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Lessons Learned from Thailand's Experience with Financial-Sector Restructuring

Veerathai Santiprabhob

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Thailand Development Research Institute

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Preface

The financial crisis of 1997 was one of the most unpleasant events in Thailand's modern economic history. It led to a sharp economic contraction and severely affected almost everyone in the country.

Over the past five to six years, three governments have implemented a number of radical measures to address their immediate problems and restructure the Thai financial system. They have depended on both decentralized market-led and centralized state-led mechanisms to address problems of insolvent financial institutions and distressed assets. These measures encompassed, among others, a blanket guarantee for depositors and creditors to end deposit runs, massive closure of insolvent finance companies, intervention in insolvent financial institutions, a public capital-support scheme for private financial institutions, new bankruptcy and foreclosure laws and legal frameworks, world-record auctions of distressed assets, and establishment of a central state-owned asset management corporation.

Overall, it is fair to conclude that these restructuring measures have succeeded in restoring financial stability in Thailand. The remaining financial institutions are now able to perform their regular financial intermediary functions and provide support for Thailand's continuing economic recovery.

Nevertheless, a number of financial institutions are still weak and a large amount of distressed assets have yet to be cleaned up. Over the coming years, the legacy of the financial crisis remains to be addressed by the Thai authorities and its large burdens to be shared by the Thai public. The restructuring measures implemented by the past three governments have also dramatically changed the structure of the Thai financial system as well as created incentive distortions among different classes of financial institutions and economic agents.

It is undeniable that the structure of the Thai financial system today and the high financial-sector restructuring costs were consequences of the fragility of the Thai financial system that led to the crisis in 1997. Equally important, they have been dictated by the design of the financial-sector restructuring program during the past five to six years. Therefore, it is my intention not only to document the rationale and characteristics of the restructuring measures in detail, but also to discuss in this study the outcomes, problems, and implications associated with each restructuring measure. I very much hope that this study will provide important and otherwise hard-to-find lessons for other crisis-affected countries and assist the authorities of such countries in designing an appropriate and cost-effective restructuring program.

Throughout the long process of conducting this study, I was assisted by and benefited from discussions with a number of people in the Bank of Thailand, the Ministry of Finance, private financial institutions, and universities. I am indebted to Takatoshi Ito who initiated the research project and organized a number of workshops at the Asian Development Bank Institute (ADBI) on financial sector restructuring in East Asia. I would also like to thank Tarrin Nimmanahaeminda, Ammar Siamwalla, Ruchukorn Sangsubhan, Sethaput Suthiwart-Narueput, Salinee Wangtal, Siritida Panomwon, and Masaru Yoshitomi for their valuable comments and thought-provoking contributions. In addition, I am grateful to the Thailand Development Research Institute for kindly publishing this study, which was previously circulated in an electronic form by the ADBI. Lastly, I would like to acknowledge the courage, hard work, and dedication of key officials of the Bank of Thailand and the Ministry of Finance in getting Thailand through the financial crisis of 1997.

Veerathai Santiprabhob

Table of Contents

Page

List of Tables

List of Charts and Flowcharts

Page

Abstract

Since the financial crisis erupted in Thailand in 1997, the Thai authorities have implemented a number of drastic financial-sector restructuring measures to restore financial stability and address prevailing structural weaknesses. The restructuring measures have been based on both market-driven and state-led mandatory approaches and could be categorized into two main groups: (1) those intended to address financial institutions' insolvency and capital adequacy, and (2) those intended to address non-performing loans and distressed assets. Owing mainly to the severe magnitude of the crisis, total public costs of Thailand's financial-sector restructuring are estimated to be in the range of 30-40 percent of GDP, raising serious concerns over the country's long-term public debt sustainability.

While the Thai financial-sector restructuring process is not yet complete, this study highlights relevant policy issues and tradeoffs as well as documents the rationale and the main features of key restructuring measures that have been implemented by three governments during the past five to six years. It also reviews their effectiveness, incentive structure, operating constraints, associated public costs, and subsequent impact on the Thai financial system going forward. It is hoped that the menu of policy and operational issues discussed in this study will assist the authorities of other crisis-affected countries in designing their financial-sector restructuring measures in the most cost-effective manner.

