC and, in this connection, a draft of the Asset Management Ordinance has been prepared on which public opinion has been sought. The ordinance, in its draft form, has several loose ends that need to be tied up based on the feedback received.

The AMC is to acquire assets and liabilities from debtors and arrange for their sale or management. In Nepal, this is too complicated. The AMC, in its formative stages, should confine itself to the purchase of impaired debts from banks and financial institutions. The proposed AMC would deal with any category of credit not placed by the NRB in the category of good credit. Taking into account the magnitude of the impaired credits in the banking system, this will be too much to handle. Furthermore, there are no indicative parameters for acquisition of impaired debts from banks and financial institutions.

Even on the purchase of impaired debt from banks and financial institutions, the AMC would not get the right of subrogation since the same has no legal recognition to date. Therefore, the assets charged to the lender are not automatically transferred to the AMC to facilitate sale.

Unless and until the legal framework is restructured meaningfully to facilitate recovery of the dues by the banks and financial institutions, the AMC will not be able to play a useful role. It will be subject to the same handicaps presently faced by the banking system, *i.e.* restraint orders, decisions being taken to court and the prolongation of legal decisions. Moreover, the multiple bank scenario will certainly slow dealing with impaired credits with particular reference to contentious issues

relating to the priority of charges. In sum, the AMC, as per the draft ordinance, will have no teeth. Therefore, we do not see the AMC (in its proposed structure) playing a useful role.

Reflections on the legal system

Interactions with the elite in the legal professions, industry and banking reflect the following on the legal system:

- Appointment of judges to the Supreme Court and other courts are not strictly in accordance with merit. Subjectivity and extraneous considerations creep in.
- Comprehension levels among the judiciary in respect of commercial cases is quite low due to the lack of a good legal education and exposure. Consequently, the outcomes of commercial cases are not easily predictable.
- Enormous time is needed for deciding simple commercial cases. It may take two years to issue a verdict and, if the case goes to appeals, it may take a further two years. There is much more delay in complicated commercial cases. Consequently, the cost is significant to the concerned parties.
- Lack of transparency and political interference impede working with the judiciary. It appears that the National Judicial Council has not moved effectively to weed out corruption and to book guilty persons.
- Expertise in specific branches of aw is conspicuously absent.
- Enactments and ordinances are secretly introduced by the government. There are no meaningful debates to elicit the views of concerned parties like banks, industry, trade, etc. Furthermore, suggestions that offered following enactment are not considered seriously.
- The Arbitration Act was passed 23 years ago. However, arbitration as an alternative vehicle for dispute resolution, is yet to gain popularity. The Nepal Council of Arbitration Practitioners was established to provide institutional support for arbitration. However, the council is still in its infancy.
- Absence of legal firms of international repute to share experiences/expertise.
- Entire judicial machinery moves manually. The use of technology is yet to take shape.
- To overcome some of the deficiencies noted in preceding paragraphs, the government:
  - Has set up the National Judicial Academy to provide continuing legal education to judges; and
  - Is proposing to set up commercial benches at the related district courts to deal with commercial cases. The concerned judges are to be given the required training. This step is aimed to improve the efficiency/effectiveness of deciding commercial cases and reduce the time lag.

General

The preponderance of bank and financial institution lending is against the security of current and/or fixed assets. The Bank and Financial Institutions Ordinance empowers realisation of the dues by disposal of the securities without intervention of the court. Perceived shortcomings are:

- The creation of the security is through the execution of relevant documents for the primary security and for mortgages by registering the same with the concerned land revenue office.

- There is no legislation requiring registration of the encumbrances or "charges" either on primary or collateral securities.
- Consequently, in a scenario where a customer avails of credit facilities from more than one bank (multiple banking), and in the absence of transparency/exchange of information among banks, it becomes very difficult if not impossible to ascertain the ranking of the charges *vis-à-vis* the extent of the share of the primary security in the event of recovery. Therefore, there is a dire need for comprehensive legislation relating to the registration of "charges".
- Efforts to recover dues through the public auction of the securities are quite often thwarted by *ex parte* restraint orders from the judiciary and the enormous amount of time required to vacate the restraint orders.
- There should be enabling provisions for the banks to seek orders from the competent court restraining the borrowers/guarantors from encumbering, alienating or transferring the assets offered as security to the banks, during the auction notice or recall notice period and/or during the course of judicial proceedings for the recovery of the banks dues.
- Recently, the superiority of the rights of the secured creditor, to be paid out of the security charged, is threatened due to the revenue authorities putting an embargo on the transfer of property arising from the sale of the same.

Issues that need to be addressed by government

These issues need to be addressed by the government:

- Generally, banks and financial institutions do not entertain unsecured lending, especially as the regulator discourages the same.
- Insolvency as a medium for the recovery of dues has yet to gain ground mainly because of the rigours of extant legislation. Consequently, reorganisation procedures are unknown in the system. However, the regulator has issued guidelines facilitating restructuring and rescheduling, and this has gained acceptance among banks and financial institutions.
- There is no practical impact of the present insolvency regulations on risk management practices and policies, and, as such, it does not provide any incentive for efficient credit risk management.
- The new insolvency legislation is expected to address, to a large extent, deficiencies/rigours of the present insolvency regulations.
- Further, due to the perceived inadequacies of the legal system (especially due to the grant of *ex parte* restraint orders blocking the sale of security, the inordinate time taken for deciding on the recovery cases and the lack of transparency), out of court settlements and out of court workouts are gaining acceptance.

The legal system in Nepal is still to achieve several milestones to play a crucial role in the development of the country's economy. This may be possible through improved efficiency, effectiveness, transparency, and willingness to move forward.

Current risk assessment and management systems and policies

Risk assessment and management systems

A good credit management system and procedures are prerequisites for effective credit risk management. Components of credit risk management are:

- *Credit policy:* Road map for the credit portfolio;
- *Credit appraisal*: Taking into account all relevant aspects of the applicant/applicant's unit such as:
  - *Audited/un-audited financials* for the past three years;
  - *Profile of the entity:* Background of the promoters and experience, installed/utilisation of capacity, product mix, process, management team, shareholding pattern, group companies, marketing arrangements, export potential, macro-level industry scenario such as competitors, etc.;
  - *Regulatory environment;*
  - *Demand and supply;*
  - *Risk factors;*
  - *What could spoil the party*;
  - *Details of credit facilities* required along with rationale;
  - *Projected profitability* estimates and cash flows in case of loans for acquisition of fixed assets;
  - *Industry scenario vis-à-vis* update on regulatory environment; and
  - *Market reports*.
- *Credit approval:* Bifurcation of credit marketing and credit approval processes and independent vetting of the proposals emanating from marketing department;
- *Post-approval procedures:* Documentation, security verification, insurance coverage etc.;
- *Post-disbursal procedures:* Monitoring the conduct of the accounts/debt servicing, periodic security verification, periodic review of performance, credit checks, audit by external agencies, tracking smoke signals;
- *Exposure limits* including for groups;
- *Sectoral exposure limits*;
- *Risk pricing*/customer risk rating/facility risk rating models;
- *Geographical exposure limits* where applicable;
- *Concentration risk*;
- *Assessment of other risk factors*/risk mitigants, *i.e.* environmental, regulatory, collection, counter-party and exchange risk, Indo Nepal Treaty etc.; and
- *Recovery management:* separate set-up for exclusive focus for exhausting "self-help remedies" and for putting through out-of-court settlements, out-of-court workouts, for filing the claims with DRT, recovery and settlement policy, roadmap.

Interactions with senior executives of commercial banks, the central bank, development banks and finance companies reveal that while very few banks have good credit risk management systems and procedures in place, most of them are in the process of doing so. Even though credit marketing and credit risk functions are segregated in leading banks, segregation has yet to take roots except in one multi-national bank. This is mainly attributable to the lack of trained/professional personnel and/or mindset.

Non-performing loans of commercial banks

Adherence to good credit risk management systems has a direct bearing on the health of the banks as can be seen from the following data:

Non-performing loans of commercial banks

Rs Million

		As at Fiscal Year Ending Mid July									Growth % (NPL/T. Loan)	
		2001			2002			2003				
S.N	Banks	Total Loan	NPL	NPL%	Total Loan	NPL	NPL%	Total Loan	NPL	NPL%	2002	2003
1	Nepal Bank	20,419	10,373	51	19,253	10,834	56	18,132	10,965	60	11	7
2	Rastriya Banijya Bank	27,375	12,337	45	27,037	14,889	55	26,609	16,005	60	22	9
A	**Subtotal**	**47,794**	**22,710**	**48**	**46,290**	**25,723**	**56**	**44,741**	**26,970**	**60**	**17**	**8**
3	Nabil Bank	8,324	1,352	16	7,802	557	7	8,114	450	6	(56)	(22)
4	Nepal Investment Bank	2,429	201	8	2,714	130	5	5,922	117	2	(42)	(59)
5	Standard Chartered Bank	5,681	297	5	5,696	276	5	6,000	248	4	(7)	(15)
6	Himalayan Bank	9,015	1,367	15	9,557	798	8	10,845	1,093	10	(45)	21
7	Nepal SBI Bank	4,188	483	12	4,584	290	6	4,796	562	12	(45)	85
8	Nepal Bangaladesh Bank	7,359	614	8	8,084	1,275	16	7,962	1,013	13	89	(19)
9	Everest Bank	2,999	118	4	4,044	42	1	5,050	111	2	(73)	110
10	Bank of Kathmandu	4,286	325	8	4,890	397	8	4,856	421	9	7	7
11	Nepal Credit and Commerce	2,889	547	19	2,878	1,155	40	3,396	701	21	112	(49)
12	Lumbini Bank	1,786	278	16	2,285	442	19	2,619	303	12	24	(40)
13	NIC	2,618	132	5	2,369	193	8	2,563	171	7	61	(18)
14	Machhapuchhre Bank	499	5	1	680	71	10	1,496	31	2	1,051	(80)
15	Kumari Bank	266	-	-	1,127	14	1	2,138	36	2	-	34
16	Laxmi Bank	-	-	-	124	-	-	776	-	-	-	-
17	Siddartha Bank	-	-	-	-	-	-	629	-	-	-	-
B	**Subtotal**	**52,340**	**5,719**	**11**	**56,835**	**5,640**	**10**	**67,159**	**5,256**	**8**	**(9)**	**(21)**
	Grand Total (A+B)	**100,134**	**28,429**	**28**	**103,125**	**31,363**	**30**	**111,901**	**32,227**	**29**	**7**	**(5)**

Notes:
-Consolidated NPA data of development/co-operative banks and finance companies are not available.
-Very high level of impaired debt with government and semi-government banks (Rastriya Banijya bank and Nepal bank Limited) is attributable to political interference, reckless and subjective lending, and lack of accountability.
-Kumari Bank, Laxmi Bank and Siddartha Bank have been established since about 2/ 3 years.

Sources of major problems

Sources of major problems in credit risk management as revealed by our study are stated below:

- Financials statements (including audited statements) do not reflect a "true and fair view" of the business entity due to creative accounting. The audited financials statements, as submitted by customers, do not reflect details relating to: (a) encumbrance "charges" on the company's current/fixed assets or to whom they are charged; (b) details of group company lending/borrowing; (c) contingent liabilities; (d) accounting policies; (e) status

on income tax assessments, etc. These should be made mandatory in the annual financial statements.

- Delegation of lending authority is based on seniority and not on the competence of the concerned officials.
- Absence of exchange of credit information/lack of transparency among competing banks gives rise to multiple banking (same customer having facilities with different banks), which contributes to excessive financing, double financing, diversion of funds, flight of capital, and asset coverage shortfall.
- Absence of:
  - Risk based pricing methodologies;
  - Customer risk rating models; and
  - Facility risk rating models.
- Lack of appreciation of the need for manning the operations with skilled professionals as most banks are set up by promoters who are traders.
- Pronounced name lending.
- Collateral based lending instead of need-based/cash flow-based lending.
- The blacklisting guidelines of the regulator contribute to new NPAs due to the spread of contagion.
- Acute dearth of experts/professionals in finance, legal, and business management.
- Over-banked centre contributes to severe competition and price-cutting.
- Lack of corporate governance.
- Permissive banking practices including name lending, and multiple banking.
- Macro level scenario of political instability, slow growing economy and small domestic market.
- Ineffective judiciary.
- Cross-border risk: the disappearance of promoters.
- Inadequacy of law to deal with financial crimes like cheating and misfeasance.

The role of the regulator

Nepal Rastra Bank is the regulator with the crucial role of overseeing the health of the financial system and issuing necessary guidelines. It also has to co-ordinate with government to develop and amend legislation as necessary. A strong regulator is necessary for the effect function of banks/financial institutions and for the health of the financial system. The requirements of regulators are manifold and are stated below:

Major prudential norms:

The regulator has laid down various prudential norms some of which are as follows:

- *Capital adequacy:* 11% of which Tier 1 has to be a minimum of 50%

- *Single/group exposure limit:* 25% for funded exposure and 50% for non-funded exposure of core capital
- *Sectoral exposure limit:* not to exceed 100% of core capital
- *Income recognition on credit portfolio:* on cash basis only
- *Loan classification and provisioning:* on funded outstanding, as follows:

Category	Criteria	Required Provision
Standard	Performing	1%
Sub-standard	Past due 3 to 6 months	25%
Doubtful	Past due 6 to 12 months	50%
Loss	Past due above 12 months	100%

Other major requirements

Other major requirements are that asset liability management committees are to meet periodically to review market risks (interest rate, liquidity and forex risk), and audit committees are to be headed by non-executive directors who meet periodically to review audit inspection reports.

Disclosure norms:

NRB requires banks to disclose the following when presenting the financial statements to the annual general meeting for approval:

- Details of loan grades, provisions under each grade and net loans;
- Loans given to the directors, promoters and employees, if any;
- Maturity profile of loans;
- Details of off-balance sheet items (non-funded facilities);
- Basis of recognising income on loans;
- Yield of loan portfolio;
- Securities taken against loans;
- Details of waived loans and interest; and
- Non-banking assets and provisions thereto.

Disclosure norms are according to international standards. Accounting policies of banks and financial institutions are required to be stated in the annual financials relating to income/expense recognition, translation of foreign currency transactions, provisions for possible loan losses, write-offs, fixed asset depreciation and amortisation, and details of investment along with basis of valuation among others.

Supervision and Inspection

Supervision and inspection is both on and off-site.

Directed lending

It is mandatory for commercial banks to comply with the directives of the regulator with regard to lending to the productive and priority sectors. The directives are summarised below:

- *40% to productive sector:* The productive sector includes advances to and investment in shares and debentures of small, medium and large industries (as defined in the Industrial Enterprises Act) and government/semi-governmental or private sector agricultural activities, insurance, banking or like companies, pre-shipment credit, export bill financing, advances for purchase of public transport means and agricultural equipment.
- *7% to priority sectors including 3% for the deprived sector:* The priority sector includes micro and small enterprises that help increase production, employment and income (as prioritised under the national development plans), with the objective of lifting the living standard of the general public, and deprived and low income people, in particular, by progressively reducing unemployment, poverty, economic inequality and backwardness. Micro and small enterprises are classified into: agricultural enterprises; and cottage and small industries and services. In addition, other businesses as specified by the Central Bank, are also included under micro and small enterprises. Further classifications are:
  - Agriculture and agro-based business;
  - Cottage and small industries;
  - Services; and
  - Other business.

The deprived sector includes low income and other groups including women, tribes, lower castes, the blind and hearing impaired, physically handicapped persons and squatters. All credits extended for the improving the economic and social status of the deprived sector up to the limit specified by the Central bank (NPR 30 000) is considered "deprived sector credit", which is an integral part of the priority sector also comprising micro credit programs and projects.

Outstanding as at mid-January 2004

	NPR Million
Priority sector	7 757
Deprived sector	2 393
Total	10 151

The role of deregulation

Nepal Rastra bank deregulated the following:

- Interest rates on deposits and advances;
- Directed lending from 12% to 7%;
- Cash reserve ratio requirement from 12% to 5% over the period; and
- Foreign exchange pricing.

These measures have improved liquidity in the financial system and enhanced the degree of competitiveness. On the other hand, deregulation of interest rates has given rise to rate war among banks and FIs.

Over the years, Nepal Rastra Bank has come a long way in improving the overall control and supervision of the financial system. It has also paved the way for financial sector reforms and de-regulation. Nevertheless, there appears to be immense scope for improving its role. Views of a cross-section of bankers, lawyers and other professionals are briefly summarised below:

- The regulator is not strong enough and is not effective in the supervision and control of the financial system, contributing to non-compliance with directives. Non-compliance is not punished with penalties.
- There is a dire need to introduce professionals and experts into different regulatory branches through outsourcing or otherwise.
- Facilitate better training by revamping the training centre, taking into account the dearth of skilled manpower in the financial system.
- Initiate actions to develop forex, money and capital markets to broaden the base of and advance the financial system.
- Effectively co-ordinate with various government functions to usher in an era of transparency in financial reporting by corporations and other business entities through the revamping of tax, company and other laws. There is a need to reform the judicial system to protect the rights of secured creditors *vis-à-vis* facilitating recovery of the dues of banks and financial institutions.
- There is a lack of transparency among the participants of the financial system arising from the permissive banking environment. NRB could lay down guidelines for credit approval/administration (including methodologies), consortium lending, and mandatory exchange of information between banks and financial institutions, etc.
- Set-in-motion the processes for determining the adequacy of credit risk assessment and management procedures in the financial system and initiate corrective actions.
- Co-ordinate the establishment of credit information/credit rating agencies.

Credit information systems

The Credit Information Bureau (CIB), under the auspices of Nepal Rastra Bank, is the provider of information on the borrowings by corporations and other business entities. It is mandatory for banks and FIs, (before sanctioning, enhancing or reviewing any credit facilities beyond NPR 1 million per party), to seek information from the CIB on borrowings. CIB is expected to provide data within a specified period to the applicant bank or FIs.

The response provided by the CIB merely indicates the aggregate amount of the borrowings by the business entities (without any further inputs on the terms of the borrowings, the security offered or the names of lending institutions) and is, therefore, of limited value to banks and FIs. Moreover, the information contained in the response is not updated. It is generally it may be four to six months old.

The financial system functions under a severe handicap due to absence of:

- A credit information agency for providing meaningful updated credit reports on business entities;
- Credit rating agencies; and
- A lack of transparency and exchange of information on credit-taking businesses.

Thus, the system is exposed to high degree of credit risk. It is appropriate to say that the regulator has a role in co-ordinating the establishment of a credit information and a credit rating agency. It should also make it mandatory for banks and FIs to exchange information about business entities, including their credit lines, with penalties for non-compliance.

Credit risk transfer (CRT) and new financial instruments

Credit risk transfer instruments and institutions are conspicuous by their absence in Nepal, notwithstanding the need. This absence arises due to the lack of experts and professionals, and the missing depth of the financial system.

