Taming the Asian Tiger: 
Revival of Non-Performing Assets on the Asian Continent

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It seems that following its financial crisis of late 1997 and early 1998, modern Asian society temporarily forgot the immortal wisdom of its great philosopher, Confucius (551-479 B.C.) who proclaimed, “Be honest, honor your ancestors, and respect your superiors.” He might have as well added, “and pay your debts.” The following is an analytical assessment of the non-performing asset problem facing the Asian economies post-crisis using the roadmap of Western financial doctrines and resulting from my observations on the continent in 1998 and 2004.

The burden of non-performing assets has affected many economies at one point or another in the history of their economic development. The Asian financial crisis created a large number of financially distressed companies, particularly in South Korea, Thailand, Indonesia, Malaysia, and the Philippines, which to this day continue to weigh down the continent’s economies. In post-crisis years, numerous events in specific countries and industry sectors created an additional steady supply of troubled situations.

Japan deserves a separate mention in this article, as its economy has been dealing with its own problem of non-performing loans (“NPLs”) crippling the banking sector for nearly the past two decades. In addition to dealing with domestic bad loans, the Japanese banks became saddled with loans they made to Southeast Asian companies. Given its own persistent economic problems, instead of defusing the effects of the Asian crisis, Japan was forced to take a defensive approach to maintain confidence in its own financial system. And China, which by itself tore down its Wall to become a major force on the world economic arena and despite its government’s protectionist regime, has for the first time in its history had to admit and find a solution to its non-performing loan problem.

The countries in the Asian region have the advantage of examining the evolution of the restructuring and bankruptcy systems in the Western world, and identifying which measures worked more effectively. Their challenge is to then apply the findings in their respective countries, taking into account the individuality of each country’s economic system, political intricacies, and cultural differences. China now has the advantage of analyzing how other Asian countries dealt and continue to deal with the issue and set its own strategy which, if history is any precedent, they will undoubtedly do in their own unique way. This article examines the scope of Asia’s NPL problem, the landscape of market participants, and how the restructuring effort is evolving in different regions.

ASSESSMENT OF THE ASIAN NPL MARKET AND ITS OPPORTUNITY

The best way to grasp the scope of the Asian NPL market is to break it down by country or region, as each of them is in a dif-
different stage of its restructuring process. Economic development, political systems, cultural and social norms, and other factors play a major role in shaping the components of the restructuring effort in each individual country, as well as the balance of power among the parties involved at all levels.

Japan

Japan has been one of the region’s sickest patients. The prolonged economic recession in that country put a lot of strain on the corporate sector. Due to its complex inter-company ownership and financial structures, lending standards have often been less than prudent. Its well-developed legal system, however, is relatively effective at facilitating collateral repossession as well as the repayment work-out process. Like most reforms in Japan, the balance sheet clean-up was initially delayed by a number of years. Foreign investors stood ready to participate in NPL purchases as early as 1993, whereas the Japanese government did not start putting pressure on the banks to dispose of bad assets until 1997. At that point, the problem escalated to a level where the banks had to sell the loans or go bankrupt. They chose to sell, and foreign investors bought with tremendous ferocity.

In the following years, particularly in 1998 and 1999, the banks embarked on a balance sheet clean-up of unprecedented magnitude, selling an estimated $600 billion worth of paper. Patience finally paid off for foreign investors, primarily investment banks and private equity
and hedge funds focusing on distressed securities, who were able to acquire assets at significant discounts to their face value. In one of the transactions, Goldman Sachs and Lone Star, a U.S. private equity fund, ended up becoming the biggest owners of golf properties in Japan. Deals completed during those years produced handsome returns for investors who had the patience and optimism to establish the infrastructure in Japan, and wait for several years for the government to pull the trigger on sales.

At present, an estimated $330 billion of non-performing assets remain in Japan (see Exhibit). However, as the country’s economy is beginning to recover, local players have also shown interest in this space. Competition for deals has intensified, which only means one thing for returns—they have been falling. However, barriers to entry in this market are high—many auctions are invitation-only and it takes years of building relationships to get on the auction invitation list of Japanese financial institutions. Judging by the substantial remaining supply of loans and the still relatively limited competition, compared to the more developed markets, the opportunity cannot be over yet, and skillful investors who know how to shift strategy in the face of changing market winds can continue to deliver returns.