With the benefit of hindsight, the study highlights the needs for: (1) a comprehensive financial-sector restructuring framework that from the outset gives sufficient emphasis to preventing asset deterioration; (2) timely implementation of necessary restructuring measures without denying and underestimating the severity of the problems; (3) transparency in implementing all restructuring measures, especially those affecting depositors and investors; (4) well-balanced incentive mechanisms and an effective legal framework to support efficient resolution of distressed assets; (5) appropriate and realistic exit strategies for the government's investments in financial institutions; and (6) sufficient banking experts to manage state-owned financial institutions and distressed assets.

Glossary

AMCorp	Asset Management Corporation
AMCs	Asset management companies
BAM	Bangkok Commerce Asset Management Company
BBC	Bangkok Bank of Commerce
BBL	Bangkok Bank
BIBF	Bangkok International Banking Facility
BIS	Bank for International Settlements
BMB	Bangkok Metropolitan Bank
BOT	Bank of Thailand
BT	Bank Thai
CAP	Covered asset pool
CAPS	Capital augmented preferred securities
CDRAC	Corporate Debt Restructuring Advisory Committee
DCA	Debtor-Creditor Agreement on Debt Restructuring Process
FBCB	First Bangkok City Bank
FIDF	Financial Institution Development Fund
FIs	Financial institutions
FRA	Financial Sector Restructuring Authority
GDP	Gross domestic product
ICA	Inter-Creditor Agreement on Restructuring Plan Votes and Executive Decision Panel Procedures
KTB	Krung Thai Bank
KTT	Krung Thai Thanakit Finance Company
LTB	Laem Thong Bank
MOF	Ministry of Finance
NPL	Non-performing loan
NTB	Nakornthon Bank
PAM	Petchburi Asset Management Company
RB	Radhanasin Bank
SAM	Sukumvit Asset Management Company
SCIB	Siam City Bank
SET	Stock Exchange of Thailand
SLIPS	Stapled limited interest preferred stock
SRA	Simplified Restructuring Agreement
TAMC	Thai Asset Management Corporation
TFB	Thai Farmers Bank
UB	Union Bank
UOB	United Overseas Bank

Chapter 1
Introduction

In 1997, Thailand experienced an economic crisis that had the combined effects of a currency crisis and a financial crisis. The crisis was indeed the most severe one since the Second World War. Key elements of Thailand's currency crisis reflected its cumulative balance of payment problems, particularly persistently large current account deficits, and unsustainable financing through short-term external borrowing.[1] The Bank of Thailand (BOT), after depleting most of its international reserves in defending the baht currency, had to float the currency on July 2, 1997, ending the decade-long fixed exchange rate regime. The value of the baht fluctuated widely after the currency was floated, particularly after BOT had disclosed the amount of its forward contracts and similar economic crises had emerged in some East Asian countries.

Although the crisis began on a certain date, elements of Thailand's financial crisis became evident well before the floatation of the baht. Those elements reflected hidden problems in a number of unsound financial institutions (FIs). During the first quarter of 1997, rumors began to spread about capital inadequacy and liquidity shortage in finance companies and small banks, and such rumors resulted in periodical deposit runs. The interbank market became segmented, and illiquid FIs had to obtain liquidity support from the Financial Institution Development Fund (FIDF), BOT's entity tasked with assisting troubled FIs. The magnitude of the financial crisis was also exacerbated by the floatation of the baht, because the Thai private sector had a large amount of foreign-currency loans outstanding with both domestic and foreign FIs. When the baht depreciated sharply and a substantial number of the external loans were called back, many of these firms went bankrupt and failed to service their loans.

