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NPL Asia

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A review of what is happening in the Asian non-performing loan (NPL) market

In our last issue of NPL Asia (November 2005) we predicted market activity would be robust in 2006, and to date the market has proven us correct. Activity levels have picked up substantially across the region. Although in Japan, Korea and Taiwan there appears to be limited scope for any major NPL disposals in the near future, the China NPL market is hot. Investors in India are also showing enthusiasm in setting up appropriate investment structures. To reduce the amount of NPLs in a short time, the Thai Government is pursuing the idea of selling NPLs via large lots, perhaps at a discount. In Malaysia, we expect a catalytic chain of sell-offs this or early next year, and in the Philippines, we expect banks and other financial institutions to take action either through auctions or negotiated sales.

In this issue we focus on China, whose NPL market – the world's largest – is finally gaining some momentum on the back of a steady stream of sales to foreign investors. That's right, China's much maligned NPL market has finally started to produce the real goods. Since September 2005 there have been 15 announced transactions. And that's just for starters. As described below, the four Government-run Asset Management Companies (AMCs) are gearing up for more.

The information contained in NPL Asia has been obtained from numerous sources in the market and is believed to be accurate at the time of going to print. We trust you will continue to find this publication useful, and we welcome any comments you may have.

Recent NPL Sellers

China: China Orient, Cinda, Great Wall, Huarong

India: Dena Bank, HSBC, ICCI Bank, The State Bank of India

Philippines: Asia Recovery Corporation, Bank of the Philippine Islands, Metrobank, Security Bank and Trust

Taiwan: China United Trust & Investment Corporation, Enterprise Bank of Hualien, Hua Nan Bills Finance Corporation, Shin Kong Life Insurance, Taichung Commercial Bank, Taiwan Cooperative Bank

Thailand: BankThai Public, Siam Commercial Bank, TAMC

China

Activity picks up

Since our first edition of NPL Asia nearly four years ago, we have been reporting on the lack of sales activity in China – a land with mountains of NPLs and to date a less-than-stellar record of sales to foreign investors. Due to the dearth of deals since the market opened in 2001, many of the initial market entrants have either started to focus on other China distressed situations such as real estate (Merrill Lynch, Morgan Stanley, Goldman Sachs, Lehman Brothers) or have pulled out altogether, moving on to other markets (Lone Star). But the pull of the China NPL market has proven irresistible for others, and their patience seems to finally have paid off. Since late 2005, a raft of deals between the AMCs and foreign investors has been announced.

Why the increase in activity? We suspect it is due at least partially to reported Government pressure on the AMCs to offload their 1999 transfer loans by the end of 2006. As of December 2005, the AMCs reported that they had resolved approximately US$105 billion of the US$170 billion of NPLs originally acquired in 1999, generating approximately US$22 billion in cash proceeds. But that still leaves approximately 40% or US$65 billion of the 1999 transfer loans that still need to be resolved during 2006 if the above deadline is to be met. In addition to the disposal targets, the AMCs have also been given targeted cash recovery rates to achieve, set at around

9%-18% depending on the AMC. Great Wall and Cinda are rumoured to have already reached their cash recovery targets, with Huarong and China Orient still striving to achieve theirs. Whether the AMCs can dispose of the 1999 transfer loans by the end of the year remains to be seen – it may prove hard to accomplish as the 1999 transfer loans are considerably older and therefore less attractive than the more recent Category IV (doubtful) loans that are also slated to be sold this year (see below). All we really know is that sales have picked up substantially and as noted below, there are signs that further disposals are on the way.

China NPL transactions: Sep 2005 – Feb 2006

Seller	Buyer	Location	OPB (RMB billion)	OPB (US$ million)	Date
Huarong	Bank of America	Xiamen	0.9	116	Jan-06
	Cargill	Xiamen	0.8	95	Jan-06
	Citigroup/ SilverGrant	Various	36.4	4,544	Nov-05
	Deutsche/ AIG	Various	16.0	1,995	Nov-05
	Mellon	Wenzhou	1.0	125	Jan-06
China Orient	PPF	Qingdao	6.4	801	Jan-06
	Mellon	Shaanxi	4.2	524	Jan-06
	Cargill	Harbin	3.5	439	Nov-05
	ADM	Tianjin	0.6	72	Dec-05
	DAC	Dalian	4.7	586	Dec-05
	DAC	Changsha	1.2	150	Dec-05
Cinda	Avenue Capital	Tianjin	5.0	624	Sep-05
	Cargill	Changsha	2.0	249	Jan-05
Great Wall	Corstone	Jiangxi	4.4	549	Feb-06
	Citigroup	Tianjin	4.5	561	Feb-06
Total			**91.6**	**11,429**	

Emerging trends

With the completion of a number of NPL transactions recently, we note several interesting market trends:

Due diligence. Foreign investors appear to have become less reliant on the traditional information found in loan files to estimate potential recoveries, focusing more on obtaining “local intelligence” on the individual debtors. This, of course, is the approach normally taken by most domestic investors, who seem to care much less about what dated financial statements say, or whether there are problems with title documents, and instead concentrate more on figuring out who all the stakeholders are, where off-balance sheet assets might be hiding and how a deal can be cut that gives them a tidy profit. After all, the ability to make a DPO (discounted pay off) happen within a reasonable amount of time isn’t normally found in a loan file. Who is providing this information to potential investors? For the most part it is local lawyers and other individuals with ‘inside’ information on the situation.