**Southeast Asia**

Since the 1997-1998 crisis, Thailand, Indonesia, Taiwan, and Malaysia have made a lot of progress addressing the problem. Many situations in these countries have been successfully restructured, the liquidity in the financial markets has greatly improved, and the economies have recovered to pre-crisis levels, thereby reducing the amount of available NPLs. Progress varies by country. Indonesia has made a considerable push over the past five years. Its central bank, Bank Indonesia, estimates that at December 31, 2003, the Indonesian banks’ total NPL ratio was 8.2%, which further fell to 7.8% by the end of March 2004. It should be noted that this compares with a staggering ratio of 32.8% in 1999. As a frame of reference, most Western banks aim to keep their NPL-to-total-assets ratios below 5%.

South Korea still has another $60 billion of loans to clean up, even as the amount has been reduced from $145 billion in 1999. In Korea, one in every ten consumers was in default on a credit card or personal loan. It is no surprise that a large portion of NPL sellers have been credit card companies, forced to clean up their balance sheets to meet the government’s mandated non-performing loan requirement of 10%. According to PricewaterhouseCoopers, approximately $7.0 billion of non-performing credit card and personal loans were sold in 2003 alone, with Lone Star emerging as the largest buyer, accumulating $2.7 billion of that amount.

Overall, the Southeast Asian countries have decreased the amount of their NPLs from over $428 billion in 1999 to $151 billion in 2004, nearly a 65% reduction. The progress is significant but the restructuring effort continues.

**China**

As the NPL markets in Southeast Asia and Japan get more mature and returns start to deteriorate, investors turn their eyes to a new land of opportunity, and it is not hard to notice it. It has the largest population in the world, and is the fourth largest trade country in the world. Foreign capital, drawn to the potential of its 1.3 billion consumer base, is increasingly being intrigued by China’s future. For several decades, the country’s financial institutions have been run as part of one enormous state-controlled economic machine. Years of government support of unprofitable and outright dying state-owned enterprises have left the country’s banks saddled with defaulted loans, by most estimates, of $414 billion which represent 40% of all loans outstanding, according to data by Standard & Poor’s.

The issue of NPLs has become one of the biggest threats to China’s economic prosperity and its cautious government has finally come to recognize this fact. As the government attempts to reform the banking sector and sets its sights on overseas public listings for some of its financial institutions, it is faced with the necessity to bring the banks’ capital ratios and reserve requirements in line with international standards. China initiated the process in 1999 by transferring $164 billion of NPLs from the four largest state banks to four asset-management companies (“AMCs”), which received a mandate to dispose of the loans by 2009. This deadline has recently been accelerated, to the delight of eager domestic and foreign buyers. In addition to the AMCs, potential NPL sellers include state-owned commercial banks, domestic private and local banks, some foreign banks, as well as provincial and municipal governments.

The loan disposition process so far has been slow, logistically convoluted and tied up in various bureaucratic government bodies who approve the sales. The non-performing paper consists primarily of senior secured and unsecured loans, denominated in local currency, where debtors are mostly state-owned enterprises. Sales have been conducted via auctions and bilaterally-negotiated transactions to local and, to a lesser extent, foreign buyers.
The latter group consists primarily of U.S. and European investment banks, mostly investing their own proprietary capital, and distressed investment funds with capital from institutional and high-net-worth individual investors.

One of the higher-profile early deals was an action by Huarong, of the AMCs, for over $1.5 billion of NPLs. It was won by a consortium of financial institutions led by Morgan Stanley and Goldman Sachs that also included Lehman Brothers, Salomon Smith Barney, and the International Finance Corporation, according to data by PricewaterhouseCoopers. The transaction took two years to complete, held up by multiple regulatory approval bodies. Although frustrating, market sources say the deal was a home run for the buyers (by some estimates the consortium paid as little as $65 million), most of whom continue to participate in the limited number of auctions that have taken place since.