Thailand has already had three governments since the crisis emerged, and the Thai economy is still struggling to recover. By the end of 2001, Thailand's real gross domestic product (GDP) was still below that at the end of 1996, and the financial sector was still fragile. The structure of the Thai financial system has also changed dramatically with the government becoming the largest player, and more than two thirds of small FIs have been closed down. Owing to various fiscal stimulus and financial-sector restructuring measures, public debts increased from around 15 percent of GDP in 1996 to more than 57 percent of GDP at the end of 2001.[2] In addition, the authorities have incurred a large amount of contingent liabilities, which will have to be realized by taxpayers over time.

MAIN CAUSES OF THE 1997 FINANCIAL CRISIS

There were at least five main factors contributing to the Thai financial crisis of 1997. First, the Thai financial system prior to the crisis comprised a large number of small FIs. At the end of 1996, Thailand had 91 finance companies and 15 banks, of which only one finance

[1] Thailand's current account deficits averaged around 7 percent of GDP during the period 1991-1996. At the end of 1996, private short-term external debt amounted to US$ 47.7 billion or around 123 percent of the country's gross international reserves.

[2] BOT, FIDF, and MOF (2000, 46) and MOF website.

company and two banks were state owned.[3] Apart from the largest banks, the other FIs were too small to benefit from economies of scale and, therefore, had higher funding and operating costs. Most FIs had a limited capital cushion, and were highly vulnerable to economic shocks. They also had concentrated loan portfolios, a large part of which was extended to the real estate sector and, in the case of finance companies, stock-market margin trading. Repayment capability and the willingness of borrowers in these sectors depended largely on their collateral value, which declined substantially during the first few years of the crisis.

Second, the Thai financial system had been highly protected for more than 20 years. During that period, foreign banks were allowed to operate only one branch in Bangkok and, in some cases, one more branch in another major city. Without competition from advanced players, Thai FIs were lagging behind in terms of risk management skills and technological infrastructure, especially in loan approval and monitoring.

Third, the long period of high economic growth, together with intense competition from small FIs, led to excessive credit expansion. During the period 1991-1996, the total assets of banks and finance companies expanded at an average rate of 22.5 percent annually. In 1996, total loans outstanding accounted for around 105 percent of GDP, and more than 25 percent of these loans were given to non-traded sectors, e.g., the real estate sector, construction sector, and personal consumption.

The high credit growth rate also led to a high degree of leverage among Thai firms. Consequently, they had limited capital to cushion themselves against economic shocks; the effects of the shocks were largely passed on to lending FIs, which also had limited capital. The high degree of leverage also reflected Thailand's limited funding sources beyond banks and finance companies. When a large number of FIs failed, many firms had limited funding options and experienced a severe credit crunch, thereby magnifying the impact of the crisis.

Fourth, there were problems related to BOT's prudential regulations and supervision. A number of key prudential regulations and supervision methods were well below international standards, thereby preventing BOT from knowing the true condition of FIs. For instance, a non-performing loan (NPL) was defined in 1996 as a loan that had been past due for at least 12 months; internationally, however, an NPL was defined as one past due for three months. Loan-loss reserve requirements were also lenient, resulting in underprovisioning against problem loans. The large number of small FIs in existence had also placed a heavy burden on BOT's prudential supervision. Furthermore, BOT had applied regulatory forbearance to favor certain troubled FIs, allowing their problems to accumulate over time.

Fifth, the floatation of the baht introduced a new type of risk to both BOT and FIs, i.e., exchange rate risks. Before the floatation of the baht in July 1997, Thailand had a fixed exchange rate with the US dollar for more than 13 years. Although BOT required that FIs comply with the foreign exchange exposure limit on a regular basis, the requirement did not cover credit risks that could arise from changes in the exchange rate.

Prior to the crisis, Thailand had liberalized capital inflows and allowed banks to operate offshore banking facilities, i.e., the Bangkok International Banking Facilities (BIBF). Given that prevailing domestic interest rates were higher than foreign rates, BIBF banks acquired a large amount of US dollar funds for lending in US dollars to local borrowers.[4] In so doing, banks could comply with the foreign exchange exposure limit as they squared their foreign-currency assets with liabilities. The exchange rate risks were then left with borrowers, many of which used the funds for investments in non-traded sectors that generated no foreign exchange earnings. Therefore, many BIBF borrowers could not service their loans when the

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3 The two state-owned banks were Krung Thai Bank (KTB) and Bangkok Bank of Commerce (BBC). The BOT and FIDF took control of the latter in 1996.