The Credit Guarantee Corporation (CGC) was set up in 1974 with the objective of encouraging finance to the priority sectors. CGC insures loans made in the priority sector up to NPR 2.5 million. It takes a 1% premium on outstanding loans and reimburses a maximum of 75% of insured sums in case of default. However, if any amount is recovered from the borrower after settlement of claims, 75% of the same is refunded to the CGC.

TABLE 5

Financial Health of Major Banks & Financial Institutions
(Based on CAMELS)
Figures as at Mid July 2003

	RBB	NBL	ADB	HBL	Nabil	NBB	NIB	SCBL
Capital Fund (Rs Million) *	(20,502)	(732)	2,033	1,436	1,804	1,039	741	1,528
Capital Adequacy Ratio (%)	(45)	(29)	N.A.	11	13	8	9	14
Asset Quality (NPL%)	60	60	Aroud 22 (#)	10	6	13	2	4
Management *	Central Bank	Central Bank	Government	B O A R D O F D I R E C T O R S				
Earnings (%)								
ROA (Net Profit / total Asset)	(18.5)	(0.6)	0.0	0.9	2.4	0.6	1.3	2.4
ROE (Net Profit / Net worth)	(27.7)	(2.6)	0.8	24.7	36.3	11.4	22.3	41.0
Liquidity Ratio *	28	47	8	50	53	32	27	57
(Cash, bank balances, Call Money and Government Securities / Deposit and Borrowings)								
Sensitivity to Market Risk	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.

* As of Mid July 2004
(#) Calculated based on NBA volume and assuming that LLP is 50% of NPL

Financial institutions suspended/closed recently

Nepal Rastra Bank has taken over management of the following commercial banks:

- Rastriya Banijya Bank;
- Nepal Bank Limited; and
- Lumbini Bank Limited.

Nepal Development bank has been barred from taking deposits. Similarly, NRB has cancelled the license of two co-operatives (Shree National Development Co-operative Society Limited and Shree Nepal Co-operative Society Limited) and has barred United Savings and Credit Co-operative Limited from collecting deposits.

State bailouts of banks, state subsidies to state banks and interference in management

So far, there have been no bailouts of banks by the state. However, the government has taken financial assistance from the World Bank and the DFID to revamp and turnaround a number of ailing banks (Nepal Bank Limited, Rastriya Banijya Bank, Agricultural Development Bank and Nepal Industrial Development Corporation).

In this regard, Nepal Rastra Bank has outsourced management of Nepal Bank Limited and Rastriya Banijya Bank. With regard to the ADB, NRB is in the process of hiring experts for taking necessary actions. NIDC is being liquidated.

Potential sources of systemic risk

Potential sources of systemic risk are:

- No legislation for registering the security transactions of banks and FIs to determine the priority of the charges;
- Absence of credit rating agencies;
- Lack of alternative investment opportunities coupled with lack of depth in secondary market/ foreign exchange market;
- Cross border risk: capital flight;
- Absence of credit risk transfer instruments/institutions; and
- The representative body of the banks *i.e.* the Nepal Bankers Association is more or less defunct due to its ineffective functioning and lack of co-ordination.

Conclusions and recommendations

The weaknesses, inadequacies and ineffectiveness of Nepal's financial and judicial systems and their impact on credit risk management systems on the financial health of banks and financial institutions are stated in the preceding paragraphs. This underscores the need for building further on financial sector and legal reforms, and also the catalyst role of the regulator. As the legislation relating to insolvency has not gained the required acceptance by the financial sector, the expected interface between credit risk management system and insolvency systems is practically absent. The government has to not only accelerate reforms, but also set up needed institutions for credit rating and for credit risk transfer. Nepal, though a small country has, a mammoth task ahead. In this regard, the recommendations are as follows:

i. The laws relating to insolvency, asset management companies, security transaction registration and anti-money laundering should be put in place expeditiously.

ii. Besides setting up commercial benches in the courts, it is necessary to impart skills to practicing lawyers and presiding judges.

iii. Increase the number of debt recovery tribunals and provide adequate manpower.

iv. Rationalise tax rates and tax laws to encourage transparency in financial reporting.

v. Legal provisions relating to fraud and forgery should be rationalised and made much more effective to facilitate access by the financial sector.

vi. Rights of secured creditors to be paid out of the concerned security should be paramount and should not be interfered with, even by the government, with regard to its dues.

vii. There should be enabling provisions for banks and FIs to seek orders from the competent court restraining borrowers and guarantors from encumbering, alienating or transferring assets offered as security to banks during the auction or recall notice period and/or during the course of judicial proceedings for recovery of bank dues.

viii. Insolvency practice should be professionalised as envisaged in the proposed ordinance and experts from overseas be invited to impart training and skills upgrades.

ix. Besides pursuing financial sector reform relating to deregulation, there is a dire need (taking into account the high level of impaired debt in the banking sector caused by permissive banking practices) to introduce regulations for credit approval, mandatory consortium lending, and exchange of information amongst banks and financial institutions.

x. Start the process for determining the adequacy of credit risk assessment and management procedures in the financial system and initiate corrective actions.

xi. Scale down single, group and sectoral exposure limits to moderate the concentration of risk in the financial system.

xii. The regulator should set up training facilities to upgrade skills in the financial system.

xiii. The regulator and the Nepal Bankers Association should co-ordinate to establish the Nepali Banking Institute, which would have the goal of professionalising the banking sector by drawing up curricula for banking education and conducting diploma examinations.

xiv. The regulator should moderate the rigours of blacklisting guidelines (more appropriately described as draconian in its content and applicability).

xv. Strengthen off and on-site supervision by the regulator to evaluate the efficacy of credit risk management systems including credit approval processes, post-disbursement procedures, recovery management, etc.

xvi. The regulator should co-ordinate the establishment of credit risk transfer institutions and credit rating agencies, and facilitate the development of credit risk transfer instruments.

xvii. The banking community should join hands to render their representative body a proactive and sensitive organisation capable of addressing key issues affecting banks with concerned authority.

xviii. Need to open the doors for professionals and experts from other countries in the area of law, finance, accounting and audit.

xix. Recommendations relating to Nepal Accounting Standards and Nepal Auditing Standards need to be implemented expeditiously for compliance by corporations.

xx. Initiate necessary actions for the development of the forex, money and capital markets to broaden the base of the financial system and its placement on a sound footing.

RISK MANAGEMENT, THE REGULATORY/LEGAL ENVIRONMENT AND INSOLVENCY SYSTEMS: RECENT TRENDS AND DEVELOPMENTS IN PAKISTAN

by
Salman Ali Shaikh

Introduction

The linkage between risk management and insolvency systems is often imperfectly understood at the regulatory/main stakeholder level. In some cases, a decline in NPL levels owing to high economic growth rates and improvements in the regulatory environment cause enough complacency that efforts to create a modern insolvency regime are put on the back burner. To amplify, an insolvency system's linkage with risk management is a bit like the concept of derived demand in economics. The need to improve insolvency systems is often felt as a consequence of a failure in the area of risk management, as evidenced by high NPLs and/or a high growth rate in NPLs. Therefore, a country can avoid serious consequences in the short term from a poor or non-existent insolvency system by making improvements in risk management, in particular, and the overall regulatory environment in general. This, in a nutshell, is Pakistan's recent experience.

The country's NPLs have neither evaporated nor disappeared. However, the past three years have seen a consistent downward trend from a peak level of 26% of banking assets in 1999, and a fairly stagnant position in 2000 and 2001 (See Annexure 1). Looking forward, this downward trajectory is expected to continue for another two years. The main factors responsible for this include a relatively good macroeconomic environment leading to lower NPL flows, significant improvements in banking supervision/regulation, robust growth in banking sector profitability leading to an increased ability to top up provisioning levels and, last but not the least, the central bank's policy U-turn in October 2002 whereby write-offs were de-criminalised and borrower-friendly settlements at fire sale values (or FSV) were actively encouraged. All this is certainly very good news. However, the bad news is that important stakeholders within the government appear to have lost their desire to implement a modern insolvency regime. It is hoped that the wake-up call will come internally and will not be in response to an NPL crisis in the future.

Legal developments

The current position

The overall legal environment in Pakistan continues to be biased in favour of lenders. In previous submissions to FAIR, the Corporate Rehabilitation Act (CRA) was discussed in considerable detail. The CRA was an attempt to restore balance between debtors and creditors rights and to develop an institutional framework, thereby creating a modern insolvency system. CRA aims to adopt a more forgiving approach towards business failure, particularly where the failure was caused by issues external to the business itself, *e.g.* a sudden change in duty structure, abrupt withdrawal of a subsidy, governmental interference in terms of input costs and/or price controls on the output side, etc. This draft law was prepared by the Banking Laws Review Commission (BLRC) in 2003 after nearly two years of deliberations. BLRC has adequate stakeholder representation from the relevant

government departments such as the State Bank of Pakistan, the Securities and Exchange Commission and the Ministries of Finance and Law. In spite of this, it appears highly unlikely that the CRA will be presented to parliament in the very near future. One of the cultural reasons for this ongoing delay is a widely shared belief that a person or entity that is unable to honour a financial obligation is *ipso facto* part of the "axis of evil" and deserves neither sympathy nor relief of any kind. On occasions like these, one is reminded of the Strange Case of Dr. Jekyll and Mr. Hyde because loan forgiveness schemes have become fairly regular parts of the regulatory toolkit. There was one major scheme launched in 1997 followed by another one in 2002. Therefore, in the absence of the CRA, the legal framework relevant to this discussion consists of the following laws:

- *Companies Ordinance, 1984:* Essentially based on English law of that period. Not designed for complex corporate reorganisation. Used mainly for liquidation/winding-up and occasionally for voluntary reorganisations/mergers. CRA, once enacted, will replace a significant portion of the Companies Ordinance.

- *Recovery of Finances Act, 2001:* This law is an improved version (for lenders) of a debt recovery law enacted in 1997. Aimed at accelerating debt recovery for banks and other financial institutions, it has the same conceptual flaw that existed in the 1997 law, *i.e.* decrees are awarded allowing accrual of interest/cost of funds. A law to deal with non-accrual loans with decrees being awarded on an accrual basis is yet another legal innovation for our pioneering lawmakers, *i.e.* to boldly go where no other law has gone before. The recovery law is implemented through special Banking Courts, which have been in operation since 1997. The quality and level of expertise of the specialised judges is very uneven, to put it mildly.

- *The National Accountability Bureau (NAB):* This draconian law was enacted in 1999, just after the military takeover, with a very broad scope. On the financial side, it contained whimsical terms like "wilful default", which became a criminal offence punishable by imprisonment. NAB could pick up a simple banking document (*e.g.* a loan restructuring agreement) and declare that the transaction was against the public interest without assigning any reasons whatsoever. Concepts like cash generation, debt repayment capacity and sustainable debt levels had no place in the enabling law that created NAB. NAB has had some success in stopping corruption using plea-bargaining as a favoured tool. With respect to the financial sector, it has been a resounding failure. Major reasons for failure include a poorly conceived and badly drafted enabling law, an inability to develop appropriate expertise/skills within NAB and an implementation pattern that reveals that the underlying priorities keep changing at regular intervals. In addition to causing a major dip in the investment climate for at least three years, the NAB law also had a negative impact on the banking system. For example, in the very important area of write-offs (*i.e.* balance sheet cleansing) decisions were either deferred, or simply avoided/not taken (See Annexure 3). Logic would dictate that the NAB law be either repealed or modified drastically in terms of scaling down its mandate. However, practically speaking, it is difficult to see how such a large white elephant with its tentacles in each province (Regional Accountability Bureaus) and specialised Accountability Courts will be cut down to size in the foreseeable future.

The current list of financial sector laws that are either in draft form or are in the pre-draft stage is as follows:

- *State Bank of Pakistan (SBP) Act:* A revamped and modernised version of the SBP Act of 1956 (amended in 2002). This law defines the functions, powers and objectives of the central bank.

- *Banking Companies Ordinance (BCO):* Currently being deliberated at the BLRC. This law is intended to replace the existing BCO of 1962 (amended in 2001). The need for a new law is clearly felt by all market participants and stakeholders. It is felt that there have been major changes in the banking industry during the past four decades in terms of new products, a major change in modes of delivery, the emergence and complexity of modern asset and liability offerings, etc. Some of the issues that are likely to be debated vigorously include the adoption of universal banking concepts, and the merits and demerits of unified financial sector supervision (like the FSA in the UK). At present, the country has two regulatory bodies for the financial system, the State Bank of Pakistan (SBP) and the Securities and Exchange Commission of Pakistan (SECP).
- *Corporate Rehabilitation Act (CRA):* The drafting stage was completed nearly two years ago. CRA is with the government, awaiting presentation to parliament. Discussed in much greater detail during the previous FAIR conferences, as well as in a previous sections of this paper.

Institutional developments

Structure

There have been no significant changes in terms of the legal framework in the recent past. The four basic layers of the judiciary are as follows:

- Civil courts;
- District and sessions courts;
- High courts; and
- The Supreme Court.

In addition, there are also specialised courts, tribunals, etc. some of which are as follows:

- Accountability courts;
- Banking courts;
- Federal Shariat courts;
- Labour courts;
- Taxation tribunals; and
- Federal ombudsman (and four regional ombudsmen).

Appointment and removal procedures:

High Court (HC) and Supreme Court (SC) judges are constitutional appointments. Appointments are made by the Chief Justice of Pakistan for the SC and the Chief Justice of the province for the HC. The Chief Justice of the HC of each province has administrative control over members of the subordinate judiciary in his province.

Removal of superior court judges is very rare. In theory, the Supreme Judicial Council is entrusted with this responsibility. In practice, it has never been used to remove a judge. The most recent test case was in 2001 when the Pakistan People's Party released transcripts of highly incriminating taped conversations between the then Chief Justice of the Lahore High Court (LHC),

Justice Malik Qayyum, and various key individuals in the Nawaz Sharif government, including the Federal Law Minister (Mr. Khalid Anwar). In addition to these embarrassing revelations relating to the use of political pressure, it was quite well known in relevant circles that the families of both the judges owned substantial amounts of defaulted loans to a major public sector bank (Habib Bank Limited). The Supreme Judicial Council did not act. However, public pressure, with the press playing a leading role, finally resulted in a situation in which judges sought early retirement, which was immediately granted.

Funding and the problem of pendency

A recent report by Bhandari and Naqvi found that the number of judges on a per capita basis is actually quite small. On a regional basis, the figure for Pakistan (114 812 persons per judge) is slightly better than India (148 263). The position in Bangladesh (97 310) and Sri Lanka (60 586) is significantly better. Figures for certain other countries/jurisdictions for comparative purposes are: Canada (15 369), the US (8 966), Belgium (7 000) and Germany (3 899).

The same report highlights the issue of growing caseloads and increasing pendency. With respect to the Lahore High Court, it states, "that while the total number of pending cases per year has increased almost 1 450% since 1929 (*i.e.* from 4 078 to 64 427) the number of judges has only increased by 156% (*i.e.* from 16 to 41)". As of October 31 2004, there were only 32 sitting judges at the LHC against a sanctioned strength of 50.

The funding position of the judiciary is far from satisfactory at any level. A very poor remuneration structure has resulted in a situation where corruption is endemic at lower levels. The major burden for funding the judiciary falls on the provinces. Expenditure on the judiciary as a percentage of overall provincial expenditure is given below (all figures are for 2001):

Punjab	0.69%
Baluchistan	0.59%
Sindh	0.51%
NWFP	0.47%

Judicial infrastructure and training

At the level of the superior courts, the quality of premises is adequate. However, the quality of premises at the subordinate courts level is grossly inadequate. The level of automation is uniformly poor.

Training, particularly for members of the subordinate judiciary, is an acute necessity, above all for judges who are assigned to specialised courts, *e.g.* Banking Courts. The Federal Judicial Academy is essentially a large building with hardly any staff. The author conducted training courses at this Academy for judges of all the Banking Courts in Pakistan in 2002. Only two out of 48 judges answered "yes" when the following question was posed to them: "Have you ever seen or read a balance sheet or annual report of any company in your life?"

Judicial independence

In theory, the judiciary is independent. In practice, notwithstanding occasional bouts of independent behaviour, the judiciary has learnt to co-operate with whatever government happens to be in power. The executive utilises subtle methods to ensure that the judiciary remains compliant. Bhandari and Naqvi's report on judicial independence notes that "General Musharraf followed in the

footsteps of General Zia by requiring all judges to swear fresh oaths of loyalty to him and his coup, and disposed of potential troublemakers by not inviting them to take oath." The then Chief Justice, Justice Saeed-uz-Zaman Siddiqui was not asked to take oath, and to make sure that he got the message, a tank was parked in his driveway. Five other judges of the Supreme Court, to their eternal credit, refused to take oath. The new-look Supreme Court, to no one's surprise, then validated the imposition of military rule in a 400-page judgment. The end result, as noted by Makhdoom Ali Khan, one of Pakistan's foremost constitutional experts, was further erosion in the rule of law and the stature of the judiciary.

The imposition of emergency, the ouster of a political government, the military takeover, the Oath of Office (Judges) Order 2000, and its aftermath have caused considerable damage to the rule of law and the image of judicial independence. If our judicial pronouncements are to have any credibility, this image must be revamped and executive interference with judicial proceedings must stop. The tenure of judges must rest on foundations a bit more solid than the goodwill of the Chief Executive. They must be allowed to rule on executive orders and legislative measures without having to worry about yet another oaths order.

The role of professionals

There is no institutionalised insolvency profession in Pakistan. There are significant pools of individual expertise in relevant professions (*e.g.* accountants, the financial sector and lawyers), but there are no self-regulating organisations like the Institute of Chartered Accountants (ICAP) and/or licensing bodies. The same holds true for vital functions like auctioneers, receivers, administrators, evaluators, etc. The CRA includes provisions for both the institutionalisation and the regulation of such professionals, but it is still a draft law. The case of evaluators is of particular interest as the SBP has, perhaps unwittingly, given them two very critical roles. For example, evaluators determine the amount of provisions that banks need to take, *i.e.* banks are allowed to deduct the "realisable value of assets" from the mandatory amount of provisions (100%) for NPLs in the "loss" category. More important, under broad-based guidelines issued in 2002, the central bank directed the banking system to undertake cash settlements of NPLs with borrowers based on FSV of the mortgaged asset(s). The determination of FSV was to be done by evaluators. NPLs amounting to over PKR[1] 52 billion, comprising around 50 000 individual borrowers, have been settled under these guidelines. Preliminary data suggests that evaluators have assisted borrowers as well as themselves by taking a deeply pessimistic view regarding the FSV of industrial assets. The draft CRA provides for creating self-regulating organisations, professional bodies and licensing agencies for these professions.