Joint ventures with AMCs. While some experienced investors tend to maintain their own servicing platforms, many investors are turning to the AMCs for post deal servicing work. For investors, having an AMC as their servicer ensures lower overheads, but the trade off is less control. From the AMC’s standpoint they win big as they get to keep their people busy and receive servicing fees – fees that they can keep as opposed to proceeds from portfolio sales which are supposed to be returned to the Government.

Another benefit of having an AMC as servicer is that Government approvals may come quicker and some costs could be lower due to their preferential tax and other benefits. Foreign buyers using this approach usually establish a consulting company (or hire a big-4 accounting firm) to oversee and monitor the AMC servicer.

Cherry picking by local investors. We have highlighted above the resurgence of the foreign investor in China’s NPL market but let’s not forget local investors, who we believe continue to make the majority of the deals – deals not listed in the above table because they are undetected. Despite fears that NPLs are being sold to foreign investors under value, let’s not forget that local investors aren’t known for overpaying. Local investors are able to maintain cosy relationships with AMCs and as a result are better placed to cherry pick the assets they want – those NPLs where through their local knowledge they know they can make a killing – substantially reducing their risk. The system can be further manipulated if the selling AMC organises an auction at short notice, essentially ensuring the ‘chosen’ investor wins. To be sure, foreign investors try to play the system in this manner as well, but we suspect with far less success than their local counterparts.

High asking prices by the AMCs for Category IV loans. During 2004 and 2005, the AMCs acquired nearly US$150 billion of NPLs in Government brokered deals from three of China’s big-4 state owned banks. Many of these NPLs were Category IV loans acquired with minimal due diligence for around $.30 cents. The AMCs did not have the funds on hand to make the acquisitions so they had to borrow from the PBOC at 2.25%. Unlike the interest on the original 1999 transfer loans, the interest from the 2004/2005 acquisitions must be repaid. This has actually helped spur sales activity as the AMCs want to reduce the interest burden on the loans they are carrying. But the AMCs still face a problem in that they have largely set their floor selling prices at the $.30 cents or so they paid for the loans plus accrued interest, and many of the international investors we have spoken to don’t believe they can achieve the yields they require at such selling prices.

Going forward

The following market indicators point towards increased sales activity for the rest of 2006:

- China Orient recently announced an ambitious disposal program for approximately RMB20 billion (US$2.5 billion) of its Category IV loans, retaining each of the big-4 accounting firms to oversee separate, co-ordinated disposals of the various pools
- Cinda has announced plans to dispose of RMB30 billion (US$3.7 billion) of Category IV loans, mostly transferred from BOC, between April and the end of the year 2006
- Huarong intends to dispose of RMB16 billion (US$2 billion) of NPLs in Hebei province in June 2006, its fifth major auction since 2000
- China Construction Bank is finishing up its second settled asset auction (mainly repossessed real estate) totalling RMB1.14 billion (US$142 million)
- Bank of China will reportedly dispose of RMB3.4 billion (US$425 million) of its settled assets ahead of its IPO anticipated for later this year
- Guangdong Development Bank has RMB40 billion (US$5 billion) of NPLs it needs to dispose of as a part of its recapitalisation and sale to foreign investors

Finally, discussions with various AMCs indicate that collectively they are targeting disposals of between RMB100-150 billion (US$12.5-18.7 billion) in NPLs by the end of the year. While they cannot possibly unload such a large quantity in the next nine months, most foreign investors will certainly hope they give it a good try.

India

Increased activity, investor interest…amidst slow liberalisation

Since our last issue of NPL Asia, which referred to the NPL market as coming alive in India, we have seen the largest NPL auction in the Indian market to date – the successful close of ICICI Bank's NPL auction involving over 300 accounts, aggregating US$330 million. Standard Chartered Bank became the successful bidder in this transaction. JP Morgan was the highest bidder in HSBC's NPL auction (29 accounts with suit filed amounts aggregating US$80 million), another advisor-led NPL auction. Seeing the enthusiastic response of NPL investors, which culminated in the successful close of the first round of NPL auctions, other Indian banks joined the NPL auction bandwagon, with a target to complete them by March 2006. The State Bank of India, India's largest commercial bank, and its associate banks have been the most prolific, though generally in small tranches. Market estimates suggest that the US$1 billion threshold has been crossed in the Indian NPL market.