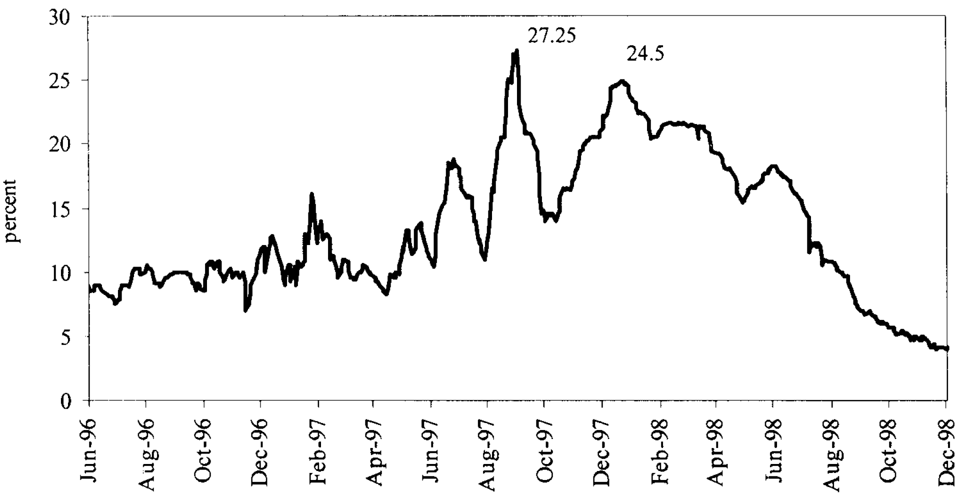
4 At the end of 1996, commercial banks' and BIBF external debts totaled around US$ 42 billion, of which US$ 27.2 billion were short-term debts. In total, private short-term external debts stood at US$ 47.7 billion at the end of 1996, as compared with US$ 38.7 billion in gross international reserves.

baht depreciated substantially, and the exchange rate risks were then passed on to FIs as credit risks.

In addition to the main causes of the crisis discussed above, the Thai financial crisis was also amplified by two other factors, which came into effect after the crisis emerged. First, interest rates were kept very high between July 1997 and August 1998 because of distortions in the financial system and the need to slow the depreciation of the baht. Short-term repurchase rates went up from around 7-8 percent at the end of 1996 to around 25 percent in January 1998 (chart 1.1). Lending rates also increased from 15 percent to 19.5 percent during that period. This long period of high interest rates not only increased the funding costs of FIs, but also further reduced borrowers' loan servicing capability.

Second, FIs and their borrowers were affected by declining collateral values after the economy contracted substantially. Before the crisis, it was a tradition in Thailand to lend against collateral, especially properties and stocks. Appraisal standards were also relaxed, and keen competition among FIs led to a low collateral-to-loan coverage ratio. After a long period of economic contraction and declining asset values, FIs became exposed to higher losses and discovered that their loans had been underprovisioned. Consequently, many FIs had impaired capital; they needed immediate recapitalization amid the crisis to preserve their solvency.

Chart 1.1: Repurchase rate (14-day) (Jun 1996-Dec 1998)



Source: BOT.