Banking ombudsman:

A banking ombudsman was appointed a few months ago, under the provisions of a law enacted in 1997. A senior retired banker was been selected and appointed. He will have at best a marginal role in dispute resolution in case of debt restructuring and/or insolvency issues. His mandate is limited to handling complaints relating to banking malpractices, inordinate delays, corruption, maladministration, etc. The rationale for the creation of this structure is the reality that the SBP receives a huge volume of complaints on a daily basis. The central bank presently has a whole cell/department dealing with these matters. The public perception is that the central bank is slow and partial to the banks. Hence, this is an attempt at creating an image of impartiality and to enhance transparency. Customers of banks will have recourse to this window within a few months. However,

[1] Pakistan rupee (PKR).

there is a large segment of the financial system that is regulated by the SECP. Unfortunately, the enabling law does not permit the ombudsman to handle complaints relating to the NBFI sectors, which comprises leasing companies, investment banks, mutual funds, insurance companies, etc.

The Corporate and Industrial Restructuring Corporation (CIRC)

CIRC is the country's first AMC. It was established in 2001, with a limited mandate, both in terms of scope of activities and time. The mandate was to acquire non-performing assets (NPAs) from the public sector banks, thereby expediting the privatisation process in the financial sector. While CIRC's performance has been very uneven, privatisation has proceeded at a reasonable pace. During the past three years, three major banks (Habib Bank Limited, United Bank Limited and Allied Bank Limited) have been successfully sold to private sector buyers.

The performance of CIRC has been the subject of considerable criticism. The main criticism focuses on the very narrow way that CIRC interpreted its mandate. They failed to develop any appetite and/or capacity for debt restructuring, and chose to act purely as an auction house. Senior bankers have been complaining that CIRC's performance has been poor and that those private sector banks that did not surrender their NPAs to CIRC have been obtaining better results in terms of both speed and value. A World Bank report on the functioning of CIRC noted that "CIRC has had a very limited success in cleaning up the balance sheets of the financial institutions." In terms of numbers, during the past four years it has acquired 233 NPAs involving NPLs of PKR 34 billion at an acquisition price of PKR 6 billion. So far, it has managed to sell/auction only 87 units/NPAs for slightly less than PKR 3 billion. CIRC's mandated "shelf life" is due to expire in less than two years. With well over 80% of the assets in the banking system now in the private sector, any extension in its mandated expiry date would defy common sense and logic.

The draft CRA has provisions designed to facilitate the creation of private sector AMCs/vulture funds. It is hoped that the incremental flow of NPLs would be managed by such private sector entities in the future.

New developments: the financial system, the regulatory environment and secured lending procedures

Recent developments (2002-2004)

The past two years have seen several major changes in the financial system as well as a significant positive shift in the overall regulatory atmosphere. Some of the more important developments are as follows:

- *Consolidation:* The 1990s saw mushrooming growth in the banking sector, with a huge increase in the number of banks, quite a few of which had low capitalisation, inadequate/inappropriate staffing, poor risk management practices and very marginal portfolio quality. The central bank has been nudging the banking system into consolidation by successively raising the minimum paid-up capital requirements in a phased manner. The minimum requirement was PKR 1 billion for 2003; it is PKR 1.5 billion for 2004 and is set at PKR 2 billion for 2005. There have been 17 mergers and acquisitions during the past two years, and several are in the pipeline. In all 17 cases, the acquiring bank was itself not a large bank. Two up-sides have been achieved; weak entities have been eliminated and concentration has not worsened. The average capital base of a commercial bank has risen from PKR 1.8 billion in 2000 to PKR 3.7 billion in 2003.

- *Privatisation:* Three major banks (Habib Bank Limited, United Bank Limited and Allied Bank Limited) have been successfully sold to private sector buyers. Well over 80% of the total assets of the banking system are now privately managed.

- *Two regulators:* This has been a slightly controversial move. Regulatory oversight for a sizeable chunk of the financial system (comprising leasing companies, *modarabas*, investment banks, mutual funds, and insurance companies) has been moved to the Securities and Exchange Commission (SECP). While this was done in a planned manner around two years ago. SECP failed to build capacity in a timely manner in order to handle this inflow. In fact, even now, the SECP lacks on-site inspection capability.

- *Universal banking:* While some of the main stakeholders are uncomfortable with this paradigm, market forces may dictate adoption. The SBP has become more permissive in this respect. Banks are now allowed to form separate subsidiaries to function as mutual funds, asset management companies, venture capital, foreign exchange companies, etc.

- *Consumer banking:* Encouraged by a low interest rate environment as well as excess liquidity, the banking system has finally expanded its lending operations to middle and lower income groups. A large range of consumer asset products such as credit cards, car loans, clean instalment loans, housing finance, etc. is now being marketed aggressively. A leasing company has recently started financing golf and country club memberships. On the other hand, liability products lack imagination. This could be because of excess liquidity and very low inter-bank rates. NPLs from the consumer sector are significantly lower than the corporate sector. Likewise, SME financing has also become part of the lending toolkit. However, several conservative banks are staying away from this sector on the grounds of the perception of relatively high risk.

- *Automation:* ATM coverage is relatively low and online banking is only offered by a few banks. However, owing to competitive pressures, there is rapid progress on both fronts. The central bank itself has been making significant progress. For example, until recently, checking of the credit history of borrowers by the Central Information Bureau (CIB) of the SBP took roughly one week, *i.e.* a written request followed by data sent by mail to the bank. CIB data is now available on line. Similarly, online data is available from credit rating agencies.

- *Prudential regulations:* The central bank has been slowly but steadily moving away from its tradition of intrusive regulation and directed lending. In general, a much more permissive regulatory atmosphere prevails. The SBP recently modernised and revised Prudential Regulations for Corporate and Commercial Banking, SME Financing, Microfinance Institutions and Consumer Financing. Draft guidelines for private sector participation in infrastructure project financing have been released for debate recently.

- *Banking audit and supervision:* This is an area of ongoing risk management where real progress has been noticed by all market participants. SBP's compliance with the Basel Core Principles is generally high. SBP now conducts comprehensive on-site inspections using a standardised CAMELSS (Capital, Assets, Management, Earnings, Liquidity, Sensitivity to Market Risk, Systems) framework for rating the overall condition of a bank. Earlier attempts at developing early warning systems were crude and cosmetic. It appears that they have been re-tooling their regulatory radar and have recently developed an early warning system called IRAF (Institutional Risk Assessment Framework). As stated earlier, the other financial system regulator, the SECP has still not developed on-site inspection capability. The need for capacity building at the SECP is considered to be very urgent.

- *Corporate governance:* Both the SBP and the SECP have issued codes of corporate governance. However, these are still "wish lists". Corporate disclosure standards have

improved, *e.g.* all banks and public limited companies have to publish quarterly accounts. However, the fact remains, that the quality of financial statements in certain industrial segments continues to be marginal. Too many companies cook their books and fudge their profits. However, in all fairness, this is an area of regulatory reform where the prime regulator (the SECP) cannot succeed unless there is meaningful reform of the tax structure and tax collecting institutions at both the provincial and federal levels.

- *Out-of-court workouts (informal):* Well over two-thirds of the stock of NPLs involve a single lender. These cases are relatively easier to resolve now that most of the banking system is privately owned. In fact, the country's NPLs would have started declining in the late 1990s had privatisation taken place half a decade earlier. In the public sector, working on resolving NPL issues was fraught with hurdles, both internal and external. These included pressures from influential borrowers, often exerted through the government, an intrusive regulatory environment and a working culture where anyone who took meaningful decisions was considered to be highly imprudent. Standard tools of risk management and damage control, like settlements, could not be undertaken owing to an archaic tax regime. For example, until recently, the tax authorities would not allow a bank to write off amounts from taxable income until the bank could "prove that it had exhausted all possible remedies". Two to three decades was considered to be fast track. For multilateral cases involving more than one bank, informal creditor committees are created on a case-by-case basis. Decision-making can be reasonably fast and coherent provided that there is no public sector bank in the committee.

- *Out-of-court workouts (formal):* There is a national committee that was created to revive sick projects. The Committee for the Revival of Sick Industrial Units (CIRSU) has broad-based representation of business, bankers, etc. CIRSU does not undertake "deep" revival; the project is never visited, nor are the characteristics of the underlying industry ever analysed. The issue of whether the sick is worthy of revival is not considered. CIRSU's methods are somewhat cosmetic. They rely entirely on financial data obtained from the lenders/banks. CIRSU's style is like a Panchayat/Jirga (informal dispute resolution mechanism in the rural areas), whereby they mediate between the two contestants, in this case, the debtor and the creditor. Revival is declared if the mediation is successful and financial restructuring is done. Conversely, if the mediation fails it is flagged as "not revived". CIRSU claims that it has revived 172 industrial units involving an outstanding NPL of PKR 46 billion. It is very difficult to comment on this claim, as CIRSU does not maintain records with respect to the post-revival status of these industrial units. The World Bank undertook an assessment of CIRSU last year, the conclusions of which were that "in the absence of operational analysis, there would generally appear to be little increment in the value of the project. Future viability and renewed distress of these projects are of concern. No track is kept of financial or operational details of the projects after revival".

- *SBP's settlement guidelines:* In 2002, in response to growing NPLs and the combined failure of CIRC, NAB and CIRSU, the SBP issued guidelines whereby banks were actively encouraged to settle NPLs with borrowers at the fire sale value of the underlying collateral. While the desperation of the regulator is understandable, it is generally felt that this freebee was too generous. Instead of being based on a mere piece of paper, such as a valuation certificate, it could have been based on a more quantitative methodology such as sustainable debt levels. In fact, such methodologies exist. One, a debt recovery programme called Excess Debt Recovery (EDR) uses sustainable cash generation as a key yardstick. It was presented to the SBP in 1998. EDR had a write-off efficiency ratio of 5:1. For each Pakistan rupee of provisions used/written off it would generate a cash recovery of PKR 5. Unfortunately, EDR was never adopted. Under these guidelines (using FSV), PKR 52 billion of NPL has been settled at the cost of unnecessarily large write offs (around PKR 35

billion), which represents a fairly poor write-off efficiency ratio. However, on a more general note, periodic recourse to these so-called one-time amnesty and incentive schemes is a *de facto* admission that in the areas of insolvency, corporate restructuring/reorganisation, etc., the legal system has effectively collapsed. The governor of the SBP admitted in a recent speech on October 14 2004 that "the legal system is still too time consuming and costly for ordinary market participants".

Efficiency of secured lending procedures

This is an area where there is need for urgent reform at many levels. The main issues are flagged briefly in this paper. The main issues that hamper the efficiency of secured lending procedures are as follows:

- *No record of land title:* Outside the main urban centres, land title is determined from the revenue record. The heroic assumption is that the person who is liable to pay taxes, is the owner of the land. There is no central register of land title.
- *Inheritance issues:* There is no concept of a will in Pakistan. Islamic laws of inheritance specify the share that each relative receives. Execution by a bank on any mortgaged land/property can be thwarted by litigation from relatives on the grounds that they have not received their due share in inheritance. Under current law, there is no statute of limitations on certain claims. Hence, litigation can pop up at any time in the future.
- *Oral gifts:* Ownership of land can be changed through an oral gift. Such a gift may or may not be reflected in the land revenue records.
- *Pre-emption laws:* This mainly applies to the rural areas. While courts do not approve of pre-emption laws, they are still a method of harassment used by neighbours to blackmail sellers of land.
- *Benami transactions:* These are transactions (typically for land) where the stated owner is a fictitious cover for the real owner. Typically used in rural areas to own land beyond the permissible maximum. Also used in the urban areas by tax dodgers and holders of undeclared money to disguise their real wealth.
- *Rent control laws:* Originally enacted to protect tenants from harassment and/or eviction, their effect is an unmitigated disaster, as the only exception is "for *bona fide* personal need" (*i.e.* of the owner of the property). Establishing this personal need can take well over a decade to settle in court.
- *Chaotic property tax and stamp duty regime:* Property taxes, particularly in the Punjab, the largest province, are imposed in a highly whimsical manner. They need to be reduced and rationalised in order to encourage the development of the real estate market. Rental income, as determined by local government, is the basis for calculation. Property tax can often exceed the annual rental from a property. Likewise, stamp duties are very high, often resulting in sales transactions not being reported. They need to be reduced to improve the documentation of land transactions.

The cumulative effect of these laws and social practices is that banks are extremely reluctant to lend against real estate outside the main urban centres. Furthermore, even in the main cities, banks are understandably very cautious in approving housing finance transactions. The debt/equity ratio they apply is often around 50% as opposed to 80% debt financing, which is the norm in countries like the UK. The removal of these impediments is crucial to the development as well as the broadening of the banking sector in Pakistan.

Conclusion

Significant improvements have taken place in the recent past across a wide spectrum of risk management and banking regulation. The banking system is healthier and has a greater capacity to absorb normal shocks. NPLs are declining on an annual basis. However, major concerns about the proper quantification of the country's NPLs and gaps in data integrity persist (See the note to Annexure 1). The macroeconomic environment is supportive. New areas of lending are opening up rapidly. This space, or breathing room, should be used creatively by the main stakeholders to plug major deficiencies in the legal system, including the repeal of out-dated laws and practices identified in several sections of this paper.

As highlighted in this paper, the country has opted for two regulators of the financial system. From a risk management perspective, this has created a unique problem, the problem of large groups and holding companies. Who regulates them from the point of view of contagion? To amplify, in the ongoing privatisation process, large Pakistani industrial groups are picking up banks, insurance companies, etc. on a regular basis. To understand these newly emerging conglomerates, a specialised regulatory cell (Large Groups Unit) urgently needs to be created either within the SBP or SECP.

With respect to the insolvency system, it is imperative that the draft CRA along with its institution-building components be expedited. Implementation should be done in a multidisciplinary manner. Both bankers and lawyers develop their own tunnel vision over time. An economic perspective, in an environment where resources are a scarce, is crucial to fully articulate and implement the concept of "sickness worthy of revival".

The past two or three years have been good, and looking forward there are more upsides than downsides. It is human nature to become complacent. Government is, arguably, human too. However, there is much work to be done, particularly in the area of legal reform. Time is of the essence, and the good times should be used to prepare strong institutions and procedures to handle any turbulence in the future.

ANNEX 1: Non-performing loans (NPLs) of the banking system (PKR in billions)

Year	NPLs in PKR	NPLs to Loans	Provisions to NPLs
1997	173.0	23.5%	46.6%
1998	183.0	23.1%	58.6%
1999	230.7	25.9%	48.6%
2000	240.1	23.5%	55.0%
2001	244.1	23.4%	54.7%
2002	231.5	21.8%	60.6%
2003	211.3	17.9%	63.7%
June 2004	207.8	14.5%	66.8%

Source: State Bank of Pakistan.

Note: Concerns relating to data integrity, conceptual and methodological issues in NPLs:

As stated earlier in this paper and in prior submissions to FAIR, the country's NPL appear to be understated. The extent of this cannot be quantified on account of the following methodological problems, which need to be addressed on a priority basis:

- Two regulators: The financial system has two regulators, the SBP and the SECP. The former monitors and publishes NPL data regularly and has on-site inspection capability. The SECP neither reports NPL data nor does it have any audit capability.

- Facility-based classification versus borrower-based classification methodologies: The SBP uses facility-based and time-based classification systems whereby a borrower using multiple banking products can be in different classifications depending upon his time-based (default) status in each individual facility. In line with global best

practices, the entire debt of the borrower should be immediately transferred to the most adverse classification category. Obviously, very low risk facilities, *e.g.* where the lender holds 100% cash collateral, may be exempted from this treatment. In fact, the audit teams of the central bank use these conservative methodologies. Consequently, SBP's published NPL figures are based on NPL data derived from time-based methodologies. Adding up NPL from the audit reports of the SBP gives a very different and much higher NPL figure. Two different sets of NPL figures within the same central bank cannot be a very coherent decision-making tool.

- The accounting implications of allowing court decrees with accrual clauses: As stated earlier in this paper, both the debt recovery laws enacted in the recent past (in 1997 and in 2001) contain accrual clauses, *i.e.* the money decree against the defaulting borrower is awarded with interest. This accrual of interest continues until the debt is entirely extinguished by the borrower. The NPL figure must, therefore, mirror and reflect legal reality. Consequently, the regulators need to devise appropriate accounting and/or monitoring systems to ensure that the all the accruals floating around in the financial system in hundreds of thousands of court decrees are accurately reflected in NPL data. Likewise, if the court awards a decree that it less than the NPL on the books of the lending institution, then the passing of a WOFUD (Write-off Of Finances Under Decree) accounting entry must be made mandatory.

- Stress on net NPL is misleading: For the past few years, the central bank has been using the net NPL figure, *i.e* gross NPL minus provisions held, in most of its publications. This is misleading, as provisions are actually shareholder's money that has been put to an unproductive use to improve the solvency ratios of the financial institution. In fact, good bankers always target recoveries above the net NPL figure, so that surplus provisions can be returned to the bottom line, *i.e.* back to the shareholder. Therefore, in line with modern best practices, the emphasis should be on gross NPL, both in terms of decision-making and financial sector reporting.

ANNEX 2: Financial soundness indicators of the banking system in percent

Indicator	1997	1998	1999	2000	2001	2002	2003
Capital to Total Assets	3.5	5.3	4.8	4.5	3.8	4.8	5.4
Return on Assets (ROE)	(1.2)	(0.1)	(0.2)	(0.2)	(0.5)	0.1	1.1
Return on Equity (ROA)	(30.7)	(2.7)	(3.9)	(3.5)	(12.6)	3.2	20.5
Cost to Income	85.2	72.7	75.8	71.6	62.4	59.1	49.1
Advances to Deposits	57.6	56.6	62.0	66.2	61.7	54.9	56.5

Note: ROA and ROE are on a post-tax basis.
Source: State Bank of Pakistan.

ANNEX 3: Financial relief given to borrowers (write-offs) by the banking system (PKR in millions).

Year	Amount
2002	9 807.66
2000	2 679.34
2001	4 614.66
1998	8 326.94
1997	8 234.11
2003	9 218.86
1999	4 034.83
1996	4 030.27

RISK MANAGEMENT AND INSOLVENCY REFORMS IN SRI LANKA

by
Kandiah Neelakandan*

Introduction and overview

Banks face risks in a variety of situations. The most serious risk is that of the customer-borrower going out of business. A more frequent risk for bankers is default by borrowers. That risk ranges from what is compendiously described as the Third World Debt Crisis, home mortgage and credit card default. Having made observations on these lines, Ross Cranston, one of the well-known authorities on banking, says that law and lawyers have a role in responding to such a situation. The Jack Committee in the UK (1989) observed that the law has an obvious relevance to the process of bankers confronting risks.

This country paper deals with the legal provisions in Sri Lanka applicable to lending by banks to their customers (the purpose of which laws is, of course, to minimise risk) and also the provisions of law in respect of insolvency and winding-up (in which there has insufficient legal reform in our country).

