

# CAFRAL Policy Note

## NPL resolution: A Lesson from the Korean Experience

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### Executive Summary

This report summarizes the main elements of restructuring of distressed loans in South Korea after the Asian Financial Crisis focusing on the role of the Korean Asset Management Corporation (KAMCO) in alleviating the NPL problem in the aftermath of the crisis. **An important similarity to the current Indian NPL problem was that in the Korean Crisis, about 1% of the borrowers (the Chaebols or Korean Business Groups) accounted for almost 90% of the NPLs.** The key strategies used for successful resolution of non-performing loans were as follows:

1. Harmonization of reporting requirements for NPLs and creation of an online bidding system
2. Creation of a secondary market for distressed loans
3. Payment in kind in some cases for banks for the distressed loans which were given zero capital charge.
4. Funding structure of the NPL Resolution fund
5. Legal framework allowing multiple resolution techniques.
6. Creation of a database for recoveries based on past auction and court recovery results, and formula based recovery payments to minimize valuation disagreements.
7. Allowing multiple approaches including Joint Venture, M&A for larger loans. Time to recovery for larger loans was 10-12 years in several cases.

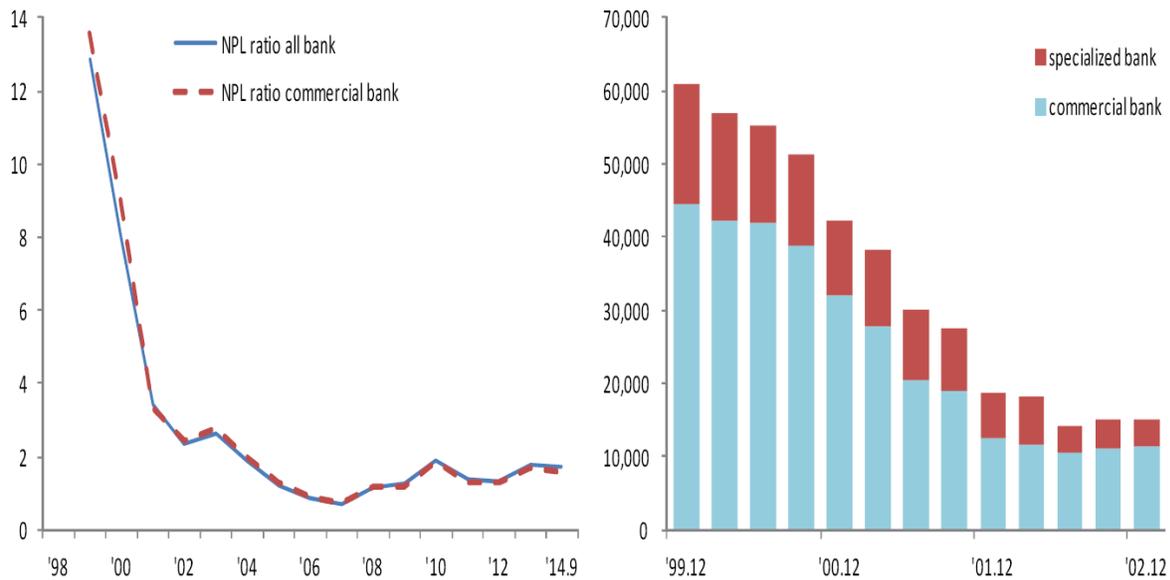
***In the Indian context, we would argue that item 6 – creation of a database of recoveries based on past auctions is an essential pre-requisite for most of the other items. Apart from this, creation of an online bidding system for loans (item 1) as well as creation of a secondary market for distressed loans (item 2) are also feasible in the current Indian context.***

Funding for the NPL Resolution fund appears unlikely given the public pronouncements in this regard by the Central Government, and the legal changes that have already been implemented in light of the recent banking ordinance passed by the Government of India.

## Background: Korean NPL Cleanup

1. In 1997, the effects of the South Asian financial crisis resulted in a NPA crisis in the Korean banking sector. This was prompted in part by external factors such as currency movements and the refusal of international creditors to rollover loans to Korean institutions, as well as by internal factors such as weak prudential supervision, and the concentration of risk in banks due to chaebols' (Korean conglomerates) dependence on them.