NPL investments by foreign investors

July 2005 guidelines by the Reserve Bank of India (RBI), permitting banks to sell their NPLs to other financial entities (banks, financial institutions and non-banking financial companies) operating in India, eased the way for banks to conduct these NPL auctions. While the transfer of NPLs to asset reconstruction companies (ARCs) was permitted under RBI guidelines issued in April 2003, the July 2005 guidelines:

- Increased the number of potential NPLs buyers (a number of foreign banks with NPL operations and a banking licence in India have since participated in the NPL auctions)
- Clarified regulatory concerns on NPL transfer among banks and financial institutions and set out the terms under which these transfers may be made

These guidelines and the resulting availability of competing investors willing to make upfront cash payments for NPL portfolio acquisitions have enabled banks to conduct their NPL auctions fairly and transparently. Since issuing the July 2005 guidelines, the Government has also clarified the long pending policy direction on foreign investment in ARCs and Security Receipts (SRs). The Government now permits foreign investors to:

- Acquire up to a 49% equity stake in an ARC under foreign direct investment route with approval by the Foreign Investment Promotion Board (FIPB)
- Invest in each tranche of security receipts issued under a scheme (set up by an ARC) collectively up to 49% and individually up to 10% under the Foreign Institutional Investor (FII) route

Allowing foreign investors to invest 49% in each tranche of security receipt scheme of ARCs is less than desirable as this would still require matching "domestic" funding, which is limited in India. Further, the proposed restriction on individual FII investment to 10% in each tranche of SR schemes of ARCs, requires these foreign investors to collaborate with multiple co-minded partners to invest in the Indian NPL market. However, this clarity on foreign investment in ARCs and SRs is expected to help accelerate market development by widening the list of eligible NPL investors.

We understand that these regulatory developments and the increased activity level in the Indian NPL market have prompted many foreign investors to initiate steps to set up appropriate investment structures. Already, Standard Chartered Bank and Actis have received FIPB approval to invest in equity of an ARC.

RBI has also granted two new ARC licences, increasing the number of registered ARCs to five, and is processing other ARC applications. Hopefully, more foreign investors will be able to work out appropriate investment structures and participate in the Indian NPL market.

With impending implementation of Basel II norms from March 2007, increased emphasis on banks' asset quality, increasing demand for bank credit and consequently, increasing capital requirements, we expect to see many more NPL auctions in the next year. Dena Bank, a public sector bank, has recently appointed PwC to assist it in carrying out its NPL auction. Further, given the enthusiastic response to these auctions, Asset Reconstruction Company (India) Limited (ARCIL), may approach the market to help originating lenders to monetise security receipts received from ARCIL when they transfer their NPLs to ARCIL against security receipts.

In addition to the NPL auctions, significant activity is also taking place in the single credit market. In a recent transaction, GECAPs extended a take-out facility of US$125 million to Sanghi Industries. While ADM Capital, Citigroup, JP Morgan Chase and Actis have been active in the Indian market for some time now, recent market buzz has carried the names of many new distressed debt investors including WL Ross, Spinnaker, Cargill, Avenue and JC Flower.

PwC's experience in NPLs in India

Client	OPB (US$ milllion)	Role
ICICI Bank	20	Financial advisor to seller
ICICI Bank	80	Buy-side advisory and due diligence
A Private Indian Bank	20	Buy-side advisory and due diligence
A Private Indian Bank	70	Buy-side advisory and due diligence
ICICI Bank	330	Financial advisor to seller
HSBC	80	Buy-side advisory and due diligence
SBI (Multiple tranches)	130	Buy-side advisory and due diligence
State Bank of Hyderabad	100	Buy-side advisory and due diligence
SBI (Multiple cities)	145	Buy-side advisory and due diligence
Punjab & Sind Bank	22	Buy-side advisory and due diligence

Philippines

The bill extending the grant of fiscal perks to special purpose vehicles that purchase banks' non-performing assets has finally been approved both by the Senate and the House of Representatives. The amendatory bill is now pending before the Office of the President and is expected to be enacted into law in April 2006.

In its report dated 14 March 2006, the Conference Committee approved the consolidation of House Bill No. 4066 and Senate Bill No. 2204, effectively amending Republic Act No. 9182 otherwise known as the Special Purpose Vehicle Act of 2002.