Sri Lanka, an island with a modest population of about 19.8 million, is a multiracial and multilingual country. Despite the problems that have beset Sri Lanka for more than two decades, there have been encouraging signs of a sustainable economic recovery since the declaration of ceasefire in the Northeast. Sri Lankans are still optimistic of achieving a political solution to the country's ethnic problem. In the background of setbacks, the economy of the country has suffered in the recent past; credit risk management is of paramount importance to the country.

Legal system

As in other ancient legal systems, the conventions, customs, sanctions and main concepts of law (though not concretely formulated) have been established over the years, especially through judicial pronouncements. The personal laws that govern the various sections of the Sri Lankan community are Kandyan Law, Thesawalamai and Muslim Law. Various tests are applied to determine whether these personal laws affect those claiming to be governed by them. Persons subject to any of these three personal laws are governed by the Roman Dutch Law, which is the common law of the country. However, the impact on the common law system from English law has been greater than the Roman tradition. Yet, the Roman Dutch law remains the residuary or the common law of Sri Lanka. Needless to say, the common law has been modified in many directions, both expressly and by necessary implication by Sri Lankan statute law and also by judicial decisions. The Penal Code and the Criminal Procedure Code govern criminal law and procedure in Sri Lanka. Civil cases are governed by the Civil Procedure Code, which shows the influence of Indian, English and US rules of procedure. The constitutional and administrative law of Sri Lanka is almost wholly based on the

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principles of English common law. The influence of the Roman Dutch law is to be found in the areas of the law relating to succession, persons, property and obligations. It is especially noteworthy that the Law of Delict (that is the law governing civil wrongdoing) is predominantly based on the Roman Dutch Law. Although the Roman-Dutch Law is the common law of the country, it has adopted English law for almost all commercial matters.

Sri Lanka, previously known as Ceylon, was first occupied by the Portuguese in 1505, then the Dutch from 1656 and finally by the British from 1796 until it became an independent country in 1948. During the Dutch rule, the Roman Dutch Law was introduced and became firmly enthroned as its common law.

By the Civil Law Ordinance (Cap.59, LEC-Revised 1980) the British introduced the laws of England in respect of maritime and commercial matters unless there is a contrary statutory provision. However, the ordinance did not introduce English procedure relating to those matters of procedure being replaced by the Civil Procedure Code. Section 3 of the Civil Law Ordinance reads as follows:

> *In all questions or issues which may hereafter arise or which may have to be decided in Ceylon with respect to the law of Partnership, Corporations, Banks and Banking, Principals and agents, carriers by land, life and fire insurance, the law to be administered shall be the same as would be administered in England in the like case at the corresponding period, if such question or issue had arisen or had to be decided in England, unless in any case other provision is or shall be made by the enactment now in force in Ceylon or hereafter to be enacted;*
>
> *Provided that nothing herein contained shall be taken to introduce into Ceylon any part of the law of England relating to the tenure or conveyance or assurance of, or succession to any land or other immovable property, or any estate, right or interest therein.*

While in the developing branches of law, particularly in the commercial field, Sri Lanka has no doubt continued to draw on English statutes and principles, the tacit adoption of English law in matters governed by common law is now at an ebb with what may be described as a conscious reaction against this tendency. This trend is most marked in respect of two methods of introduction, *viz*: (a) judicial decisions; and (b) use (in judgments and statutes) of terms peculiar to English law referred to in the preceding sections (*vide* C.G.Weeramantry in his treatise on contracts). In the recent past there have been various statutes enacted by the parliament of Sri Lanka in commercial areas, of course, most of them based on English models.

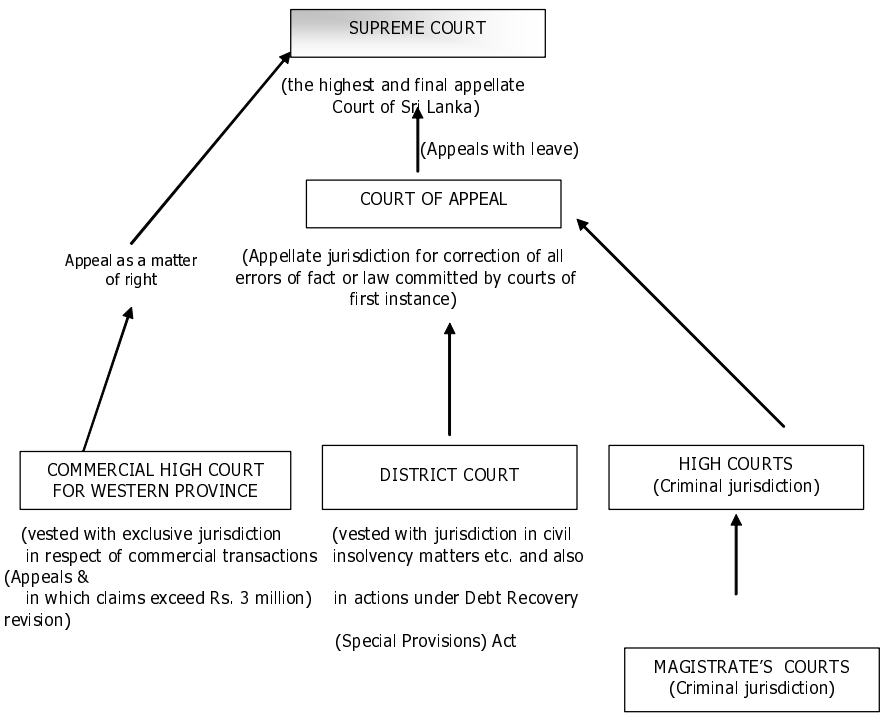
When we assess the insolvency and creditor rights systems in Sri Lanka, we have to be mindful of the fact that although statutes and English law govern most relevant matters, the law applicable to properties are common law (Roman Dutch) and statutory law. When a property is taken as a mortgage, the Roman Dutch law provisions apply thereto, subject to the modifications made by the statutes. At the same time, insolvency rights and the law applicable to banking is the English law subject to statutory modification. The relevant applicable provisions are identified below.

The parliament enacted the Arbitration Act No. 11 of 1995, which came into operation on 1 August 1995 as a measure providing for a comprehensive infrastructure for resolving commercial disputes (domestic and international) through arbitration. This law was enacted honouring Sri Lanka's obligation to give effect to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958. The High Court of Sri Lanka is vested with jurisdiction to enforce foreign arbitral awards as well.

The law applicable to corporate insolvency is found in the provisions contained in the Companies Act No. 17 of 1982, which was enacted on 20 May 1982 and came into operation on 7 June 1982. The Companies Winding-up Rules of 1939, enacted under the Companies Ordinance, continue to apply to the winding-up proceedings under the Companies Act in view of the provisions of Section 450(1) of the Companies Act. There is a separate insolvency ordinance that governs the insolvency of individuals, which has no relevance to this report.

Structure of the courts

The hierarchy of courts of first instance in Sri Lanka is set out in Section 2 of the Judicature Act No. 2 of 1978. Primary courts, magistrate's courts, district courts and high courts are courts of first instance. High Courts exercise appellate and review jurisdiction in some matters. The Court of Appeal and the Supreme Court are the appellate courts. Below is a diagram briefly setting out our court system.



Legal framework for creditor rights:

Creation and enforcement of security in real property

Introduction

Mortgage of immovable property is the most popular and acceptable form of security in Sri Lanka and governed by the Roman Dutch Law.

The word "land", when used in a mortgage, has a much wider meaning than it has in everyday speech. The general rule of English law on this matter is summed up by the maxim *quic quid plantatur solo, solo cedit* (whatever is attached to the soil becomes part of it). If, therefore, a building

is erected upon land and chattels are attached to the building, the term "land" *prima facie* includes the soil, the buildings and the chattels affixed thereto. Similarly, "land" includes growing crops and timber. The Mortgage Act originally defined "land" to include things attached to the earth or permanently fastened to anything attached to the earth and any estate right or interest in or over land. According to Voet, buildings being annexed to the land are immovable. So also are articles that have been annexed to immovable structures if the manner of their attachment is so secure that separation would involve substantial injury either to the immovable property or to its accessory. Thus, it was held in the case of Tissera v. Tissera 42 NLR 10, that machinery in a fibre mill fixed with screws to the floor of the building on a concrete foundation and intended to remain permanently fixed to the building in which it was installed, would constitute part of the land on which it stands. Further, in another case, Brodie v. Attorney General 7 NLR 81, it was decided that fixtures are movables, which by being affixed to or into the ground, or annexed or attached to a building, acquire the character of immovables. Thus, counters, cooking ranges, water tanks, electric bells, batteries and indicators, baths, lavatory fittings and office equipment fixed in position by bolts, screws and in other ways were held to be fixtures and, in the absence of special agreement, pass upon the sale of the building containing them.

The term "mortgage" includes any charge on property for securing money or money's worth. In view of the provisions of Section 46, the mortgagee of any immovable property cannot proceed against any property whatsoever other than the mortgaged property of the mortgagor in satisfaction of his claims. Act No. 3 of 1990 has amended Section 46 of the Mortgage Act and introduced a new Section 47 A. The purpose of the amended Section 46 appears to enlarge the meaning of the mortgaged property. The words "mortgaged property" have been substituted in place of "mortgaged land" so that there will be no doubt as to whether any machinery installed on the land and other properties attached to the land are covered by a mortgage. The purpose of this amendment seems to be only for clarity. The restrictions and the limitations imposed by Section 46 remain subject to a new provision added by the new Section 47A.

The amendment brought in by Section 47 A is a significant amendment. The new section contains provisions for execution of a special instrument by the mortgagor renouncing the benefit of Section 46. This renunciation could be obtained in respect of loans where the principal exceeds LKR[1] 150 000.

The new section applies only to mortgage bonds in favour of lending institutions that are banks within the meaning of the Banking Act No.30 of 1988 and four State agencies (The State Mortgage & Investment Bank, The National Development Bank, The National Savings Bank and The Development Finance Corporation of Ceylon). In terms of the new section, at the time of execution of a mortgage bond in favour of a lending institution, the mortgagor executes a separate instrument containing a special declaration on the part of the mortgagor that he renounces the benefit of Section 46 and that the notary has explained the effect of such renunciation to him. Then in addition to the mortgaged property, any other property belonging to the mortgagor shall be liable to be ordered to be sold under the decree in an action upon the mortgage subject to one restriction, namely, that no process for the seizure and sale of any such other property shall be issued until the mortgaged property is sold and the proceeds thereof applied in satisfaction of the decree. Needless to say, a renunciation made under Section 47A will not enable a creditor to issue writ to sell the defendant's residence, which is not mortgaged, or any other property exempted by Section 218 of the Civil Procedure Code unless the same has been mortgaged.

[1] Sri Lanka rupees.

It appears that a creditor who has obtained mortgage of immovable property and also such renunciation, can proceed against the debtor's properties which are not mortgaged only if such creditor obtains a decree in an action upon the mortgage and has not obtained full satisfaction of that decree. Therefore, a creditor who chooses to exercise the right of *parate* execution may not be able to enjoy the benefit of a renunciation under Section 47A.

The Recovery of Loans by Banks (Special Provisions) Act No.4 of 1990 has been enacted to provide for the recovery of loans granted by Banks for the economic development of Sri Lanka. (Please see paragraph 4) a) v)(1) below)

According to Section 69 of the Sri Lankan Mortgage Act the owner of land may create a mortgage of such land in favour of an approved credit agency by the execution of an instrument in the form set out in the Second Schedule to the act and by the deposit with that agency of the title deeds of such land. This presupposes the acceptance of the property as security without a proper examination of its title. The lender will therefore have to run the risk that the title of the borrower (not having been carefully examined as in ordinary cases) may prove defective. If a mortgage is created by deposit of title deeds of any land under and in terms of Section 69 of the Mortgage Act and attested by an officer of a lending institution, then the said special instrument of declaration and renunciation under Section 47A could also be executed before such officer, and any reference in the provisions of this new act to the notary attesting the mortgage bond is deemed to be a reference to such officer.

Realisation of mortgage of immovable property largely depends on factors like the title of the mortgagor and the availability of vacant possession. A prudent banker will not accept an immovable property if the mortgagor's title is defective or if a tenant who is protected by the Rent Act occupies it.

If the mortgage of an immovable property has to be realised, the mortgage bond must be put in suit and the procedure described by the Mortgage Act should be strictly followed. All the Banks in Sri Lanka have now been given a right of *parate* execution. State banks which had this right of *parate* execution even before the debt recovery legislation of 1990, and the banks which are companies registered in Sri Lanka who have been given the *parate* execution right under the new debt recovery legislation of 1990, can realise the security of mortgaged immovables by the exercise of the right of *parate* execution, that is, by selling the mortgaged immovable properties by auction without recourse to a court of law. In the case of foreign banks, which only have branches in Colombo, they are also institutions which have been given the power of *parate* execution, but there is doubt as to whether a board of directors that is not Sri Lankan can exercise that right. When exercising the right of *parate* execution a bank should act carefully by strictly following the procedure, particularly in respect of the publication of required notices.

Effective recording and registration procedures

The mortgage bond has to be registered at the land registry where the lands are situated, (*vide* Section 7 of the Registration of Documents Ordinance). It only confers priority and no validity. There is no time limit within which it should be registered. In the case of a mortgage of movables executed by the company, the same should be registered with the Registrar of Companies within 21 days. Failure to do so will result in the mortgagee losing his status as a secured creditor; *vide* Section 91 of the Companies Act.

The Registration of Documents Ordinance contains the provisions, (*vide* Section 30 of the Registration of Documents Ordinance) to register priority notices in respect of registration of documents affecting lands. This will enable a mortgagee to have priority notice registered for execution of the mortgage so that the priority conferred by the mortgage will not be prejudiced. There

is no such mechanism available in the case of registration with the Registrar of Companies. Nevertheless, that does not affect the process of registering since, once a document is registered, it maintains the status of the mortgagee secured creditor which will entitle the mortgagee to claim priority over the unsecured creditors.

Existence of hidden liens

Hidden liens are generally the first charges under statutes. It is relevant here to deal with first charges under statues *vis-à-vis* mortgagees as secured creditors. This question arose in the Court of Appeal in the Development Finance Corporation of Ceylon and others v. Deputy Commissioner of Inland Revenue and others, C.A. (S.C.) Appeal Nos. 437/75(F), 438/75(F) and 439(F), D.C. Colombo Case No. 77764/M. The seventh defendant (the Commissioner of Labour) claimed monies due from the Company (Bonars [Ceylon] Ltd.) under Sec. 2(b) (iii) of the Wages Boards Ordinance, Section 38(2) of the Employees' Provident Fund Act and Section 19(1)(b)(iii) of the Shop and Office Employees (Regulation of Employment and Remuneration) Act No. 19 of 1954 as first charges on the sales proceeds of a property of the company which was mortgaged to three banks (the fourth, fifth and sixth defendants). The trial judge held with the Commissioner of Labour, but the Court of Appeal set aside that judgment in the appeals by the banks, having considered the judgments reported in 4 NLR 311, 6 NLR 169, 10 NLR 175 and referred to above. In the case of Velliappa Chetty v. Pitchai Maula, 4 NLR 311, it was held that a special mortgagee of movables is entitled to be preferred to all other creditors of the debtor in respect of proceeds of the sale of such movables. In the case of Raheem v. Yoosuf Lebbe, 6 NLR 169, it was held that a decree holder was not entitled concurrence with a registered mortgagee and also in Bapurae Dajiba v. Narayanan Govinal Kale A.I.R. (37) 1950 Nagpur and Wheatley v. Silkstone and Haigh Moor Coal Company (1885) 29 Ch. D. 715. In the said Development Finance Corporation of Ceylon case, the Court of Appeal of Sri Lanka, in its judgment delivered by Ranasinghe J. (as he was then) with Vythialingam J., held on 15 May 1979:

> *On a consideration of all these matters I am of the opinion that the "first charge" imposed by the provisions of the three Acts relied on by the 7th defendant, viz. Wages Boards Ordinance, Employees' Provident Fund Act, and the Shop and Office Employees (Regulation of Employment and Remuneration) Act operates, as of the debtor and is not entitled to take precedence over secured creditors who hold securities executed validly and bona fide by the debtor.*
>
> *I therefore, hold that the claim put forward in this case by the 4th, 5th and 6th defendants all take precedence over the claims put forward by the 7th defendant AB regards the 4th, 5th and the 6th defendants, their claims will rank inter se, in order of time that is, according to the dates of registration of their respective bonds.*

Limitations on foreigners taking security

Sri Lankan exchange control laws are still restrictive. Even if a foreigner takes security, he will have difficulties in realising and taking the sale proceeds out of Sri Lanka. Subsections 4 to 8 of Section 30 of the Exchange Control Acts read as follows:

> *(4) Notwithstanding anything contained in any other law, no transfer of any interest in any business in Sri Lanka made by a person resident outside Sri Lanka to any person also resident outside Sri Lanka shall be valid unless such transfer is confirmed by the bank on an application made to it for such confirmation by the transferor or the transferee. The preceding provisions of this subsection shall not apply to the transfer of any share in a company.*

(5) Except with the general or special permission of the bank, no person resident in Sri Lanka shall transfer any interest in any business in Sri Lanka, or create any interest in any such business, to or in favour of a citizen of a foreign state.

(6) Except with the general or special permission of the bank, no person resident in Sri Lanka shall give a guarantee in respect of any debt or any other obligation or liability of a person resident outside Sri Lanka.

(7) Except with the general or special permission of the bank, no person resident in Sri Lanka shall lend any money either to any firm or company (other than a banking company) which is controlled directly or indirectly by persons resident outside Sri Lanka.

(8) In this section, "foreign company" means a company not incorporated under any law in force in Sri Lanka and in the case of which any of the following conditions is fulfilled:

(a) That the company is by any means controlled (directly or indirectly) by any person or persons resident in Sri Lanka; or

(b) That more than half of the sums which, on a liquidation thereof, would be receivable by holders of share or loan capital, would be receivable directly or indirectly by, or for the benefit of, persons resident in Sri Lanka; or….

It may be relevant to quote Sections 7 and 8 of the Exchange Control Act:

(7) Except with the permission of the bank, no person shall in Sri Lanka

(a) Make any payment to or for the credit of a person resident outside Sri Lanka, or

(b) Make any payment to or for the credit of a person resident in Sri Lanka by order or on behalf of a person resident outside Sri Lanka, or

(c) Place or hold any sum to the credit of any person resident outside Sri Lanka.

Provided that where a person resident outside Sri Lanka has paid a sum in or towards the satisfaction of a debt due from him, paragraph (c) of this section shall not prohibit the acknowledgment or recording of the payment.

(8) (1) Except with the permission of the bank, no person resident in Sri Lanka, shall, subject to the provisions of this section, make any payment outside Sri Lanka to or for the credit of a person resident outside Sri Lanka.

(2) Nothing in this section shall prohibit the doing of anything otherwise lawful by any person with any foreign currency obtained by him in accordance with the provisions of Part I of this Act or retained by him with the consent of the bank.