There are two polar camps among the Chinese NPL market observers—those who believe this is an unprecedented opportunity bound to produce unprecedented returns in exchange for the risk, and those who have lost their patience and packed their bags. Skeptics say that the market is not going to free itself of political and bureaucratic obstacles in the foreseeable future and that NPL sales will not reach the scope of those in Japan in 1998-1999. Optimists agree that obstacles are abundant, but only inefficient markets create opportunities for outsized returns, and they are willing to place bets. Proponents of investing in China say that problems in the early deals were inevitable, given that such a vast market was just taking its first steps in the right direction. Both buyers and sellers have learned a lot in the process, and many issues have been smoothed out. China is working on its new Bankruptcy Law which is expected to go into effect sometime this year. The Chinese government is putting effort into streamlining the process and is reducing the number of regulatory bodies required to approve the sales to probably three government agencies.

**SOURCES OF SUPPLY AND DEMAND FOR NON-PERFORMING LOANS**

Access to the supply of NPLs is one of the key components of success in the Asian markets. Sellers of distressed loans can be classified into the following categories:

- Banks and other financial institutions that originated the loans;
- Asset management companies set up by the governments to acquire the loans from the banks and then dispose of them in the market;
- Local governments that acquired the loans via nationalizations and closings of bankrupt banks; and
- Foreign banks.

Many of these parties are non-economic sellers of loans and have little regard for the intrinsic value or upside potential of the paper. Saddled with tremendous amounts of non-performing assets following the Asian economic collapse, banks were forced to dispose of the paper to improve the strength of their balance sheets and bring them into line with capital guidelines. The motivations of the AMCs and governments are primarily driven by political pressures and the need to facilitate the restructuring process to enhance economic growth.

The demand side of the equation consists primarily of distressed securities funds and investment banks investing mostly their proprietary capital. Multilaterals such as the International Finance Corporation play a role particularly in helping the governments develop strategy and plan for asset dispositions. Experts estimate that total demand for distressed assets in Asia is in the range of $25 billion, most of which has already been invested. It should be noted, however, that the investment banks could be a substantial swing factor, as they have the ability to tap into their balance sheets and allocate substantial pools of capital opportunistically.

In Southeast Asia, where many defaulted enterprises are family-controlled, families often step in to purchase their own non-performing debt for fear of losing control over their holdings. Social differences are also interesting to point out here—the Southeast Asian families are very much focused on preserving their ownership of the enterprise, with little regard to the destiny of the workers or the impact on the community. On the other hand, in China, social issues are a much more important consideration in a restructuring—job preservation and local tax revenues take center stage in the process.

Proactive sourcing of paper is a key component of success in Asian investing, where only the largest issuers enjoy a liquid market. Direct access to the sellers of paper, without relying on brokers, is the way to achieve the most attractive pricing. The investment banks, who in Western markets act more as brokers of securities than purchasers, are competition as buyers for their own account. Clearly, relationships with banks, AMCs, and local governments are what separates those who have done successful deals from those who complain about the illiquidity of the market.
ADAPTING STRATEGY IN THE FACE OF CHANGING MARKET DYNAMICS IS KEY

It is no secret that the ability to quickly adjust to dynamic market conditions is critical in any environment. It is particularly relevant in situations where the availability of supply is non-market driven and political and social considerations take precedence. Asia is such an environment. Single corporate loan purchases based on fundamental credit analysis in late-stage or post-restructuring situations have been an effective way to generate mid-20% returns in the Southeast Asian market. However, the supply of NPLs in that market, consisting of many family-owned companies, continues to shrink following many bank dispositions since 1998 and a favorable economic climate. Within the next 18 months, the remaining supply is likely to be significantly diminished, and returns will not be sufficient on a risk-adjusted basis.