FIGURE 1



Source: Financial Supervisory Services

As of 1998, total NPLs in the Korean banking sector amounted to 17.7% of total loans. However, an effective cleanup strategy steadily reduced NPLs to 12.7% in 1999, 8.1% in 2000, 3.4% in 2001, and 2.5% in 2002. The main drivers of this cleanup were the Korean Asset Management Company (KAMCO) and the NPA Fund, with the mandate to purchase NPAs in the window of 1998-2002. Under this provision, 50% of the NPLs were to be dealt directly by banks via collateral sales and calling in loans, and 50% would be purchased by KAMCO.

KAMCO selectively purchased loans that fulfilled the following criteria:

1. Saleable, whose security rights and transfer are legally executable
2. Critical to the rehabilitation of the bank from a public policy perspective
3. Loans with multiple creditors

To facilitate quick disposal of the NPLs, KAMCO undertook the following actions.

**1. *Online NPL Auction Platform & Harmonized Reporting standards***

Prior to 1998, recordkeeping of NPAs and IT standards across institutions were ad-hoc. KAMCO reclassified all NPAs from scratch manually and created an NPA information system. Although this delayed the resolution process, it provided a unified reporting system which greatly aided creation of an online bidding system.

To meet this need, KAMCO created both an internal system for NPA reporting, i.e. banks reporting to KAMCO, and an external Onbid system, i.e. information transmitted from KAMCO to investors, that allowed for online auctions of NPAs. The harmonized information system and manual vetting reduced information asymmetry, while the Onbid auction system encouraged private primary and secondary market participation while reducing corruption.

**2. *Establishment of a Secondary Market for NPLs***

An important feature of the NPA resolution strategy was the establishment of an active secondary market for NPAs. The secondary market increased not only price transparency, but also investor interest due to increased liquidity.

KAMCO played a key market making and marketing role. It conducted 150 roadshows to investors directly worldwide in 1999 alone. KAMCO conducted both domestic and international road shows and was successful in bringing foreign investors to the domestic NPA market. This increased credibility and local investors started investing in NPAs as well. At present, the NPA market in South Korea is mature enough for banks to directly sell to investors, bypassing KAMCO. The NPL sales market accounted for 28% of all NPLs resolved in 2012, up from 7% in 2007.

**3. *Payment-in-Kind Bonds and Risk-Weighting***

While purchasing NPAs from banks, KAMCO paid the banks using Payment in Kind (PIK) bonds issued by the NPA fund and by reusing recovered funds from NPA sales.

Critically, these NPA bonds were underwritten by the state, were tradeable, and listed on the exchange. The government guarantee meant that banks could assign a zero risk weight to these bonds, reducing bank capital requirements – a key concern for equity strapped banks. The government guarantee also reduced the cost of capital for KAMCO.

**4. *Legal Framework***

Legally, the NPA Fund was a separate entity and KAMCO was the public NBFC. KAMCO's major shareholding was the Ministry of Finance and Economy (43%) and the Korea Development Bank (29%) – a government owned bank. Laws were passed to enable securitization, debt for equity swaps/debt in possession, consolidated bankruptcy etc. An independent public fund oversight committee was established to aid in the monitoring and decision making of public funds was created.

## Evolution of Valuation and Structuring Mechanisms

KAMCO had a fluid pricing formula for NPLs in the early stages of their operation, i.e. 1997-98, and final settlement prices were subject to negotiation. These ex-post negotiations were lengthy and contentious and were based on actual sales. Since 1999, NPA prices offered by KAMCO to banks were fixed and were based on a model which took the PV of projected cash flows. The bank could accept or reject the offer and there was some room for negotiation, but not much.

While banks took a hit by marking down the loans, the government also worked to recapitalize and/or nationalize private banks, and pay depositors of closed institutions.

The following shows the haircuts by various types of loans for KMACO restructured loans. KAMCO purchases could be divided into four categories: (i) “Ordinary loans” of companies with ongoing operations, (ii) “Restructured loans” of companies undergoing or having undergone a court receivership, (iii) “Daewoo loans”, which were dealt with independently as the Daewoo Group’s was a large bankruptcy, and (iv) “Work-out loans” of companies in the out-of-court work-out programs.

As the cleanup process progressed and economic conditions improved, the focus gradually shifted from speed of disposal to recovery maximization.