	R.A. 9182 or The SPV Law of 2002	Amendatory Law
Filing of applications for the establishment and registration of an SPV	Sec. 6. Applications for the establishment and registration of an SPV shall be filed with the Commission not beyond eighteen (18) months from the date of approval of the Implementing Rules and Regulations (IRR) by the Congressional Oversight Committee (COC) created in Section 23 Hereof.	Sec. 1. Section 6 of R. A. 9182 is hereby amended to read as follows: Applications for the establishment and registration of an SPV shall be filed with the Commission within 18 months from the date of effectivity of this amendatory law.
Fiscal incentives to the sale or transfer of NPAs from banks to SPVs, or transfers by way of dacion in payment by borrowers or third parties to financial institutions	Sec. 15. All sales or transfers of NPAs from the FIs to an SPV or transfers by way of dation in payment (dacion en pago) by the borrower or by a third party to the FI shall be entitled to the privileges enumerated herein for a period of not more than two (2) years from the date of effectivity of the IRR: Provided, That transfers from an SPV to a third party of NPAs acquired by the SPV within such two-year period or transfers by way of dation in payment (dacion en pago) by a borrower to the SPV shall enjoy the privileges enumerated herein for a period of not more than five (5) years from the date of acquisition by the SPV: Provided, further, That properties acquired by an SPV from GFIs or GOCCs which are devoted to socialized or low-cost housing shall not be converted to other uses.	Sec. 2. Section 15 of the same act is hereby amended to read as follows: Same provisions except that reckoning date shall not be more than two (2) years from the date of effectivity of the "amendatory act".

Under the bill, "applications for the establishment and registration of an SPV" to be filed with the Securities and Exchange Commission were extended from 19 September 2004 to 18 months from the date the amendatory law came into effect. The deadline for getting exemptions from documentary stamp tax, capital gains tax, creditable withholding income tax and value-added tax, and reduced transfer fees and other incentives, was extended by two years after the date the amendatory law came into effect.

Congress passed the SPV law in 2002 to encourage the disposal of an estimated Php500 billion (US$9.7 billion) of the banking system's bad loans and foreclosed assets. The law exempts buyers and sellers of banks' non-performing assets from paying documentary stamp tax, capital gains tax and the expanded value-added tax on these transactions.

According to the Bangko Sentral ng Pilipinas, banks were able to dispose of a total of Php96.7 billion (US$1.9 billion) through SPVs by the end of 2005. Of the total transfers under the SPV law, 91% involved NPLs and only 9% (Php8.6 billion /US$165 million) were real and other properties owned or acquired (ROPOAs).

Since the passage of the SPV law, which expired in April 2005, the central bank has already granted 46 financial institutions – 44 banks and two non-bank – a total of 339 certificates of eligibility.

As of end-November 2005, the bad loans ratio of the country's universal and commercial banks stood at 8.45%. The ratio is seen to go down further to 7.5% after extension of the grant of fiscal perks to special purpose vehicles that purchase banks' idle assets.

NPA sale transactions in December 2005 and first quarter 2006

Although the SPV law expired in April 2005, a number of financial institutions still went to market.

Capping 2005 was Metrobank's auction of approximately Php6.8 billion (US$130 million) worth of NPLs. The auction also attracted big financial firms, and was won by Hypo-und Vereins Bank's Singapore branch.

The beginning of 2006 saw Asia Recovery Corporation's (ARC's) sale of its idle assets to a German bank. The idle assets of about Php13.2 billion (US$253 million) were acquired from parent firm Metropolitan Bank and Trust (Metrobank) in 2003. Hypo-und Vereins Bank won the auction.

Bank of the Philippine Islands (BPI) also sold about Php8.7 billion (US$167 million) of non-performing assets this year to Avenue Asia.

Security Bank and Trust (SBTC) also held a limited auction sale of NPLs worth approximately Php1.2 billion (US$23 million). The limited auction was held last March and was won by ADM.

Busy year ahead

Banks and other financial institutions are expected to take advantage of the amendatory SPV law either through auctions or negotiated sales.

Banks are no longer reluctant to sell their NPAs according to the SPV law because they are now more familiar with its provisions. On the other hand, investors are now keen on acquiring the banks' assets being disposed of through the SPV law.

For 2006, Metrobank is again poised to auction about Php10 billion (US$192 million) of idle assets in the second quarter. Ayala-led Bank of the Philippine Islands is also planning to sell approximately Php10.0 billion (US$192 million) worth of NPAs.

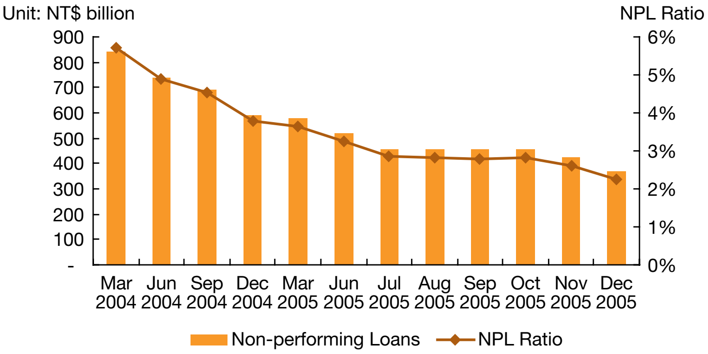
The Development Bank of the Philippines is expected to auction approximately Php13 billion (US$250 million) worth of NPAs while fellow state-run Land Bank of the Philippines is said to be keen on disposing of bad assets through SPV.