The opportunity in Japan is still abundant, but its nature is changing. Large pools of small loans have historically dominated the distressed loan auction sales by Japanese banks. A handful of players, including Goldman Sachs, Morgan Stanley, Lone Star, and Cerberus Capital, have been the dominant participants in many invitation-only auctions. A typical NPL pool consists of several hundred small business and personal loans, which in the past could be bought for as little as 10 cents on the dollar. The key to making these transactions work is to have a substantial servicing capacity that could consider each credit separately and either negotiate a discounted payoff with the borrower or repossess and sell the underlying asset. It is a very labor-intensive process which can only be effectively completed by hiring and training locals. One successful investor in Japan has a servicing arm employing as many as 75 people.

As the supply of NPL pools in Japan continues to diminish, the opportunity set has shifted towards more private-equity style transactions. They involve buying single large and medium-size corporate loans and converting the debt into equity of the underlying enterprises. That is only the first component of the transaction, and a more challenging part lies ahead. The purchaser needs to get involved with operational and managerial issues of the debtor, and figure out ways to improve performance of the company as a single entity, or break it up in pieces if the sum of parts is worth more. This has to be accomplished in a complex social environment of Japan, with its long-standing traditions and business culture. There are examples of success with this strategy—Ripplewood Holdings’ home run restructuring of Shinsei Bank which is now a public company and Cerberus Capital’s progress with its Aozora Bank, formerly Nippon Credit Bank, which is still private.

It remains to be seen how the Chinese NPL market will unfold, when it finally unfolds—whether via sales of pools of loans or through larger single credit purchases and their restructuring. Prior experience in other Asian countries could certainly serve as a source of wisdom.

EXIT STRATEGIES

A variety of exit strategies could be employed in the Asian NPL markets, and their effectiveness varies from country to country. Let us examine them individually:

**Negotiated Discounted Payoffs.** This strategy has worked effectively in Japan where some of the problems were a result of the banks’ ineffective collection efforts, as opposed to the borrowers’ complete unwillingness to pay. Discounted payoffs have also been the most common method used so far in China.

**Asset Value Strategy.** Repossession of the underlying assets works best in countries with strong legal systems and relative easiness of law enforceability. Japan and South Korea have the strongest bankruptcy systems in Asia. While judgments are obtainable in China and the Philippines, their enforcement is challenging due to many political and social issues. In Indonesia and Thailand, both judgment and enforcement are a challenge.

**Financial Restructurings.** Financial restructurings whereby the debtor and the creditor agree on new terms for interest and principal repayment have been a very common strategy in Indonesia, Thailand, and the Philippines. Investors in China have so far focused on asset values, as opposed to cash flows. The country also lacks mechanisms to ensure that debtors will abide by the restructuring agreement.

**Sales in the Secondary Market.** There is an active secondary market for post-restructuring paper in Southeast Asia and Japan, once the underlying enterprise stabilizes its operations and cash flow. China’s secondary market is in its embryonic stages of development. If the country makes further progress with bankruptcy reform and accelerates sales of NPLs, it is logical to assume that a more active trading market would follow.

**Debt-for-Equity Swaps.** As mentioned earlier in the article, the Southeast Asian families do everything in their power not to give up ownership and control of their companies, making this approach very difficult to implement in those countries. The Japanese model is evolving towards
this resolution and could become an effective way to acquire control of Japanese enterprises. In China, this approach has not yet been tested but I believe it could grow into a method to cheaply acquire control of companies.

A FINAL THOUGHT

Historically, the best returns have been achieved by investors who had the courage to invest during times of major structural market changes as well as external shocks. The Asian crisis of late 1997 and early 1998 created such an environment in Southeast Asian countries, and early investors in those markets are still enjoying rewards. Japan took longer to realize the need for a major banking sector clean-up, and investors who have been patient can now benefit from the oligopolistic nature of that marketplace and its high barriers to entry.

China is the new frontier, with many risks, question marks, and unknowns. In its banking sector restructuring, China has now reached the point where the rest of Asian countries were in 1998. Investment history makes one thing clear—particularly in asset classes with limited supply, pioneers who establish a franchise before a marketplace gains wide acceptance have the greatest potential for reward.

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