We also quote below the provisions of Section 35, which deal with legal proceedings:

(1) The provisions of Part II of this Act shall apply to sums required to be paid by any judgment or order of any court or by any award as they apply in relation to other sums, and it shall be implied in any judgment or order of any court in Sri Lanka, and in any award given under the law of Sri Lanka, that any sum

required to be paid by the judgment, order or award (whether a debt, as damages or otherwise) to which those provisions apply shall not be paid except with the permission of the bank.

(2) Nothing in this Act shall be construed as preventing the payment by any person of any sum into any court in Sri Lanka, but the provisions of Part II of this Act shall apply to the payment of any sum out of court, whether under an order of the court or otherwise, to or for the credit of any person resident outside Sri Lanka.

(3) In any insolvency proceedings, winding up of a company, or administration of the estate of a deceased person, carried on under the law of Sri Lanka, a claim for a sum not payable without the permission of the bank shall, notwithstanding that the permission has not been given or has been revoked, be admitted to proof as if the permission had been given and had not been revoked.

Provided that nothing in the preceding provisions of this subsection shall be construed as affecting the application of the provisions of Part II of this Act to payments by the assignee of the insolvent's estate, or by the liquidator, or by the executor of the last will, or administrator of the estate, of the deceased, or by any other person in such insolvency proceedings, or winding up, or administration.

(4) The provisions of this Act restricting the making of settlements shall not apply to any deed of arrangement made for the benefit of creditors generally, and the provisions of subsection (3) shall apply in relation to proceedings under any deed of arrangement as they apply in relation to insolvency proceedings.

(5) Where the permission of the bank is required under this Act for the payment of a debt the amount of which is sufficient under section 18 of the Insolvency Ordinance, to enable the creditor to petition for the sequestration of the estate of the debtor if the debtor commits an act of insolvency, the debt may, notwithstanding the aforesaid requirement, be allowed to be a good petitioning creditor's debt, if and to the extent that the debt can be satisfied either by a payment into court or by a payment to a blocked account.

Even if there is a judgment, the payment by a resident of Sri Lanka to their creditor has to be with the permission of the Controller of Exchange.

There are Board of Investment of Sri Lanka (BOI) enterprises that are given certain incentives and benefits by the BOI under the applicable laws and regulations. The BOI can exempt a BOI enterprise from the exchange control regulations whereupon the BOI enterprise will be able to do certain things free of exchange control restrictions. However, the exemption granted by the BOI to the BOI enterprise cannot be extended to the shareholders or its creditors. The provisions of Section 17 of the BOI Law make it clear that the exemption given to BOI enterprises apply only to the enterprise and not to the shareholders and lenders/creditors.

Section 17 of the Board of Investment of Sri Lanka Law empowers the BOI to enter into agreements with any enterprise and to grant exemptions from any law referred to in Schedule B thereto or to modify or vary the application of any such laws to such enterprise in accordance with such regulations as may be made by the minister in charge of the subject of the BOI. Every such agreement is reduced to writing and constitutes a valid and binding contract between the BOI and the enterprise upon registration of such agreement with the BOI.

One of the laws referred to in the Schedule B is the Exchange Control Act. BOI enterprises are entitled to benefits and exemptions under the said Section 17 and are generally exempted from the provisions of the exchange Control Act. Such exemption is granted by an agreement the BOI enters into with the BOI enterprise concerned.

Such exemption can be given to the enterprise only and not to its shareholders or lenders. However, the foreign shareholders have the comfort of the Securities Investment External Rupee Account (SIERA) scheme through which they are permitted to convert foreign currency and invest in Sri Lanka rupees in the companies in which the foreign investment is allowed by way of a general approval to take out of Sri Lanka the dividends and the proceeds of sales of such shares by converting from Sri Lanka rupees to the foreign currency. Nevertheless, the lenders do not have that comfort. This unsatisfactory state of affairs compels even large foreign lenders who support big infrastructure projects to seek specific approvals from the Controller of Exchange for matters such as (a) lending in foreign currency and recovering in the same currency (*viz*: conversion of the recovered debt and interest from Sri Lanka rupees to foreign currency), and (b) obtaining security such as shares of local shareholders and local assets for foreign loans.

Section 2 of the Companies (Special Provisions) Law No. 19 of 1974 which has not been repealed by the Companies Act No. 17 of 1982 (as the provisions of Part XIII of the Companies Act are subject to the provisions of Companies (Special Provisions) Law No. 19 of 1974, *vide* Section 394 of the Act) contains the following provisions:

> *(1) On and after the first day of September, 1974, in this Law referred to as the "appointed date" no company –*
>
> *(a) Shall have an interest in any property in Sri Lanka, whether as owner, co-owner, lessee, mortgagee, or otherwise, or*
>
> *(b) Shall carry on any undertaking in Sri Lanka unless such company is recognised as an "existing company", or is incorporated, under the principal enactment, or is an exempted company.*
>
> *(2) Before the appointed date, the Minister may from time to time, by Order published in the Gazette, alter such date, and thereafter the new date specified in the Order shall be deemed to be the appointed date for the purposes of this Law.*

An "existing company" means a company formed and registered under the Joint Stock Companies Ordinance or the Joint Stock Banking Ordinance No. 87 or the Companies Ordinance which preceded the Companies act (*vide* Section 449(1)).

An "exempted" company is a company exempted by the minister in terms of a direction made by him under Section 3 of the Companies (Special Provisions) Law No. 19 of 1974. The list of exempted companies are set out in the direction gazetted in the Gazette Extraordinary No. 142/9 of 18 December 1974 as amended by the direction published in the Gazette Extraordinary No. 612/6 of 29 May 1990.

In terms of the provisions of Section 83(b) of the Banking Act No. 30 of 1988, as amended by Act No. 33 of 1995, a company incorporated outside Sri Lanka which has been issued a license under Section 5 of this act as a licensed commercial bank, is with effect from the date of issue of such licence, deemed to be an exempted company for the purposes of the Companies (Special Provisions) Law No. 19 of 1974.

There was an imposition of a 100% tax under the Finance Act No. 11 of 1963 on foreigners acquiring any immovable property, but this levy was removed on the 1 April 2002. However, with a law passed recently, the said 100% tax on acquisition by foreigners of immovable properties has been restored by the new government.

Effectiveness of enforcement mechanisms

Applicable laws governing enforcement

Enforcement of the security has generally been through civil actions and enforced according to the provisions of the Civil Procedure Code.

The Debt Recovery Act No. 4 of 1990 has been enacted to provide for the recovery of loans granted by banks for the economic development of Sri Lanka. This law was previously applicable to a loan granted by a bank (other than the Bank of Ceylon, People's Bank and rural banks), on a mortgage of "property" within the meaning of this act. "Property" is defined to mean any movable or immovable property and to include the right title and interest of the lease in any case where a loan is secured by a mortgage of the interest of a lessee under a lease from the state. The statutes creating Bank of Ceylon and People's Bank had already given the right of *parate* execution to those banks. The Amending Act No. 24 of 1995 has amended the definition of the bank to include all licensed commercial banks (other than rural banks), DFCC and the National Savings Bank. In other words, the right of *parate* execution has been extended by this act to commercial banks in respect of those mortgages. This right was earlier exercised only by a few state banks on the basis that they are answerable to parliament. This new law has extended that power to other commercial banks also, subject to the provisions in respect of the procedure to be followed by those banks. "*Parate* Execution" means the right of execution whereby a creditor can sell his debtor's assets mortgage to him without the intervention of the court and recover the monies due to him.

Before 1990, a few state banks (namely Bank of Ceylon, People's Bank, National Savings Bank, State Mortgage and Investment Bank and National Development Bank) had *parate* execution rights to enforce the mortgages without the intervention of court. The Recovery of Loans by Banks (Special Provisions) Act No. 4 of 1990 changed this position by granting parate execution rights to all the licensed commercial banks. The property, whether immovable or movable, mortgaged to a licensed commercial bank can be sold by the bank by taking necessary steps in compliance with the said Recovery of Loans by Banks (Special Provisions) Act No. 4. If the mortgagor defaults, the bank has the right to enforce the mortgage by its board of directors passing a resolution and authorising a licensed auctioneer to auction the property, of course, complying with the procedural steps in respect of publications. The provisions of this act have certain defects. They can be summarised as follows:

a) Whether a property mortgaged by a third party for the facilities granted to a customer of the bank is subject to *parate* execution

b) Whether any one or more of the banks of a syndicate of banks who have obtained a concurrent bond over the properties can seek *parate* execution

c) Whether the board of directors of a foreign bank can pass a resolution for *parate* execution.

(1) Amendments to the Debt Recovery Act No. 4 of 1990

Although the government gazetted a bill to amend the said Act No. 4 of 1990, the constitutionality of that bill was challenged in the Supreme Court. Upholding the objections, the Supreme Court ordered on 26 August 2003 that the bill could be passed only by the special majority required under the provisions of Article 84(2) of the constitution. Quoted below are the provisions of Article 84(2):

> *84 (2) Where the Cabinet of Ministers has certified that a Bill is intended to be passed by the special majority required by this Article or where the Supreme Court has determined that a Bill requires to be passed by such special majority, such Bill shall become law only if the number of votes cast in favour thereof amounts to not less than two-thirds of the whole number of Members (including those not present) and a certificate by the President or the Speaker, as the case may be, is endorsed thereon in accordance with the provisions of Article 80 or 79.*

(2) Constitutionality

When deciding on the constitutionality of an amendment proposed to be made into law, the Supreme Court of Sri Lanka, in August 2003, had given the essence of this law in the following words:

> *The legislative scheme as contained in the Act empowers the Bank to decide that a default has been made in respect of any loan and to proceed upon such decision to take possession of the mortgaged land and to sell it by public auction without any intervention of a Court of justice. The Bank is also empowered to fix the price below which no person other than the Bank would purchase such property and to issue a certificate of sale to any purchase and which shall be conclusive evidence of the due compliance with the provision of the Act. It also prevents the borrower or any person deriving interest from the borrower from seeking to invalidate such sale in a Court of law.*
>
> *From the foregoing analysis, it is seen that where a Bank that has lent or advanced money on the security of a mortgage alleges a default on the part of the debtor, the Bank has a choice of resorting to one of two procedures for recovery. The first, is the regular procedure set out in the Mortgage Act which provides for a hypothecary action and if the Court finds that the mortgage ought to be enforced a sale of the property is ordered.*
>
> *The second is the procedure laid down in the Act No. 4 of 1990, whereby the Bank could at its own option, without recourse to a court, take over the possession and management of the mortgaged property, cause it to be sold and issue a certificate conveying title in the property to the purchaser. From the perspective of the provisions of the Constitution, the question that arises for consideration is whether the availability of two such procedures that may be availed of by the Bank is inconsistent with Article 12(1) of the Constitution, which guarantees the equal protection of the law to every person.*

As there were conflicting findings by courts of first instance as to whether such a *parate* execution right is available to a bank against the property mortgaged by a third party for loans granted to a customer, the government sought to amend the law specifically extending the process of the *parate* execution to instances where the property has been mortgaged by a person other than the borrower. The proposed amendment further provided that a resolution of the board of directors of a bank to exercise *parate* execution power cannot be challenged in any court.

The proposed amendment addressed another issue confronted by banks when they syndicate and give loans. The suggested amendment to extend the right of *parate* execution to a syndicated loan secured by a concurrent mortgage given in favour of several banks. The provision intended to empower any one of such banks to resort to *parate* execution in respect of the entire outstandings to the syndicate.

The other proposed amendments were:

a) That no enjoining order or interim injunction can be filed to restrain the bank from taking any steps pursuant to a *parate* execution resolution of its board after 30 days of the publication or receipt of notice of such resolution.

b) Making removal of any movable property or taking steps which would decrease the value of an immovable property without the consent of the mortgagee-bank as illegal offences.

c) Enlarging the definition of the term "bank" to include specialised banks, finance companies and the Housing and Development Finance Corporation.

Remedies and processes by which a secured creditor realises on its collateral

In the case of mortgages on which *parate* execution is not available to the mortgagee, the mortgagee has to institute action in the appropriate civil court in compliance with the relevant provisions of the Mortgage Act and the Civil Procedure Code. The procedure that will be followed is that the court will issue a summons on the defendants and notice to other parties who have an interest in the mortgaged property only after a *lis pendens* action is registered at the Land Registry and a declaration by an attorney-at-law in court. Thereafter, the defendant will have an opportunity of filing answer, raising issues and go through the trial. After the trial, the court will enter judgement and decree. Thereafter, the defendant has a right to appeal to the Court of Appeal and from the Court of Appeal to the Supreme Court only on a question of law. Pending an appeal to the Court of Appeal, the judgment creditor (the mortgagee) can apply for and obtain an order to sell the mortgaged property. The court will permit the same, subject to the judgement debtor filing objections and the court inquiring into the matter. Once the order to sell is issued, whether pending appeal or whether no appeal is made, the auctioneer will be entitled to take steps to sell the property. The properties will be advertised and prospective purchasers will offer the title deeds for examination. If there is any defect in the title, the realisability of the mortgage may not be possible.

Ease and predictability of enforcement

Whether by way of *parate* execution or through court action, enforcement of a mortgage is not difficult provided (a) the property has a good title, and (b) there is vacant possession available (if the property is tenanted, proceedings have to be taken to eject the tenant). If the tenant is protected by the Rent Act, then the purchaser will need to be able to evict him unless there is a possibility of eviction of a tenant under any of the provisions permitted by the Rent Act.

Time frame to obtain judgement to enforce security or to complete execution, foreclosure, public/private auction, including appeals

In the case of *parate* execution the ultimate sale can be reached within a period of about four to five months unless the mortgagor succeeds in obtaining an injunction or writ to stay the sale. Although our courts have in the recent past been reluctant to give such injunctions or writs, the mortgagors are still making efforts and raising various technical issues. In the case of a court action,

the time taken to reach the judgment stage is, unfortunately, long. The original court proceedings may take about three to five years if it is a contested case. Appeal to the Court of Appeal takes a longer time and, as the appeal to the Supreme Court is only on a question of law, the matter can generally be decided within a period of a few months.

Costs

Costs payable in court proceedings are another unrealistic aspect that encourages the debtors to delay legal proceedings. Costs are payable according to Costs (Regulations) 1997 made under Section 214 of the Civil Procedure Code. Although it is an improvement from the situation that prevailed before, the taxed costs are still not commensurate to the actual expenses creditors incur in the legal proceedings.

Credit information

One of the difficulties experienced by bankers and other lenders is the lack of availability of credit information. This issue has been addressed to a limited extent by the creation of the Credit Information Bureau, commonly referred to as CRIB.

The Credit Information Bureau of Sri Lanka was established under the Credit Information Bureau of Sri Lanka Act, No. 18 of 1990 (amended by Act No. 8 of 1995), with the objective of collecting and collating information on borrowers and to furnish such information to shareholding lending institutions. At present, 82 institutions, including all licensed commercial banks, licensed specialised banks, registered finance companies, registered leasing establishments, and the Central Bank, are shareholders of CRIB.

According to official sources, CRIB currently collects information on regular advances of LKR 500 000 and over, and irregular advances of LKR 100 000 and over. The number of credit reports issued during the year 2003 increased to 389 171 from 285 269 in 2002, reflecting higher demand for credit with the recovery in economic activity and also demonstrating that credit information is used as an important risk management tool by lending institutions.

The Central Bank of Sri Lanka has reported that the number of advances recorded in the database amounted to 159 500 in 2003, compared with 1 349 500 in 2002. Of the number of advances in 2003, 106 000 advances were regular, while 53 500 were irregular advances (advances which are more than six months in default). The value of irregular advances in the database was about LKR 103 billion compared with about LKR 99 billion in 2002. Of the total irregular advances, 74% were accounted for by the corporate sector, while the balance was accounted for by individual borrows. More than 90% of these irregular advances were advances of over one million LKR.

Consumer protection regime

Enactment of the Consumer Affairs Authority Act No. 9 of 2003 and creation of the Consumer Affairs Authority has been of concern to banks and other financial institutions. Because of the inclusion of these institutions to fall within the ambit of the definition of "trader", certain stringent provisions of the Consumer Affairs Authority Act apply to the banks and other financial institutions. Pursuant to the representations made by the Sri Lanka Bankers' Association, the then Minister of Commerce and Consumer Affairs agreed to amend that law to refer all the complaints against them to a financial ombudsman, if created. Accordingly, the Sri Lanka Bankers' Association took steps to have the office an independent financial ombudsman created on the same lines as that in the UK. The banks and the other financial institutions formed a guarantee company for that purpose. However, the

promised amendment has not yet been made and the new Minister of Commerce and Consumer Affairs has promised to look into the matter.

Security in personal property

Mortgage and pledge

Mortgage is the privilege over the property of another, which tends to the security of a debtor or personal claim. "Pledge" strictly speaking, or "pawn" is constituted when the thing that is the subject of the contract is delivered to the creditor, while the transaction is called "hypothec" when the possession does not pass. The word "mortgage" is used in a comprehensive sense as equally applicable to pledges or pawns, and hypothecs. The distinction between a pledge and a mortgage is that in a pledge the subject of the contract is delivered to the creditor while in a mortgage the possession does not pass unless it is a usufructory mortgage. Oral pledges of movable property require for their validity an actual delivery to the pledgee. Pledge is constituted by actual delivery of possession. Its essential characteristic is that possession of the thing passes thereby to the creditor.

A banker's lien is also considered to be a pledge. Lien does not normally confer a right of sale. It is merely a right to retain the goods until the debt is paid. A banker's lien however is described as an implied pledge and it is generally considered that the remedies of a pledge apply, where appropriate, to securities subject to the lien of a bank. In practice, a bank always obtains a letter of pledge setting out the right of a bank in relation to the goods from time to time pledged although the actual or constructive possession of the goods that constitute the pledge is given to the bank.

Subject to statutory modifications, the law applicable to pledge as for mortgage in Sri Lanka is the Roman Dutch Law which does not allow a pledgee to sell the property pledged without reference to a court of law even if there is an agreement between the parties on *parate* execution. According to Roman Dutch Law such an agreement is one that the law will not recognise except in the case of movables of small value and of shares held by a bank, in which case the right to do so depends on custom by which the law has been abrogated. This position has since been changed by the provisions of the Mortgage Act in respect of mortgage of shares, corporeal movables etc. in favour of approved credit agencies which have been dealt with elsewhere in this paper.

Mortgage of properties, which is the most popular and acceptable form of security in most countries, is governed by the Roman Dutch Law in Sri Lanka subject to changes and modifications made from time to time by statutory law.

Security in movables

Various types of business debts such as working capital, overdraft and commercial credit facilities are secured by movable properties such as stock-in-trade, plant and machinery that is not fixtures.

Under Sri Lankan law, a mortgage of movables can be created only in two ways, namely, (a) by delivery, or (b) by registered written instrument.