(Sources: BAP 2005 4Q Banking Report, Business World)

Taiwan

More transparency in NPL figures

The new regulation of broadly defined NPLs has been implemented to be in line with the international standards since July 2005, in accordance with the stipulations of the Financial Supervisory Commission. The new ratio has incorporated "Loans Under Surveillance"(Note 1) and after the recalculation, we can see a more accurate outlook for Taiwanese banks' NPL ratio (see below). Since most banks have disposed of major NPLs and gradually improved their risk management policies to comply with Basel II, we expect to see a relatively low NPL ratio in the first half of 2006 compared to the ratios in 2004 and 2005.



Note 1. Loans under surveillance include: (1) Medium or long-term installment loans overdue for more than three months but less than six months; (2) Other loans whose principal is overdue for less than three months, but with interests repayment overdue for more than three months and less than six months; (3) Loans whose overdue period reaches NPL standards but need not be classified as NPL (including restructured loans meeting specified performing standards, loans with approved compensation from the Credit Guarantee Funds, loans with sufficient time deposits or demand deposits for repayment, and other specified loans granted exemption from being reported as NPLs).

Under the current Government policy, it is difficult for a bank with a high NPL ratio to apply for new business or set up new branches. Therefore, most banks have pushed down their NPL ratios through sales of NPLs or have written-off a huge amount in order to stand in a more competitive position. As a result, a new record low NPL amount (NT$371 billion / US$11.5 billion) and ratio (2.24%) in the whole domestic banking system for the previous three years was seen in December 2005. Notwithstanding the upside figures, Taitung Business Bank, Enterprise Bank of Hualien, Chinfon Bank, Bowa Commercial Bank and the Chinese Bank still have higher NPL ratios, at over 5%. In addition, Land Bank of Taiwan, Taiwan Cooperative Bank and Farmers' Bank stood in the top three of highest NPL amounts in December 2005.

Consumers credit crunch

The credit card and consumer lending business has been the principal revenue and profits driver of many banks in Taiwan in recent years. Consumer lending has represented over 50% in several banks' loan book value. However, as too many banks competed to offer cards and loans to a limited number of people in Taiwan, bank officers started to loosen their credit policy to grab more business. In the end, people just got credit too easily from the banks. Many people's borrowing and consumption far exceeded what they could afford. The credit crunch problem broke out among banks in early 2005. In total, 31 cash-card issuing banks wrote off NT$22.7 billion (US$700 million) in cash-card loans from their books in 2005. The 50 credit-card issuers also wrote off NT$48.2 billion (US$1.5 billion) in credit-card receivables in 2005.

As of February 2006, there was approximately 400,000 individuals defaulting on their card related debts to banks in Taiwan. To help those individuals, the Government has promoted several schemes in which they can reschedule payment terms with the bank. Meanwhile, several banks have temperately stalled their consumer lending business and shifted their focus back to corporate lending. It appears that the consumer credit crunch in the banking system has been gradually controlled.

Currently, banks are very conservative in new lending and are very aggressive about managing the sour assets on their loan book. It is anticipated that they can rid themselves of this problem in about 18 months. However, the dilemma is that when all the banks adopt the same strategy of moving away from consumers and toward corporate banking, will the loosened credit policy and corporate credit crunch occur again in future? This reveals the fundamental handicap of the Taiwan banking industry – too many banks in a too small market, and banks which are finding it hard to differentiate themselves in terms of products, services, customers and strategy.

NPL auction market continuing

In order to improve their asset quality, local banks continued to clean up their NPLs in 2005. At least ten public auctions were announced in the market. The loan sale of Taiwan Cooperative Bank was the largest transaction with a face value of NT$44.4 billion (US$1.38 billion) in 2005. However, the average deal size of 2005 has shrunk to below NT$10 billion (US$310 million).

Looking into the first half of 2006, we notice that some banks remain keen on disposing of their NPLs via either public auction or private sale, but it is expected that most deals will still have a limitation on deal size. We also found that among those reported auctions, banks have started to resolve the write-offs and unsecured NPLs to improve the assets quality with a possible gain rather than a loss reflected in the Income Statements. Shin Kong Life Insurance, one of the leading life insurance companies in Taiwan, is currently holding a limited auction of its unsecured and deficiency loans with total debt amount of around NT$3.6 billion (US$112 million).

It is important to note that Land Bank of Taiwan, a Government-owned bank with the third largest total assets in Taiwan, has formally announced that it will dispose of its NPLs worth approximately NT$25.9 billion (US$800 million) via a public auction before the end of May. This transaction is anticipated to be the largest and most remarkable NPL offering in the first half of 2006 and will attract the most interest from market investors.