### NPL Haircuts by Type of Loan [Oct. 31, 2002, unit: US\$ bn]

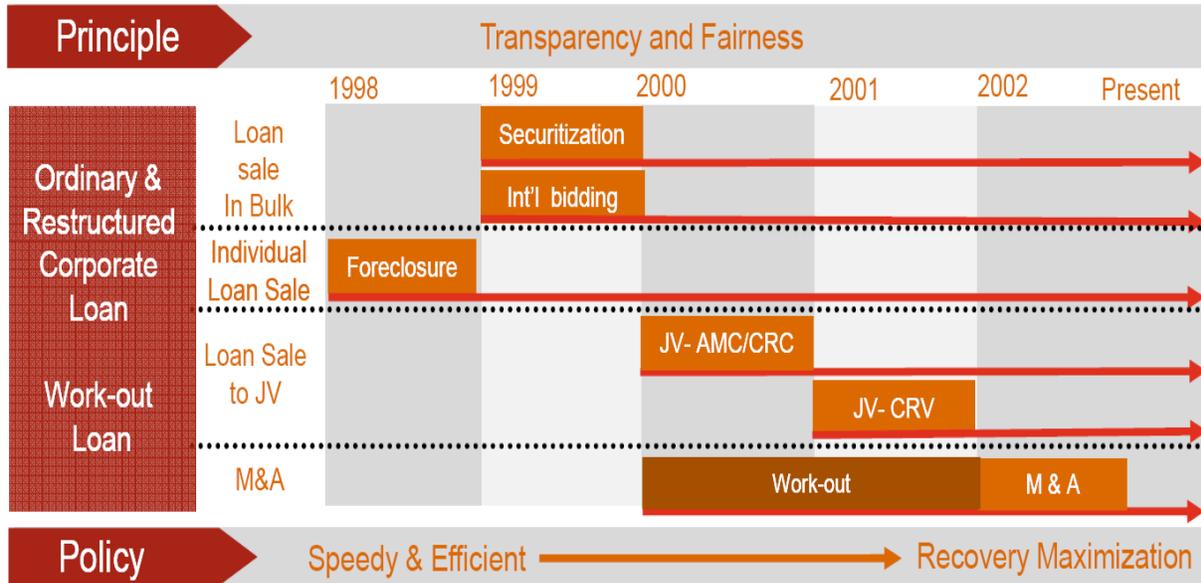
| Classification           | Face value<br>(A) | Purchase Price<br>(B) | Ratio<br>(B/A) |
|--------------------------|-------------------|-----------------------|----------------|
| Ordinary Loans           | 24.13             | 7.39                  | 30.62%         |
| Restructured Corp. Loans | 32.92             | 13.58                 | 41.26%         |
| Workout Loans            | 1.77              | 0.38                  | 21.49%         |
| Daewoo Loans             | 25.87             | 10.17                 | 39.33%         |
| <b>Total</b>             | <b>84.68</b>      | <b>31.52</b>          | <b>37.23%</b>  |

### NPA Recovery in USD by Type of Resolution [Oct. 31, 2002, unit: US\$ bn]

| Methods                        | Face value   | Purchase Price | Recovered Value |
|--------------------------------|--------------|----------------|-----------------|
| International Bidding          | 4.86         | 1.05           | 1.28            |
| ABS issuance                   | 6.42         | 3.37           | 3.31            |
| Sale to AMC                    | 2.06         | 0.53           | 0.74            |
| Sale to CRC                    | 1.48         | 0.29           | 0.54            |
| Individual Corporate Loan Sale | 1.80         | 0.45           | 0.58            |
| Court Auction                  | 6.60         | 2.07           | 2.55            |
| Collection by schedule         | 9.51         | 3.20           | 4.48            |
| Payment by W/O plans           | 1.95         | 1.38           | 1.68            |
| Recourse & Cancellation        | 15.36        | 8.11           | 8.11            |
| <b>Total</b>                   | <b>50.04</b> | <b>20.45</b>   | <b>23.26</b>    |

A large fraction of the smaller loans were restructured by 2002 as shown earlier in Figure 1. Figure 2 below gives a time line for resolution of the larger more complex loans which were restructured as joint ventures between KAMCO and Asset restructuring companies. The later structures were geared more towards recovery maximization as opposed to speed of resolution, which was the emphasis in the initial stages. The final liquidation of some of these vehicles took almost 10 years, until 2012.

**FIGURE 2**



### Conclusion

The setting up of KAMCO and the NPA Fund played an important role in resolving the NPL crisis. Moreover, KAMCO's employment of a wide range of innovative techniques of NPL management and disposal led to the development of a market for distressed assets in Korea and contributed to the deepening of broader financial markets.

Given that the Indian NPL problem is more concentrated among the larger credits, apart from the institutional set up in terms of auction and recovery data that we recommend, joint ventures may be a better vehicle for risk sharing as well as NPL resolution.

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