The Mortgage Act No.6 of 1949 contains a special provision applicable to mortgage of movables where a mortgagee is an approved credit agency. All licensed commercial banks in Sri Lanka are approved credit agencies. The State Mortgage and Investment Bank, the Loan Board, the National Savings and the other institutions approved by the Director of Commerce on application made in terms of Section 114 of the Mortgage Act are also approved credit agencies within the meaning of the

Mortgage Act. In terms of Section 85 of the Mortgage Act, where a mortgage of any corporeal movable is created in favour of an approved credit agency, it shall be lawful for the agency to sell any of the movables subject to the mortgage, which may for the time being actually be in the possession and custody of the agency. The power conferred on the agency to sell could be exercised only if the instrument of mortgage or an agreement between the parties contains provisions in terms to this section empowering the agency to exercise the power of sale conferred thereby and if one of the following conditions is fulfilled:

a) Where the mortgage is created as security for the payment of money stated to be payable on demand, if the mortgagor fails to make payment of the monies due and payable under mortgage within one month of the issue to him by the agency of a notice of demand in accordance with the provisions of Section 86; or

b) Where the mortgage is created as security for the payment of any money stated to be payable on a specified or ascertainable date, if the mortgagor fails to make payment of the monies due and payable under the mortgage within one month of the date of issue to him by the agency, after that date, of a notice of demand in accordance with the provisions of Section 86.

When considering the realisability of a mortgage of movables in Sri Lanka, one has to bear in mind the provisions of Section 18 of the Prevention of Frauds Ordinance read in conjunction with Sections 17 and 18 of the Registration of Documents Ordinance. In terms of Section 18 of the Prevention of Frauds Ordinance, no promise, contract, bargain or agreement unless it be in writing and signed by the party making the same, or by some person thereto lawfully authorised by him or her, shall be of force or no avail in law for the purpose of pledging movable property, unless the same shall have been actually delivered to the person to whom it is pledged. Section 17 of the Registration of Documents Ordinance provides that no pledge, mortgage or bill of sale of movable property shall be of any force or effect in law or give the pledgee, mortgagee or transferee any lien charge claim right or priority to such property unless:

a) Such property is actually delivered into the possession and custody of the pledgee, mortgagee or transferee or some person on his behalf and continues to remain actually, ostensibly and bona fide in such possession and custody; or

b) Such pledge, mortgage or bill of sale is created by an instrument in writing signed by the person effecting the same or by some person authorised by him and duly registered within 21 days in the Office of the Registrar of Lands.

It was held in the case of Indian Bank Ltd. v. Chartered Bank 43 NLR 49, that the phrase "ostensibly and *bona fide* in such custody" in Section 17 (earlier numbered 18) means the possession of the person possessing should not only be *bona fide* but should be of such a nature as to make it apparent to others that such person was in possession.

Transfers or assignments of pledges, mortgages and bills of sale are also required by Section 18 of the Registration of Documents Ordinance to be in writing and similarly registered.

Mortgage of movable–general–appointment of receiver

Where a mortgage is created in respect:

a) Of the entirety of the goods which are, or may at any future time, be in any specified premises; or

b) Of the goods which constitute or may at any time constitute the entire stock-in-trade in any specified premises…

…and an action is instituted by the mortgagee for the enforcement of the mortgage or the recovery of the moneys due thereunder, the mortgage may, at or after the time of the institution of the action, make application to the court by petition (supported by an affidavit) for the appointment of a receiver of the mortgaged property (*vide* Section 96 of the Mortgage Act).

At any stage before filing by the mortgagor of his answer, the court can deal with the application for appointment of a receiver *ex parte*.

Seizure by other creditors of mortgaged movables

Section 105(1) of the Mortgage Act contains provisions to preserve the rights of a mortgagee of movables even if other creditors seize such mortgaged movables. The provisions are quoted below:

> *Where any movable property whatsoever which is subject to a mortgage is seized in execution of a decree in favour of any person other than the mortgagee*
>
> *(a) The claim of the mortgagee shall not be investigated or dealt with as provided in Sections 241 to 247 of the Civil Procedure Code;*
>
> *(b) The mortgagee shall be entitled to make application to be added as a party to the proceedings in which the seizure was effected;*
>
> (c) *Where the mortgagee is so added before the sale under the seizure, and makes application in that behalf supported by affidavit declaring that the property is subject to a mortgage in his favour, the court shall order that the sale under the seizure be stayed and that the property be sold by public auction by an auctioneer to be appointed under subsection (2).*

Notice of an order under Subsection (1) (c) Section 105 is required to be given to the parties to the action and the court will, after such inquiry as may be necessary, appoint an auctioneer to conduct the sale and give directions as to the time and manner of such sale.

Decree and sale of movables in hypothecary action

Where in a hypothecary action, in respect of any movable property, the court finds that the mortgage ought to be enforced, the decree shall, in relation to the mortgaged movables, order that the movables be sold in default of payment of the moneys due under the mortgage within such period as may be specified by the court not exceeding one month from the date of the decree. Provided, however, that the court may, in its discretion and subject to such conditions, including the making of specified payments on specified dates as it thinks fit, on application made in that behalf before the entry of the decree, fix such longer period than one month as the court may consider reasonable (*vide* Section 107 of the Mortgage Act).

Subject, as hereinafter provided, the mortgaged movables shall be seized and sold by the fiscal under Chapter XXII of the Civil Procedure Code and all the provisions of that code relating to the

seizure and sale and delivery to the purchaser of movable property seized in execution of a decree for the payment of money shall apply accordingly. Provided, however, that the court may, in its discretion if it thinks fit so to do, either in the decree or subsequently, direct that the property shall be sold by the fiscal or by an auctioneer approved by the court, without being previously seized and shall, in such case, in the decree or subsequently, give directions as to the conduct and conditions of sale to the delivery of possession to the purchaser at such sale, and as respects such other matters as the court may find necessary.

Variation for special types of collaterals

Special provisions in respect of mortgage of motor vehicles, shares, insurance polices and assignment of book debts need be looked at separately.

Mortgage of motor vehicles

Special provisions have been made in the Mortgage Act for mortgage of motor vehicles. One advantage in the case of this category of movables is the convenience of identification by reference to the distinctive number given by the Registrar of Motor Vehicles.

Where any motor vehicle is mortgaged to any person:

a) The instrument of mortgage will, on presentation to the Registrar of Motor Vehicles, be registered by means of an entry made in the register of motor vehicles kept under the Motor Traffic Act; and

b) The certificate of registration issued under that act to the registered owner of the motor vehicle may be presented to the Registrar of Motor Vehicles who will, on such presentation, make an endorsement on the certificate to the effect that the motor vehicle has been mortgaged by the instrument of mortgage (*vide* Section 102(1) of the Mortgage Act).

Where the instrument of mortgage of any motor vehicle has been registered under Section 102, the following provisions shall apply:

a) Notwithstanding anything in any other law, any sale or other disposition of the motor vehicle by or against the mortgagor shall not, so long as the mortgage continues in force, extinguish or be deemed to extinguish the mortgage of the motor vehicle, which shall remain subject to the mortgage in the hands of the transferee or other person in whose favour such disposition is effected.

b) Upon the issue by the registrar under the Motor Traffic Act of any new certificate of registration to any person registered as the new owner, or of a duplicate certificate, the Registrar shall make an endorsement on the certificate to the effect that the motor vehicle has been mortgaged by the instrument referred to in paragraph (a) of Section 102 (1) (*vide* sec.103).

The registration by the registrar of an instrument of mortgage of a motor vehicle and any endorsement made upon the certificate of registration under Section 102 or under Section 103 to the effect that the motor vehicle is mortgaged, shall be cancelled by the registrar at the request of the mortgagee or upon an order being made by a district court directing such cancellation upon application made to it in that behalf by petition and affidavit.

Mortgage of shares

Where the holder of any shares:

a) Creates a mortgage of such shares in favour of an approved credit agency by means of an instrument in the form set out in the third schedule to that act, and

b) Deposits with such agency the certificate or certificates issued to him in respect of such shares, and

c) Executes and delivers to such agency an instrument of transfer of such shares in favour of such agency or of any nominee of such agency, or an instrument of transfer in which the name of the transferee is not entered at the time of the execution (referred to as a "transfer in blank"), the provisions of Section 73 of the Mortgage Act will apply, that is to say:

   (i) If the shares are mortgaged as security for the payment of any moneys stated to be payable on demand, and the mortgagor fails to make payment of the moneys due and payable under the mortgage within one month of the issue to him by the agency of a notice of demand in accordance with the provisions of Section 74, of the Mortgage Act; or

   (ii) If the shares are mortgaged as security for the payment of any moneys stated to be payable on a specified or ascertainable date, and the mortgagor fails to make payment of the moneys due and payable under the mortgage within one month of the issue to him by the agency, after that date, of a notice of demand in accordance with the provisions of the said Section 74, it shall be lawful for the agency to sell, or as the case may be to cause the nominee to sell, the shares at their current market value and, where a transfer in blank had been executed, to complete the sale by the insertion in the transfer in blank of the name of the purchaser as the transferee of the shares.

Such a right of the agency to sell any shares includes the right to purchase the shares at the current market value or, where the transfer had been executed in favour of the agency to retain the shares, credit being in either event given to the mortgagor to the extent of the current market value.

The rights of the agency may be exercised in respect of all the shares which are for the time being subject to the mortgage under the instrument referred to above or separately in respect of any shares so subject.

Upon the exercise of the right of sale or purchase of any shares and the completion of a transfer in blank by the insertion of the name of the purchaser as transferee of the shares, the transfer, as so completed, shall have the like effect as though it had been executed by the mortgagor at the time of completion.

Where a transfer (other than in blank) of any shares has been executed by the mortgagor in favour of an approved credit agency or a nominee of such agency, the fact that the transfer had been executed by way of mortgage shall not affect the right of the agency or the nominee, during the pendency of the mortgage, to apply to be registered as holder of the shares and to be so registered.

Upon the sale or purchase of any shares in exercise of the right conferred by Section 73 of the Mortgage Act:

a) The moneys realised upon such sale or credited shall be applied by the agency in satisfaction of the debt due and payable under the mortgage, and the mortgagor shall be entitled to receive the balance, if any, remaining after such debt is satisfied.

b) If the moneys realised or credited upon the sale or purchase of all the shares mortgaged by the instrument are insufficient to satisfy such debt, the deficiency may be recovered from the mortgagor in the ordinary course of law.

Where a mortgage of shares has been created, and the mortgage is discharged by payment of the moneys due and payable thereunder, or by reason that the moneys realised upon a sale or purchase of only some of the shares so mortgaged are sufficient to satisfy the debt, or otherwise:

a) The mortgagor is entitled, in the case of a transfer in blank, to receive from the agency the certificate or certificates in respect of such shares or of the shares remaining unsold, as the case may be, together with the transfer in blank in respect thereof.

b) The mortgagor is entitled in the case of a transfer, otherwise than in blank, to receive from the agency or its nominee, at the instance of the agency, a duly executed instrument of retransfer of the share or of the shares remaining unsold, as the case may be.

Bankers should ensure that the right of sale of mortgaged shares is properly exercised. Section 78(1) of the Mortgage Act provides "Where any shares mortgaged as provided in Section 73 are sold or caused to be sold, or are purchased by the agency, otherwise than in the due exercise of the right conferred in that behalf by that section, the mortgagor shall be entitled to recover from the agency the amount of any; loss or damage suffered or incurred by reason of such sale or purchase…."

The operation of any other written law or of any regulations or provisions which apply to the transfer of shares, or to the registration of the transferee of any shares as the holder thereof, or which confer any right to decline to effect such registration will not in any way be affected or modified by reason that a transfer of any such shares is effected in the exercise of the right conferred by Section 73 (*vide* Section 79).

With the coming into operation of the Central Depository System (CDS), the sale and purchase of all shares in publicly quoted companies have to be processed through the CDS. A shareholder desiring to sell his shares is required to open an account with the CDS and execute a nominal transfer in its favour and the shares so transferred are registered in the name of the CDS. However, the shareholder continues to be a member of his company for all other purposes. In taking a mortgage of shares in publicly quoted companies, a bank or other approved credit agency has to, in addition to the requirements under the Mortgage Act referred to above, obtain from the mortgagor the following documents:

a) A CDS account opening form duly completed;

b) A sold transfer form, one for each certificate, duly completed;

c) A letter of authorisation empowering a broker to act for him in the sale of the shares by the approved credit agency and to pay the proceeds to such agency.

The letter of authorisation becomes necessary as only share brokers who are members of the Colombo Stock Exchange are allowed to deal with the CDS. The above steps must be followed when obtaining a mortgage of shares in a publicly quoted company.

For the above purposes (covered by Sections 73 to 79 of the Mortgage Act) "shares" means any shares, debentures, stock or other securities in the funds of the government of Sri Lanka or in the capital of any company incorporated or registered in Sri Lanka.

Mortgage of life insurance policies

In Sri Lanka, where the holder of a policy of life insurance:

a) Creates a mortgage of the policy in favour of a bank (an approved credit agency) by means of an instrument in the form set out in the Third Schedule to the Mortgage Act of Sri Lanka; and

b) Assigns the policy to the bank by way of mortgage and deposits it with such agency, the provisions of Section 81 of the Mortgage Act apply in the following manner:

   i. If the policy is mortgaged as security for the payment of any moneys stated to be payable on demand, and the mortgagor fails to make payment of the moneys due and payable under the mortgage within six months of the issue of notice of demand of payment in accordance with the provisions of Section 82; or

   ii. If the policy mortgaged as security for the payment of any moneys stated to be payable on any specified or ascertainable date, and the mortgagor fails to make payment of the moneys due and payable under the mortgage within six months of the issue, after that date of notice of demand of payment in accordance with the provisions of Section 82; or

   iii. If any premium due on the policy remains unpaid after one month from the issue, in accordance with the provisions of Section 82, by the agency of a notice demanding payment of such premium to be made to the insurer,

Such agency may be entitled to surrender the policy to the insurer and to receive payment of the surrender value of the policy or of such amount as would have been payable to the assured if the policy had been surrendered by him. If the moneys so received are insufficient to pay such debt, the agency shall be entitled to recover the balance in the ordinary course of law (Section 83). If the policy is surrendered by the agency otherwise than in the due exercise of the right conferred by Section 81, the mortgagor shall be entitled to recover from the agency the amount of any loss or damage suffered or incurred by him in consequence of such surrender (Section 84).

A word of caution to bankers who exercise the right conferred by Section 81 is necessary because of the provisions of Section 84 of the Mortgage Act. If the policy is surrendered by the agency, other than in the due exercise of the right (conferred by Section 81), the mortgagor will be entitled to recover from the agency any loss or damage suffered or incurred by him inconsequence thereof. Therefore, the bankers and the other agencies should familiarise with the provisions of the Section 81 and 82 and ensure strict compliance when realising a security of an insurance policy.

Assignment of book debts

If an assignment of any book debt:

a) Is executed in favour of an approved credit agency; and

b) Is expressed to be by way of mortgage; and

c) Is duly registered under the Registration of Documents Ordinance Section 90 of the Mortgage Act confers on the agency the right to demand accept and recover payment of such debt from the person owing such debt to the assignor. (This right is in addition to the right to enforce such mortgage by action in any competent court).

No such right to demand accept and recover payment of such debt conferred by Section 90 can be exercised:

a) Unless notice of the assignment is given by the agency, to the person owing such debt, in any manner provided by Section 91, and the debt is due and unpaid at the date on which notice is so given;

b) If the right to demand, accept or receive such payment is, by the instrument of the mortgage, declared to be conditional upon the happening of any event or the non-fulfilment of any obligation by the assignor, unless such event has happened or such obligation has not been fulfilled within the time specified in that behalf in the instrument, as the case may be.

The provisions referred to above apply in relation to a book debt notwithstanding:

a) That it may not be specially assigned; or

b) That it may not have been due, or that the consideration therefore may not have passed, at the time of the execution of the assignment.

"Book debt," means any debt which:

a) Is due or may become due to any person on account of any loan made in the ordinary course of any business carried on by that person as a money-lender, or on account of goods sold in the ordinary course of any business carried on by that person a seller of such goods, or on account of work or services performed or rendered in the ordinary course of any business carried on for profit by that person, and

b) Is shown in the books kept by such person in the ordinary course of the business.

Section 91 of the Mortgage Act reads:

(3) Notice of the assignment of a book debt may be given by the agency to a person owing such debt in any manner set out hereunder, that is to say:

(a) By sending or presenting to the person owing such debt a notice addressed to such person and signed by the assignor to the effect that the debt has been assigned to the assignee; or

(b) By sending or presenting to such person (i) a general notice signed by the assignor to the effect that all book debts which are due or may become due have been assigned to the assignee, or (ii) a copy of such notice certified by a director, manager, partner or secretary of the agency.

(4) Any notice referred to in paragraph (a) or paragraph (b) of subsection (I) may be signed by the assignor at the time of the execution of the assignment or at any time thereafter, and may be sent or presented to the person owing the debt at any time while the assignment is operative.

Two other forms of security also need our attention in this report

Trust receipts

A trust receipt is another kind of security against which credit is granted by an approved credit agency. Trust receipts fall into two categories: trust receipts for imported goods; and trust receipts for exportation of goods.

In Sri Lanka, the Trust Receipts Ordinance No.12 of 1947 governs the execution of trust receipts, and the registration and effect of trust receipts so executed. The operation of the ordinance is restricted to trust receipts executed in favour of approved credit agencies.

Our Act No. 14 of 1990 has introduced another type of trust receipt called "The Inland Trust Receipt". The act provides for the execution of an inland trust receipt in favour of an approved credit agency in such a case as where a person proposes to purchase goods for the purpose of transportation and sale within Sri Lanka and obtains advances by way of loan, overdraft or otherwise from that agency for the purpose of making payment for the goods and of meeting expenditure in connection with the transportation and sale and preparation for transportation and sale thereof. In the case of this trust receipt, the person executing the same undertakes to hold the goods in trust for the agency, to mark the goods or the packages or cases containing them in a specified manner, to keep the goods in specified premises, to hold in trust and to pay the agency from time to time proceeds received from the sale of those goods or a specified proportion thereof, etc. This act also has made provision for the registration of an inland trust receipt with the Registrar of Lands as a bill of sale. It also gives the agency in favour of which the trust receipt is executed the same preferential rights which are available under the Trust Receipts Ordinance and mentioned above.

Guarantee

Guarantee is another form of security often sought by bankers for their advances in Sri Lanka. Although it is not a healthy practice, bankers seek the personal guarantees of directors in advances granted to companies. Bankers may be doing this for their convenience, but such an attitude does not at all contribute to the development of banking in any country. Nevertheless, the bankers should realise that the real value of a guarantee turns upon value, form and enforceability of the document.