NPL disposition via public auction in the second half of 2005

Seller	Approx. size in NT$ billion	Approx. size in US$ million	Winning bidder
Enterprise Bank Of Hualien	4.5	140	Pine Street Asset Management
Hua Nan Bills Finance Corporation	7.4	230	Hua Nan Asset Management
Taichung Commercial Bank	3.4	105	Orix Taiwan
Taiwan Cooperative Bank	44.4	1,380	(For Pool 1&3) Cooperative Bank Asset Management (For Pool 2) TAMCO
China United Trust & Investment Corporation	8.0	250	(For Pool 1) Shin Fong Asset Management (For Pool 2) Kuo Yi Asset Management
Total	**67.7**	**2,000**	

Thailand

Bank of Thailand looks to accelerate NPL resolution

The Bank of Thailand (BOT) has recently announced that Bangkok Commercial Asset Management Company (BAM) has been given the mandate [by the BOT] to be the key bidder for problem loans within the Thai Banking Sector. We also note that BAM recently merged with Asset Management Corporation (AMC).

The BOT is hoping that BAM will be a key channel for commercial banks disposing of their remaining distressed assets. The mandate was put in place to encourage banks to meet the BOT target for NPLs to be reduced to 5% by the end of this year and to 2% by the end of 2007.

The general view is that selling the NPLs via large lots will be the most efficient way for banks to reduce the NPLs in a short time. In this regard, BAM is in talks with banks on a discount formula to buy NPLs of varying quality. It is not yet clear though how such a sale would work, i.e. would BAM bid in auctions against third parties, private AMC's and other distressed debt investors, or would they receive exclusivity?

However, despite the mandate, no bank has yet to announce a large sale to BAM. The following banks and institutions have, however, publicly announced an intention to sell in 2006:

- KTB, which has stated that it plans to sell eight to nine billion baht (US$200 to 225 million) worth of NPLs to foreign investors during 2006
- The Government Savings Bank, which intends to dispose of a large portfolio of mortgage loans
- The Thai Asset Management Company (TAMC) which has also announced plans to sell the NPLs and repossessed assets that it has acquired from banks, with an initial focus on repossessed assets

Furthermore, the Financial Institutions Development Fund ("FIDF") is selling its stake in listed and non-listed companies through a series of auctions throughout 2006 (the first auction was to conclude at the time of going to press), FIDF's assets were mostly derived from the now-defunct 56 finance firms that failed in the financial crisis in the late 1990s. FIDF also plans to divest its holdings in financial institutions, which include 56.4% of KTB, 47.58% of SCIB and 48.98% of BankThai.

Some of the recent known transactions:

- Siam Commercial Bank has sold Bt2.5 billion (approximately US$62.5 million) worth of non-performing loans via an auction to two companies: Standard Bank (Asia) which bought Bt2.05 billion (US$50 million) of NPLs and PMA Credit Opportunities, which purchased Bt450 million (US$ 11.25 million) of NPLs.
- BankThai Public (Bank) sold an unknown number of NPLs to Sathon Asset Management, Sukhumvit Asset Management, Bangkok Commercial Asset Management and Tawee Asset Management. We understand total proceeds were approximately Bt7.5 billion (US$187.5 million) received in January 2006.
- In 2005, the TAMC sold approximately seven billion baht (US$175 million) worth of distressed assets.

The main issue facing investors is whether NPLs will be sold at realistic market prices to third parties or whether they will be transferred to private or state owned AMCs. However, the recent political situation in Thailand is not expected to prevent banks from going to market.

According to the BOT, NPLs in Financial Institutions totalled Bt478 billion (US$12 billion) as at February 2006.

Korea

Corporate loans

By the end of 2005, the NPL ratio in Korean corporate loan sector had been further reduced to 1.22%, declining by 0.68% from 2004. Due to the continued sale and disposal of NPLs, the corporate loan sector achieved the lowest NPL ratio since 1999.

As most banks disposed of NPLs by issuing Asset Backed Security (ABS), rather than by directly selling them, there were no significant corporate NPLs disposed in the market during the second half of 2005.

Consumer loans

Since the financial crisis of the credit card companies starting in 2002, the NPL ratio in the consumer loan sector has been steadily improving as a result of credit card companies' continued efforts to reduce it. At the end of 2005, the NPL ratio of household loans was 0.98% and that of credit card receivables 2.4%. This was a decrease of 0.62% for household loans and 2.73% for credit card receivables compared to the previous year.

Similar to the corporate loan market situation, consumer NPL disposals were hard to find in the market due to the decreasing rate of delinquency and the shift of the NPL disposal trend from direct selling to transferring to an Asset Management Corporation (AMC) or an issuing ABS.

Whereas foreign investors are relatively less interested in acquiring NPLs on account of past failures to realise their expected return, local mutual savings banks have expressed their continued interest in investing in NPLs. However, as the financial capacity of most local mutual savings banks is limited, there are only a few investors capable of participating in a deal which involves a large amount of Outstanding Principal Balance (OPB). Consequently, the sale of Samsung Card's credit card receivables was successfully completed in a private deal with PwC acting as the financial advisor.

Korean NPL sales completed since 4Q 2005

Seller	Date	Deal size (Unit: US$ mil)	Buyer	Asset type	PwC's role
Samsung Card	Dec 2005	1,685	Domestic	Credit Card	Financial Advisor
Total		**1,685**			

Japan

The economic recovery continues

Following a prolonged period of stagnation, the prospects for a sustained Japanese economic recovery appear to be the best they have been since the stock market and real estate bubbles burst in the early 1990s.

NPLs on the whole continue to decrease

According to Fitch Ratings, NPLs at Japanese banks, net of all loan-loss reserves, now stand at 1.2% of total loans extended or 15% of balance-sheet equity, compared to 6.2% and 95% respectively reported in 2002.

The total amount of NPLs of all banks as of 30 September 2005 was ¥16 trillion (US$135 billion). The figure has decreased by ¥2 trillion (US$17 billion) from ¥18 trillion (US$150 billion) from 31 March 2005. This improvement appears to be a result of the improved soundness of bank loans, owing to the improvement in some borrowers' business conditions and the progress of corporate revitalisation.

Megabanks show signs of revival

The NPL problems of Japan's three megabanks appear to be subsiding. Mitsubishi UFJ Financial Group (MUFG), Mizuho Financial Group and Sumitomo Mitsui Financial Group recorded good gains in the first half of fiscal year 2005 through to 30 September 2005, after writing-off many of their NPLs.

MUFG, Japan's largest banking group in terms of total assets (formed through the October 2005 merger of Mitsubishi Tokyo Financial Group and UFJ Holdings), posted a ¥712 billion (US$6 billion) net profit for the first half of fiscal 2005. The major factor behind the group's performance was the large return from loan-loss reserves for NPLs. Its main banking units, Bank of Tokyo-Mitsubishi and UFJ Bank, combined on 1 January 2006.

In the past, Japan's megabanks spent most of their time and resources in cleaning-up their balance sheets through writing-off NPLs. Recently, however, the megabanks have disposed of most of their NPLs and there appears to be limited scope for any major NPL disposals in the coming years.

NPLs of regional banks remain relatively high

NPLs of regional banks are around double that of the "city banks" (the largest banks headquartered in Tokyo).

Compared to the city banks, less progress has been achieved in restructuring them. Government policies towards regional banks are driven, in part, by concerns about small and medium-sized enterprises' financing. These policies have contributed to a rising trend in regional bank lending, although this is due in part to their loans for housing, which are replacing declining public lending. Accordingly, time will tell if there will be either major disposals of NPLs from regional banks or the restructuring / consolidation of these institutions.

Going forward

Following the Government's intervention and the increased regulation of Japan's banks, the NPL problem in Japan has greatly diminished. With a lower number of NPLs, Japanese banks have started lending again, with Japan's loan balance up 1.3% in December 2005 compared to 2004, the fifth straight monthly increase and the largest gain since the data became publicly available in 1998. Morgan Stanley estimates that interest rates in Japan may rise to 0.25% by the end of 2006, further stimulating the Banking sector. This increase in lending may result in future NPLs, in particular at the regional banks, unless Japanese banks have learnt their lesson and improved their loan origination and monitoring practices.

Malaysia

A fresh supply of NPLs in Asia?

To date, NPL sales in Malaysia have been principally represented by the two massive carve-outs from local banking institutions to Danaharta[1], the national asset management company, between 1999 and 2000. Danaharta in turn sold, by way of limited tenders, most of the non-ringgit denominated loans it acquired. Throw in the sporadic sales of non-ringgit denominated loans by offshore institutions with establishments in Labuan, and almost the entire history of NPL sales in this country is summarised.

However, this situation may be set to change in the very near future. On 28 December 2005, Bank Negara Malaysia (BNM) issued "Guidelines for the sale of NPLs by Banking Institutions". The event was sudden but anticipated as a number of parties, including PricewaterhouseCoopers (PwC), had approached BNM over the past three years to discuss the benefits of NPL sales. Though receptive to the idea, the central bank had not provided any written directions prior to these guidelines.

BNM stated that the guidelines are intended to make available to banking institutions an additional option for problem loan resolution. Interestingly, the guidelines were issued just as Danaharta was closing its doors after seven and a half years of operation. Danaharta's residual recovery assets of almost RM3 billion (US$0.8 billion) have been managed by Prokhas since 1 January 2006. Prokhas is a wholly owned subsidiary of the Ministry of Finance, tasked with collecting Danaharta's recovery assets.