The form and execution of a guarantee must be in conformity with the applicable law. Although the English law, as amended by statutes, is applicable to banking matters in Sri Lanka, the law applicable to a guarantee is Roman Dutch Law. As stated earlier, a guarantee granted even in favour of a bank in Sri Lanka is governed by the Roman Dutch Law. Sureties are entitled to certain benefits under the Roman Dutch Law unless they renounce the same. The situation in India and other countries is different.

Finance leasing

In 2000, the Sri Lankan parliament enacted the Finance Leasing Act No. 56 of 2000 for the regulation and monitoring of the business of investing money for the provision of equipment under a finance lease. Under this act leasing institutions that carry on finance leasing business activities need be registered with and supervised by the Central Bank.

Section 20 of the act empowers the lessor to, *inter alia*, recover possession of the leased equipment and recover damages. Police assistance and the court's intervention can also be obtained by such lessor under the provisions of Sections 27, 28 and 29 of the act. It will be of interest to note that Section 26 of the act provides as follows:

> *26. (1) The rights of a lessor under this Act may be enforced against a trustee in bankruptcy of the lessee, or against any creditor of a lessee, including any creditor who has obtained an attachment in execution of such equipment.*
>
> *26. (2) For the purposes of subsection (1), "a trustee in bankruptcy" includes a liquidator, administrator or other person appointed to administer the estate of a lessee for the benefit of the lessee's creditors.*

Commercial Paper

Commercial Paper was another avenue for short-term borrowings by large corporates. At the same time, it continued to provide investors with alternative investment opportunities. According to the Central Bank of Sri Lanka, the issues of commercial paper declined significantly in 2003 (by over 50% to LKR 11.1 billion) reflecting higher liquidity in the market and the increasing competitiveness in bank lending rates. The majority of commercial paper was supported by commercial banks.

Negative pledge

Although a negative pledge is not a security, commercial banks found comfort in taking negative pledges from large conglomerates by evaluating their credit rating. In some instances, the conglomerates have given negative pledges to all their banks by one instrument and each bank has thereby ensured that another bank does not rank in priority in its claims over the other.

Unsecured claims

Debt Recovery (Special Provisions) Act No. 2 of 1990 as amended by Act No. 9 of 1994

Licensed commercial banks, a few named specialised licensed banks (*viz*: State Mortgage and Investment Bank, National Development Bank, National Savings Bank and Development Finance Corporation of Ceylon) and finance companies registered under the Finance Companies Act to carry on finance companies, all of whom are collectively defined as lending institutions can institute action under the Debt Recovery (Special Provisions) Act which was a law enacted to regulate the procedure relating to debt recovery by lending institutions. This procedure has been designed to facilitate recovery of debts that fall within the meaning of the definition of that term contained in the act.

> *"Debt" means a sum of money which is ascertained or capable of being ascertained at the time of the institution of the action, and which is in default, whether the same be secured or not, or owed by any person or persons, jointly or severally or as principal borrower or guarantor or in any other capacity, and alleged by a lending institution to have arisen from*

a transaction in the course of banking, lending, financial or other allied business activity of that institution, but does not include a sum of money owned under a promise or agreement which is not in writing.

The summary procedure laid down in this law is somewhat similar to that applicable to liquid claims as observed by the Court of Appeal in Ramanayake v. Sampath Bank (1993) 1 SLR 145.

After the service on the defendant (as debtor or the guarantor) alienation or disposal of movables or immovable property in any manner by him or his representatives in interest without the approval of the court is prohibited.

Of course, this law requires strict compliance with the procedure laid down. Unless the documentation is in perfect order, the plaintiffs take the risk of the action being dismissed. There is no specific provision to amend the plaint once it is filed and likewise the decree once entered cannot be amended. It is still a moot point as to whether the parties can resort to *causus omissus* provisions contained in Section 19 of the law which provides that in the matters not provided for in the act the provisions of the Civil Procedure Code would apply.

An effort made by the government to amend this law further by making a few changes which included the enlargement of the scope of the definition of "the debt" and also to extend the application of the law to all the licensed specialised banks failed as the Supreme Court struck down some of the provisions of the amending bill as unconstitutional and declared that the same cannot be passed by a simple majority but only by a special majority.

Non-judicial collection techniques

Banker's lien

A banker's lien has been judicially recognised for a long time. Bankers have a general lien on all securities deposited with them, as bankers, by a customer, unless, there is an express contract, or circumstances that show an implied contract, inconsistent with lien.

The lien applies only to the securities, which came into a banker's hands in the ordinary course of business. If the securities were handed to a bank for a special purpose (i.e. for safe custody), no lien could be exercised. If securities are deposited for a particular loan or an advance never granted, the right of lien cannot be exercised in respect of some other loan or advance. The difficulty arises in deciding exactly what securities are subject to the banker's lien. According to the leading authority on banking, Paget, "the better view would seem to be that the lien only attaches to such securities as a banker ordinarily deals with for his customer, otherwise than for safe custody when there is no question or contemplation of indebtedness on the part of the customer."

Set-off

The right of set-off of a bank against its customer arises from their relationship, which is that of debtor and creditor. The right of a bank to look upon any credit balance as security is a right of set-off, which is also known as the right of combination of accounts. Monies deposited by a customer becomes the property of the bank subject to the bank's obligation to repay the customer upon demand or within the agreed period of notice in the case of a deposit. Lord Denning M.R. said in the case of Halesowen Presswork Assemblies Ltd v. Westminster Bank Ltd (1970) 3 WLR 625:

Using this phraseology, the question in this case is: suppose a customer has one account in credit and another in debit. Has the banker a right to combine the two accounts so that he can set off the debit against the credit and be liable only for the balance? The answer to this question is: yes, the banker has a right to combine the two accounts whenever he pleases, and to set off one against the other, unless he has made some agreement, express or implied to keep them separate.

Liquidation

Principal laws governing liquidation

Laws which apply to formal or judicial liquidations

The Companies Act No. 17 of 1982 (as amended) and the Winding-up Rules made in 1939 under the repealed Companies Ordinance, which are still in force, having been adopted under the Companies Act.

Certain BOI companies exempted from winding-up

Section 17 of the Board of Investment of Sri Lanka Law empowers the Board of Investment of Sri Lanka (BOI) to enter into agreements with any enterprise and to grant exemptions from any law referred to in Schedule B thereto or to modify or vary the application of any such laws, to such enterprise in accordance with such regulations as may be made by the minister in charge of the subject of the BOI. Every such agreement is reduced to writing and constitutes a valid and binding contract between the BOI and the enterprise upon registration of such agreement with the BOI.

One of the laws referred to in the Schedule B is the Companies Ordinance, but the Companies Act No. 17 of 1982 replaced the Companies Ordinance. In terms of Section 16(1) of the Interpretation Ordinance, where in a written law or document reference is made to any written law which is subsequently repealed, such references shall be deemed to be made to the written law by which the repeal is effected or to the corresponding portion thereof. Accordingly, the reference to the Companies Ordinance in the said Schedule B is deemed to be a reference to the Companies Act No. 17 of 1982.

In terms of the Board of Investment of Sri Lanka Regulation No. 2 of 1984, gazetted on 8 April 1994, the BOI may embody or incorporate in any agreement entered in terms of Section 17 of the aforesaid law, with an enterprise, if such enterprise is a resident company and which, in accordance with such agreement, has invested or intends to invest in Sri Lanka within the period specified in such agreement, not less than USD[2] 50 million or its equivalent in any other foreign currency, to meet the cost of any project approved by the BOI (hereinafter referred to as a "flagship company"), the following provisions:

i. That the number of contributories who may present a petition for the winding-up of a flagship company on the ground specified in Subsection (f) of Section 255 of the Companies Act No. 17 of 1982 shall be not less than five contributories holding not less than 10% of its issued share capital; and

[2] United States dollar (USD).

ii. That only a creditor to whom a flagship company is indebted and is unable to pay a debt of not less than LKR 1 million shall be entitled to present a petition for winding-up of a flagship company by court on the ground specified in Subsection (c) of Section 255 of the Companies Act, No. 17 of 1982.

Accordingly, the provisions contained in Section 255 of the Companies Act stand at variance in respect of the BOI enterprises, which are flagship companies.

State-owned enterprises, banks and financial institutions

Please see above in respect of liquidation of state-owned enterprises and banks and financial institutions.

Types of winding-up

A company can seek to have itself wound up either by compulsory winding up or under supervision of court or voluntarily

We elaborate on those types of winding up below:

Compulsory winding up by court

A company may be wound up by court if:

- The company has, by special resolution, resolved that it be wound up by court; or
- Default is made in delivering the statutory report to the registrar or in holding the statutory meeting; or
- The company does not commence its business within a year from its incorporation, or suspends its business for one year; or
- The number of members is reduced, in the case of a private company below two or, in the case of a public company, below seven or, in the case of a people's company to below 50; or
- The company is unable to pay its debts; or
- The court is of the opinion that it is just and equitable that the company be wound up.

In terms of the provisions of the Companies Act, a company shall be deemed to be unable to pay its debts where:

- A creditor, by assignment or otherwise, to whom the company is indebted in a sum exceeding LKR 500 then due, has served on the company, by leaving it at the registered office of the company, a demand under his hand requiring the company to pay the sum so due, and the company has for three weeks from the date of so leaving, neglected to pay the sum, or to secure or compound for it to the reasonable satisfaction of the creditor; or
- Execution or other process issued on a judgment, decree or order of any court in favour of a creditor of the company is returned unsatisfied in whole or in part; or
- It is proved to the satisfaction of the court that the company is unable to pay its debts, and, in determining whether a company is unable to pay its debts, the court shall take into account the contingent and prospective liabilities of the company.

Voluntary Winding-up

A company may be wound up voluntarily:

- When the period, if any, fixed by its articles for the duration of the company, expires and the company in general meeting has passed a resolution that it be wound up voluntarily; or
- When any event has occurred, on the occurrence of which the articles provide that the company be dissolved, and the company has passed a resolution in general meeting that it be wound up voluntarily; or
- When the company resolves by special resolution that it be wound up voluntarily; or
- When the company resolves by extraordinary resolution that it cannot, by reason of liabilities, continue its business and that it is advisable to wind up.

Within the period of five weeks before the passing of the resolution for the voluntary winding up of a company under Section 308, the directors of the company or, if the company has more than two directors, the majority of them, should, at a meeting of the board, make a statutory declaration that they have made a full inquiry into the company's affairs and that they are of the opinion that the company will be able to pay its debts in full within such period, not exceeding 12 months from the date of commencement of the winding up. This declaration (on Form 66) has to be delivered to the registrar before the expiry of the period of five weeks, as mentioned above, prior to the passing of the resolution for the voluntary winding up of the company under Section 308. The declaration has also to embody a statement of the company's assets and liabilities as at the latest practicable date before the making of the declaration. A winding up, where this declaration has been made and delivered to the registrar, is called a "members voluntary winding up". A winding up where no such declaration has been so made and delivered is called a "creditors voluntary winding up". A voluntary winding up is deemed to commence at the time of the passing of the resolution for the winding up (*vide* Section 310)

In the case of a voluntary winding up, the company should from the date of commencement of winding up cease to carry on its business except so far as may be required for the beneficial winding up thereof. However, the corporate state and corporate power of the company will continue until such time as the company is dissolved. Any transfer of shares, not being a transfer made to or with the sanction of the liquidator, will be permitted after the commencement of the winding up and any alteration in the status of the members of the company will be void. (v*ide* Sections 311 and 312).

Claims in winding-up: Proving and recognising of claims in every mode of winding-up

Debts of all descriptions should be proved in every winding up as provided for in Section 345. Section 346 extends the application of the Insolvency Ordinance in respect of the insolvency of the estates of individuals adjudged as insolvent shall be observed with regard to the rights of secured and unsecured creditors and to debts provable etc. in winding up of companies. However, Section 347 provides that in a winding up there shall be paid in priority to all other debts the following:

i) Income tax;

ii) Business Turnover Tax (now Value Added Tax);

iii) All rates or taxes (other than income tax) payable within the 12 months prior to the relevant date up to a sum of LKR 2 000;

iv) All dues to the Government of Sri Lanka for services given or rendered periodically;

v) All provident fund dues, gratuity payments and industrial court awards payable to any employee or workman;

vi) All wages or salaries to employees as specified in that section for four months;

vii) All accrued holiday remuneration as specified in that section; and

viii) Workmen's compensation as specified in that section.

The abovementioned priority debts rank equally among themselves and have priority over the claims of holders of debentures under any floating charge. Subject to the retention of such sum as may be necessary for the costs and expenses of winding up, the said priority debts should be discharged forthwith as far as the assets are sufficient to meet them.

This section also provides that in the event of a landlord or any other person distraining or having distrained on any goods or effects of the company within three months immediately prior to the date of a winding-up order, the debts to which priority is given in the provisions of this section shall be a first charge on the goods or effects so distrained on or the proceeds of the sale thereof. Provided that in respect of any money paid under any such charge, the landlord or other person shall have the same rights of priority as the person to whom the payment is made.

Another matter that may be relevant here is the position of the first charges under statutes *vis-à-vis* mortgages as secured creditors. This question arose in the Court of Appeal in Development Finance Corporation of Ceylon and Others v. Deputy Commissioner of Inland Revenue and Others CA (SC) Appeal Nos. 437/75(F) 438/75(F) and 439(F) D.C. Colombo Case No. 77764/M, which was discussed above.

Whether a charge created is a fixed charge or floating charge will also be relevant when coming to determine priorities in a winding up of a company. A fixed charge applies to the property it covers from the point of creation. A fixed charge will usually take priority over a subsequent fixed charge and over any floating charge no matter when created. This is, however, subject to the provision that if a floating charge is created prior to a fixed charge and the floating charge prohibits the creation of any subsequent charge with priority over that floating charge and this condition is actually registered with the prescribed particulars at the company's registry, then that floating charge will take priority over a subsequent fixed charge.

We should also make note of the provisions of Section 350 of the Companies Act No. 17 of 1982 on the effect of a floating charge created within 12 months of winding up and the provisions of Section 347 of the act that deal with preferential claims. Similar provisions are generally found in the company laws of other countries.

It is important to have any charge created by a company registered in Sri Lanka in compliance with the provisions of Section 91 of the Companies Act. Those provisions apply to charges created on lands, book debts and assets of the company. Even if the property of the company is situated outside Sri Lanka or the charge is created outside Sri Lanka, the provisions of Section 91 apply with certain modifications as to the stipulated period of time for registration. In the absence of such registration the charge is, as far as any security on the conveyer's property or undertaking is conferred thereby, void against the liquidator and any creditor of the company.

Effect of winding up on antecedent and other transactions

Section 348 declares that any conveyance, mortgage, delivery of goods, payment, execution or other act relating to property which would, if made or done by or against an individual, be deemed in

his insolvency a fraudulent preference, shall, if made or done by or against a company, be deemed, in the event of its being wound up, a fraudulent preference of its creditors and be invalid accordingly. It might also be noted that for the purposes of this section, the commencement of the winding up shall be deemed to correspond with the act of insolvency in the case of an individual. Any conveyance or assignment by a company of all its property to trustees for the benefit of all its creditors shall be void to all intents.

Liabilities and rights of fraudulently preferred persons are covered by Section 348 and set out in Section 349. It is also relevant to refer to Section 350 which provides that where a company is being wound up a floating charge on the undertaking or property of the company created within 12 months of the date of commencement of the winding up, shall, unless it is proved that the company immediately after the creation of the charge was solvent, be invalid except to the amount of any cash paid to the company at the time of, or subsequently to the creation of, and in consideration for, the charge, together with interest per annum on that amount at the legal rate.

Section 351 contains provisions in respect of onerous property and Section 352 contains restrictions of rights of creditors as to extension or attachment in case of a company being wound up. Sections 354 to 360 contain offences by officers antecedent to and in the course of winding up that make the officers of the companies liable to be punished for fraudulent acts referred to therein.

Wishes of creditors and contributors

Section 371 provides that the court may, as to all matters relating to the winding up of the company, have regard to the wishes of the creditors or contributories of the company and that direct meetings of the creditors or contributors be held. In the case of those meetings, regard will be had to the value of each creditors debt and in the case of contributories, regard will be had to the number of votes conferred on each contributory by this act or the articles.

Rehabilitation/Compositions/Schemes

Although Sri Lanka does not have any general legal framework for rehabilitation/compositions/schemes, the following are relevant here:

Power to compromise with creditors and members: Sections 206 and 207 of the Companies Act

i. Sections 206 and 207 of the Companies Act contain provisions in respect of power to compromise with creditors and members.

ii. If a compromise or arrangement is proposed between a company and its creditors or between the company and its members, or between the company and both its creditors and members, the court may, on the application of any creditor or a member of the company, or its liquidator, order a meeting of the creditors or of the company's member to be summoned for the purpose of sanctioning such compromise or arrangement.

iii. If a majority representing three-fourths in value of the creditors or members, voting either in person or by proxy, agrees to any compromise or arrangement, such compromise or arrangement will, if sanctioned by the court, be binding on the creditors or on the members or on the liquidator. Such a court order will have no effect until a certified copy therefore is delivered to the Registrar of Companies for

registration. A copy of such order has to be annexed to every copy of the company's memorandum issued after the making of the order.

iv. The expression "arrangement" includes any reorganisation of the share capital of a company by the consolidation of shares of different classes, or by the division of shares into shares of different classes, or by both these methods.

v. If a meeting of creditors or members is summoned as mentioned above, the company is obliged to send to every creditor or member, together with the notice of the meeting, a statement explaining the effect of the compromise or arrangement so far as it influences the material interests of the directors, whether as directors or as a member or as creditors of the company, as against the material interests of other persons.

Reconstructions and amalgamations (mergers): Sections 208 and 209 of the Companies Act

i. Provision for reconstructions and amalgamations are found in Sections 208 and 209 of the Companies Act.

ii. Where a compromise or arrangement, as referred to in the preceding paragraph is shown to court as a scheme for the reconstruction of any company or companies or for the amalgamation (merger) of any two or more companies and that, under that scheme, the whole or any part of the undertaking or property of any company involved in the scheme is to be transferred to another company, the court may, by the order sanctioning the compromise or arrangement, make provision for all or any of the several matters outlined under Paragraphs (a) to (f) of Section 08(1).

Where a scheme or contract involving the transfer of shares in a company to another company has been approved by the holders of shares in the transferor company in terms of Section 209(1), the shares held by any dissenters to the scheme or contract can be acquired by the transferee company as provided for under the same section.

To manage mortgaged properties: Section 5 of the Recovery of Loans by Banks (Special Provisions) Act No. 4 of 1990

The provisions are found in Section 5 of the Recovery of Loans by Banks (Special Provisions) Act No. 4 of 1990 (as amended by the Act No. 24 of 1995) for a board of directors of a bank-mortgagee to take possession of mortgaged property and control and manage the same. If the loan is granted to any agricultural or industrial undertaking on the security of any plant, machinery or other movable property, the board of the bank-mortgagee can authorise any person to take possession thereof and manage and control such undertaking.