Gross NPL levels in the banking system have been falling post Danaharta carve-outs, from a high of RM61.9 billion (US$16.7 billion) in 2001 to RM45.2 billion (US$12.2 billion) as at December 2005 (six-month classification). The net NPL ratio dropped from 8.1% in 2001 to 4.6% at the end of 2005. There is room for improvement, especially with the emphasis on risk management in relation to the Basel II capital adequacy standards, target for compliance in 2008. Perhaps in line with this, the guidelines repeatedly emphasise the need for the boards of directors of NPL sellers to consider risk.

Some other salient points of the guidelines include:

- Outright sale is allowed to either eligible third parties or to special purpose vehicles (SPVs) within the seller bank group. Eligible third parties include domestic banking institutions, other domestic investors and foreign investors. However, foreign investors and non-banking domestic investors must form SPVs to buy the NPLs
- The SPVs must be locally-incorporated and tax resident
- Equity participation by foreign investors is permissible in both types of SPV, but maximum participation is 49%
- Sales to third parties must be on a without recourse basis, whilst sales to same-group SPVs can be either with or without recourse
- NPLs that can be sold include corporate, SME and personal loans
- Losses arising from sales cannot be amortised
- Approvals are needed from BNM and the minister of finance pursuant to specific sections of the Banking and Financial Institutions Act 1989 and other existing regulations
- Seller institutions can act as service agents post sale, subject to arrangement with buyers.
- If the buyer is another Malaysian banking institution, purchased NPLs may be classified as performing for the first six months after purchase

The guidelines do not provide any other form of incentives, which are common in many countries embarking on NPL sales, for instance tax exemption for stamp duty and other transaction costs. Perhaps the central bank believes that no extra encouragement is needed because 'fire sales' should not happen since the country is no longer under threat of systemic crisis.

The lack of extra concessions does not seem to deter international investors' interest. Many enquiries have been received from investment institutions since the beginning of January 2006, with some preferring to court the potential sellers directly. There is even a reported handful of those who had begun talks with potential sellers before the guidelines were issued.

On the sell-side, we have observed that banking institutions are not rushing to sell, in spite of a growing queue of suitors. The reasons for this are varied. The pessimistic and by far the most common view is that the seller's bottom line would be hurt by disappointingly low offer prices, since investors invariably aim for high returns. Optimists, on the other hand, feel that this would

[1] *Danaharta in this article refers collectively to the three legal entities set up to acquire and manage the NPLs between 1998 and 2005.*

not be necessarily so, given Malaysia's relatively well structured legal framework and the significant provision buffer banks have built up in the last seven years. Then again, some banks have just begun to seriously consider this NPL resolution option.

PwC strongly believes that some NPL transactions will take place within 2006. The first transaction to take off is expected to start a catalytic chain of sell-offs as is usual in the emerging markets. Even if only half of the banking system's NPLs are put on sale, this should be an interesting market to watch in the coming months.

Our NPL related services

Throughout Asia, PwC has partners and staff experienced in delivering a complete range of NPL related services, including:

Sell-side services

We act as the lead financial adviser in relation to all facets of NPL sales, including complete management of the disposal process:

- Preparation for sale: Portfolio review, classification and stratification; Pooling and packaging sub-portfolios to maximise their potential value; Advising on appropriate form of investor review files; Advising on appropriate marketing and disposal strategies; Preparing confidential information memoranda; Co-ordinating and managing of third party service providers such as lawyers and Asset Appraisers.
- Investor sourcing: Identifying potential investors for bilateral deals or public tenders; Targeting specialist investors for specific sub-portfolios/tranches.
- Execution/completion of sale: Managing the entire portfolio sales process; Transaction structuring; Designing appropriate bidding/sales procedures; Overseeing investor contact, including investor invitation and investor qualification; Evaluating investment proposals; Negotiating detailed terms; Co-ordinating the involvement of legal and other advisers.

Buy-side services

We offer complete advisory services tailored to meet investor requirements:

- Due diligence and negotiation support: portfolio review and valuation.
- Advising on appropriate deal structures for proposed negotiated transactions.
- Advising on accounting/tax implications of proposed structures.
- Advising on the nuances of the government approval process (if applicable).
- Assisting in the deal completion process, including assistance in securing requisite government approvals.
- Identifying potential portfolio investment opportunities.

Post-deal services

- Portfolio Management: Portfolio strategy advice and implementation; Managing the loan collection process; Advising on loan servicing set-up issues; Advising on issues that impact the collection process.

Dedicated Website

For more regular updates on NPL activity in Asia or Europe, or for past editions of **NPL Asia**, please visit our website:

www.pwc.com/loansales

Our Contacts

Across Asia, we have experienced partners and directors that can assist you with your NPL related needs in any of the following territories. In addition, PwC has a dedicated international NPL advisory group that can act as an overall co-ordinator for worldwide NPL mandates and opportunity identification. Through this group, both buyers and sellers of NPLs can receive consistent, seamless service across the world, integrated with territory specific knowledge and expertise:

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