Tourist Development Act

Special provisions have been made in the Tourist Development Act No. 14 of 1968 (as amended) in respect of loans by an approved credit agency on the security of land alienated by the Ceylon Tourist Board. The provisions, which are similar to those contained in the Recovery of Loans by Banks (Special Provisions) Act No. 4 of 1990, authorises, *inter alia*, the lender to authorise a manager to take possession and manage the mortgaged property.

Orders in applications under Sections 210 and 211 of the Companies Act

In applications made to court under Sections 210 and 211 of the Companies Act, the court has wide powers to make orders in respect of, *inter alia*, the regulation and conduct of the affairs of a company. This is in addition to the power to give remedies for oppression or mismanagement under Sections 210 to 211 of the Companies Act.

Stepping-in arrangements for BOI Enterprises.

In most infrastructure projects, the BOI agrees to stepping-in arrangements for creditors of a BOI enterprise. This is included in BOI agreements.

Rehabilitation of non-performing or under-performing businesses

Under the Inland Revenue Act

Exemption is granted from income tax for acquisition of non-performing or under-performing business enterprises engaged in specific areas of activity for rehabilitation as provided for in terms of Section 21E of the Inland Revenue Act No. 38 of 2000 (as amended by Act No. 19 of 2003).

Exemption from income tax of any company acquiring non-performing or under performing business enterprises.

The profits and income of any trade or business (other than any profits from the sale of capital assets of a company which acquires a non-performing or under performing business enterprise engaged in a specific area of activity, to rehabilitate such enterprise [subject to terms approved by the Minister and subject to adequate provision being made to meet the statutory liabilities outstanding at the time of acquisition of such enterprise]) shall be exempt from income tax, for a period of three years, where the acquisition was completed and commercial operations commenced on or before 31 March 2004.

The period of three years referred to above shall be reckoned from the year of assessment in which the acquired enterprise commences to make profits or any year of assessment, not later than two years reckoned from the date on which each enterprise commences commercial operations, whichever is earlier.

Bank restructuring

Two licensed commercial banks, i.e. Union Bank of Colombo Ltd. (UBCL) and the National Mercantile Bank Ltd. (MERC) were successfully recapitalised and restructured with the assistance of two established large banks. This restructuring was carried out under the supervision of BSD and was facilitated by the necessary regulatory approvals of the Monetary Board.

The UBCL was recapitalised and restructured by a consortium of investors led by the Sampath Bank Ltd. (a LCB) in August 2003. Accordingly, the consortium infused fresh equity capital of LKR 252 million subscribing to a different class of ordinary shares. Further LKR 100 million of capital in the form of debenture proceeds was infused, increasing n the total new capital fusion to LKR 625 million. The resolution of non-performing loans of the UBCL was accomplished through the establishment of a Special Purpose Vehicle Company (SPV) to which the non-performing loans were transferred. This capitalisation and restructuring process successfully transformed the weak

financial position of the UBCL by restoring the capital adequacy ratio to over the statutory minimum requirement of 10% and reducing non-performing loans considerably.

The MERC Bank was recapitalised and restructured by the DFCC Bank (a LSB) by the acquisition of a 94% stake of MERC Bank to make it a subsidiary of the DFCC Bank. Consequent to the recapitalisation, the capital position of the MERRC Bank rose to a level adequate to restore its capital adequacy ratio to over the statutory minimum requirement of 10%. The board of directors of MERC Bank was also reconstituted to allow for adequate representation from the DFCC Bank. Later, the corporate name of MERC Bank was changed to DFCC Vardhana Bank Ltd. Its operations, which were carried out through three branches at the time of restructuring, were expanded with four more branches established at the premises of four branches of the DFCC Bank

Proposed reforms

The Central Bank of Sri Lanka has constituted a special committee consisting of representatives of stakeholders (*viz*: banks, the Chamber of Commerce, and the Bar Association of Sri Lanka) to suggest legal reforms to make the recovery process of loans more effective and at the same time to work out a legal scheme for restructuring sick industries. BRIPASL (the Business Recovery and Insolvency Practitioners Association of Sri Lanka) is assisting this committee in formulating a scheme.

Insolvency treatment

State-owned enterprises

This aspect is governed by the statutes, if any, separately governing the respective enterprises. If there is no separate statute, the general statutes apply. If the government ceases to hold more than 20% of the capital of the corporation, the corporation's business has to be transferred to a company and the corporation should be dissolved as provided for in Part IV of the government-sponsored Corporations Act No. 19 of 1995 (as amended). Where the appropriate minister considers that the activities of a public corporation should be terminated, the minister may, as provided for in Section 19 of the Finance Act No. 38 of 1971 (as amended), under the authority of a resolution passed by the parliament, dissolve the corporation and appoint one or more persons to be the liquidator or liquidators of the corporation. The liquidator's powers and closure of liquidation are provided for in Sections 20 and 21 of the said Finance Act.

Licensed commercial banks

Voluntary liquidation of a licensed commercial bank incorporated in Sri Lanka is possible only with the prior authorisation granted in writing by the Monetary Board as provided for in Section 51 of the Banking Act No. 30 of 1988 (as amended). Provisions for compulsory liquidation of a licensed commercial bank are contained in Section 56 of the said Banking Act. The liquidation proceedings are to be carried out in terms of the provisions of the Banking Act. While Section 12(1) of the Banking Act empowers the Monetary Board to give (with the concurrence of the minister) the approval for a closure of a branch of a licensed commercial bank, Section 70 of the said act sets out the procedure for closure of business of licensed commercial banks incorporated outside Sri Lanka with the approval of the Monetary Board.

It must be noted that the provisions contained in Part VIII of the Banking Act in respect of liquidation of licensed commercial banks incorporated within Sri Lanka and closure of branches of licensed commercial banks incorporated outside Sri Lanka, prevail over the provisions of the Companies Act and the Monetary Law.

Finance companies

Section 18 of the Finance Companies Act No. 18 of 1998 (as amended) empowers the director (who is the head of the department of the Central Bank of Sri Lanka to which the subject of finance companies is assigned) to take steps for winding up of a finance company. Furthermore, Section 20 of the same act empowers the Monetary Board to take over administration and management of a finance company.

Accountability and reporting process

Prudential regulations and directions issued by the Central Bank

The Banking Supervision Division of the Central Bank of Sri Lanka (BSD) continued to monitor compliance by banks with regulatory requirements introduced from time to time under the provisions of the banking act and other prudential directions applicable to capital, liquidity, large exposures, share ownership in banks, investments in shares by banks, asset quality, income recognition, provisioning for bad and doubtful debts, related party transactions, acquisition of immovable property, disclosure of quarterly and annual financial statements and the audit of banks.

During the year under review, the following directions and determinations of the Monetary Board and prudential requirements were issued by the BSD:

i) Amendment to Schedule II, relating to the Valuation of Securities for Provisioning Purposes, in the Directions on Suspension of Interest on Non-Performing Advances and Classification of Bad and Doubtful Advances for Provisioning Purposes. This amendment effected the following:

   (1) At the time of first provisioning for a loan secured against a primary mortgage over property, only 75% of the forced sale value (FSV) of the property based on a current professional valuation report can be considered as the value of security.

   (2) When a loan is transferred to the "loss" category, (i.e. where a loan has been non-performing for 18 months or more) the following progressive discounts will apply to the FSV of immovable property held as collateral, based on a current professional valuation report. A current professional valuation report is a report that is not more than four years old in respect of loans for residential purposes granted against residential property occupied by the borrower. In respect of loans granted for all other purposes, it is a report that is not more than three years old.

No. of years in "loss" category	% of immovable property that can be counted as the value of security
1-2 years	60%
2-3 years	50%
3-4 years	40%

   (3) With regard to loans in the "loss" category for more than four years, all immovable property held as collateral should be reviewed on a regular basis and discounted further at the discretion of management.

ii) Directions in the single borrower limit were amended to incorporate the following in respect of licensed commercial banks incorporated in Sri Lanka and licensed specialised banks:

(1) Funds realised from a new share issue or a rights issue may be considered as capital funds for the computation of the single borrower limit effective from the date on which the proceeds of the share issue were received by the bank and accounted for in its books.
(2) A bank's current year's profits could be considered in the capital funds for the computation of the single borrower limit to the extent that the external auditors of the bank have certified such profits as being capitalised profits as at the date of certification
(3) Further, if a bank incurs losses during the current year or if there is any reduction in the retained profits due to payment of dividends etc., capital funds considered for the computation of the single borrower limit should be reduced accordingly to reflect the reduction.

iii) Requirements relating to maintenance of statutory liquid assets of off-shore banking units (OSBU) of licensed commercial banks were amended to provide for the maintenance of foreign currency liquidity for OBSU liabilities, LKR liquidity for liabilities of domestic banking units and for the expansion of the definition of liquid assets to accommodate specified instruments.

iv) Guidelines on Know Your Customer Rules (KYC) relating to certificates of deposit (CDs) were introduced. Licensed commercial banks and licensed specialised banks were required to satisfy themselves with KYC in respect of customers who invest in CDs with banks, and of persons cashing CVDS issued on 30 June 2003 and thereafter.

v) All LCBs and LSBs were informed that their financial statements should be published in the press on a quarterly basis within two months of the end of each quarter.

vi) All licensed commercial banks (LCBs) and licensed specialised banks (LSBs) were requested to compile a representative list of their interest rates on deposits and advances and, in the case of LCBs, their buying and selling rates for foreign currencies as well, and to display such information to the general public in all branches and other banking outlets commencing 1 January 2004 at the latest.

Under the off-site surveillance system, the BSD continues to monitor the financial condition of LCBs and LSBs based on periodic information provided by the banks on their operations. In terms of the provisions of the Monetary Law Act, all licensed commercial banks are subject to statutory examinations, i.e. on-site examinations, at least once during each examination period as determined by the Monetary Board, which at present is two years, or if the necessity arises, at a lesser interval. On-site examinations of licensed specialised banks are conducted in terms of the provisions of the Banking Act.[3]

Credit rating

Deposit taking institutions are required to obtain a credit rating and publish the rating obtained as per the Budget of 2003. By the end February 2004, Fitch Ratings Lanka Ltd. had published ten entity ratings given to financial institutions. It had also published three other entity ratings given to corporates. It is now also mandatory to obtain a credit rating for issues of all varieties of debt

[3] Source: Central Bank Annual Report – 2003.

instruments, except for those issued by the government, where the value exceeds LKR 100 million. Amongst the issue ratings published up to February 2004 were the five-year debentures of Sri Lanka Telecom Ltd. issued in 2000 and listed on the CSE (SL AA+), the issue of 100 million preference shares of LKR 10 each of Commercial Bank of Ceylon Ltd. issued in 2003 and listed on the CSE (SL AA-), the five-year debentures of Commercial Bank of Ceylon Ltd. issued in 2003 and listed on the CSE (SL AA), LKR 400 million debentures of Aitken Spence & Company Ltd. issued in 2002 and listed on the CSE (SL AA), and the three-year debentures of Singer Sri Lanka Ltd. issued in 2002 (SL A). Fitch Ratings Lanka Ltd. is the only rating company operating in Sri Lanka, at present.

Cross-border insolvency

There is no legal provision or recognition in respect of the matters raised in this paragraph. However, we briefly set out the law applicable in respect of reciprocal enforcement of judgments.

Recognition of foreign judgments or orders

Foreign judgments can be enforced in Sri Lanka only if such enforcement is permitted under the Reciprocal Enforcement of Judgments Ordinance.

The ordinance provides that where a judgment has been obtained in a superior court in the United Kingdom, the judgment creditor may apply to have the judgment registered in Sri Lanka at any time within 12 months after the date of the judgment or such longer period as may be allowed by the court. Upon registration, the judgment is of the same force and effect as if it had been a judgment originally obtained in Sri Lanka.

The same ordinance provides that the ordinance may, by declaration of the minister, be extended to judgements obtained in a superior court in any other part of the Commonwealth in like manner, as it extends to judgments obtained in the United Kingdom. So far, the ordinance has been extended by orders and made under the provisions of Section 6 of the act only to the following countries:

Country	Number and date of gazette	
Hong Kong	7 442	23 January 1925
Mauritius	7 444	30 January 1925
New South Wales	7 489	2 October 1925
Straits Settlements	7 427	31 October 1924
Tanganyika	7 448	27 February 1925
Uganda	7 448	27 February 1925
Victoria	7 587	10 June 1927
Federation of Malaya	10 127	21 July 1950

It is important to note that an insolvency order or winding-up order does not fall within the scope of a "judgement" under this ordinance because of the definition thereof which we quote below:

> *"Judgement" means any judgement, decree, or order given or made by a court in any civil proceedings, whether before or after the passing of this Ordinance,* ***whereby any sum of money is made payable,*** *and includes an award in proceedings on an arbitration if the award has, in pursuance of the law in force in the place where it was made, become enforceable in the same manner as a judgment given by a court in that place.*[4]

[4] Emphasis is ours.

INSOLVENCY PROCEDURES RELATING TO BANKING INSTITUTIONS IN SRI LANKA

by
Joan de Zilva

Some points for consideration

We have experienced our first bank failure in Sri Lanka (of a small specialised bank, not a commercial bank) with no systemic effect.

The Banking Act provides for the cancellation of the license of a bank and the steps that may be taken after such cancellation. This is, *prima facie*, what the Section appears to provide for. However, it may also provide for actions before the cancellation of the license. The Banking Act has been amended to make it absolutely clear that intervention by the regulator can occur before the license is cancelled. The Section provides for the regulator (*i.e.* the Director of Bank Supervision) or his appointee to rehabilitate the bank.

A number of questions arise from our experience with our first bank failure. What is the right time to intervene in a weak bank without precipitating (through market reaction to regulatory intervention) the very failure we are trying to avert? Will intervention send the wrong signals and cause a run on the bank? This is only natural as there will be a flight to safety at the first sign of trouble, and the bank will collapse when it could very well have been rehabilitated.

Why is it necessary to suspend a banking business?

In this case, irregular accounting practices were used to mislead the regulator. Even though the bank was liquid and able to meet its liabilities, it was doing so with new deposits or through the market at a very high risk premium. Even a freeze imposed on deposits was of no avail, as funds were being mobilised in the guise of investment instruments, of which the public was not aware. To date, investors in so-called "money market bills" (as opposed to deposits) believe that they are depositors and not creditors. This distinction is important, since creditors do not rank *pari passu* with depositors and therefore stand to lose in a liquidation.

When you have intervened as a regulator through a freeze on deposits or in some other manner should the public be informed?

This matter came up in this case because of spurious deposit mobilising schemes that were rampant at that time. The Central Bank had to make a public announcement of the financial institutions that were registered with the Central Bank and which were licensed to accept public deposits. The name of the failed bank was published as, subject to the freeze, it could accept deposits to the extent that the limit was not exceeded. Two weeks after the list of institutions was published, the bank's business was suspended and a liquidation decision was subsequently taken. The fact that the name of the bank was published, notwithstanding it being subject to intervention, was challenged. If, indeed, the name of the bank had not appeared on the published list, it would have had adverse reactions from its depositors to its detriment.

How does suspension compare with administration?

Suspension is not the same administration, as the term is commonly understood. Even after suspension, the bank continues to be under the control and management of the Board of Directors though their powers are limited by the regulator to prevent them from conducting banking business. The bank's assets are frozen and only basic payments are allowed with the consent of the regulator. The role of the regulator under these circumstances is that of a quasi administrator. During the period of suspension, the regulator, possibly with the help of the auditors, assesses the condition of the bank and a decision is taken on the measures needed to rehabilitate the bank or merge it with a stronger bank, etc.

Should the final decision of the regulator be permitted to be challenged in a court of law?

This is the intractable challenge we face today over this failed bank where, for the second time, the *bona fide* decision of the Monetary Board has been challenged in court, staying the hand of the regulator to liquidate the bank and deal with its assets.

This is equivalent to the usurpation of the powers of the regulator over the financial institutions under its purview by the court. The court ordered that the decision to liquidate and cancel the license be invalidated and that the regulator should examine any available options for the recapitalisation of the bank as a going concern. When it was represented that all options had been examined and that the liquidation decision was the last resort, the options available were required to be examined further. The approach and attitude of the court exemplifies a crucial aspect of the administration and resolution of weak banks, in that judicial intervention could frustrate the efforts of the regulator to effect an orderly exit of a weak bank.

What are the implications?

What are the implications for financial stability in a scenario where weak banks are not permitted to exit in a clean and swift manner as a result of the lack of knowledge of the judiciary to adjudicate on matters relating to banking and finance, especially in view of the fiduciary responsibility of bank management which is a feature unique to bank management alone?

1) Is the curtailment of judicial intervention in this instance beneficial?

Is the curtailment of judicial intervention in this instance beneficial to financial stability and what are the constitutional safeguards available to give effect to this policy stance? What is the experience of other jurisdictions? This has been our first bank failure and the moral hazard of regulation was paramount in the expectations of the public that the regulation and supervision of banks by the Central Bank ensure the safety of their deposits regardless of market signals that revealed certain institutions to be more risky than others.

2) What is the alternative?

What is the alternative to a scenario where not only decisions to liquidate a bank can be challenged in a *certiorari* action, but even decisions of the Monetary Board to appoint a receiver, administrator *etc.*? We see the answer in educating the judiciary on the policy objectives of the regulation and supervision of the banking system and on the adverse repercussions that judgements that do not take these objectives into account could have on financial system stability.

What is the result of judicial intervention in regulatory decisions? The meagre assets available to depositors in liquidation are dissipated and run down, and fast lose their value. At the same time, employees are able to claim their wages at the expense of depositors' funds. As a consequence, a delay in implementing the liquidation process is detrimental to the interests of depositors and creditors. It is almost two years since the first suspension of this bank and a steady depletion of the cash assets available to depositors has resulted from the payment of salaries, expenses, etc. This is not taking into consideration the considerable pressure on the regulatory and legal resources of the Central Bank as a result.

Finally, it is my considered view that the decision of the regulator should be final on how it proposes to deal with a failed bank. This is based on the principle that it is the prerogative of those who are responsible for the entry of a bank to be responsible for its exit through the cancellation of the banking license issued to such institution.

OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(26 2006 02 1 P) ISBN 92-64-03597-4 – No. 55045 2006

Credit Risk and Credit Access in Asia

The sheer volume of debt hanging over Asian companies suggests that corporate insolvency should remain a top policy concern. This, despite signs of improvement resulting from dramatic regulatory overhauls that followed the 1997-1998 Asian financial crisis. Moreover, the absence of widespread real restructuring following corporate collapses in Asia may force governments to acknowledge higher real losses dissimulated in their financial systems. Effective risk management practices, sound legal systems for restructuring, liquidation and recovery, and the underlying institutional infrastructure and capacity require increased attention by Asian countries.

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ISBN 92-64-03597-4
26 2006 02 1 P



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