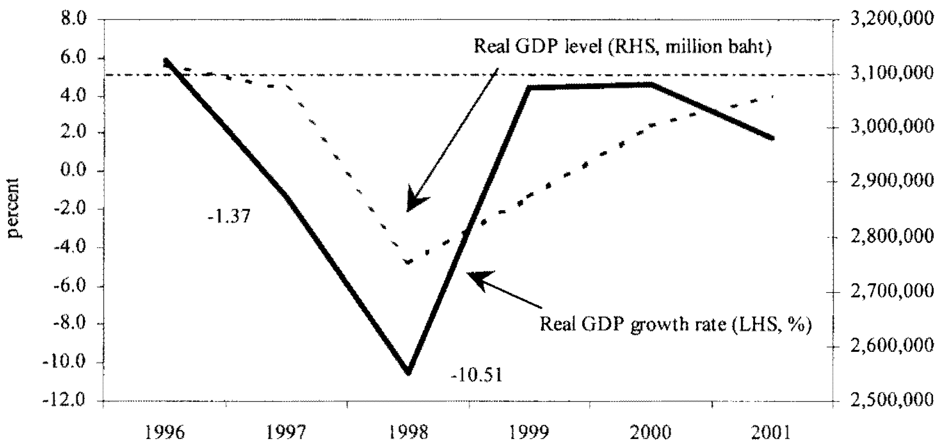
MAGNITUDE OF THE CRISIS

The Thai economy contracted by 1.4 percent in 1997 and 10.5 percent in 1998 before recovering gradually over the following years (chart 1.2). By the end of 2001, the level of real GDP was still below that of 1996.

The sharp economic contraction resulted in extensive bankruptcies and a rapid growth of NPLs. NPLs in the Thai financial system reached their peak at 47.7 percent of total loans in May 1999, before declining gradually (chart 1.3). Owing to rising provisioning requirements and declining revenues, Thai banks had incurred cumulative losses of around 688,452 million baht during the period 1997-1999, almost double the size of their total capital at the end of 1996. The FIs that failed to recapitalize were closed down or the authorities intervened in their operations. As a result, the number of fully licensed banks declined from

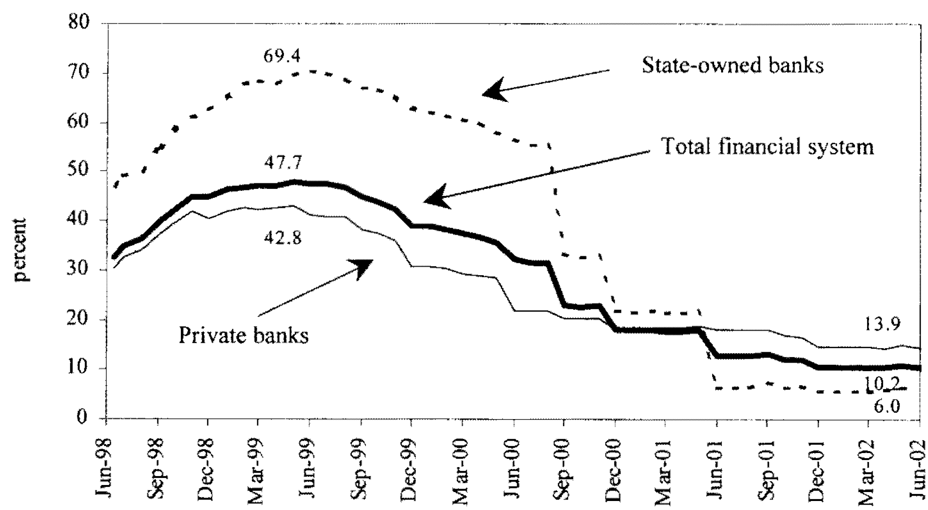
15 at the end of 1996 to 13 in June 2002, three of which were state-owned and four of which were taken over by foreign banks.[5] More dramatically, the number of finance companies declined from 91 at the end of 1996 to only 19 in June 2002.

Chart 1.2: Real GDP growth rate and real GDP level (1996-2001)



Source: NESDB.

Chart 1.3: Ratio of NPLs to total loans (Jun 1998-Jun 2002)



Source: BOT.

As the financial-sector restructuring has yet to be completed and the government has incurred substantial contingent liabilities from various restructuring measures, it is difficult to pinpoint the total public costs incurred as a result of the 1997 financial crisis. During the period 1998-2000, the government had fiscalized around 700,000 million baht in financial

5 A restricted license bank, which was upgraded from a group of finance companies, began its operations in April 2002.

restructuring costs by issuing government or government-guaranteed bonds. Another round of fiscalization occurred when the government issued 300,000 million baht in saving bonds in September 2002. The authorities estimated that the government would have to take on another 500,000-900,000 million baht from their contingent liabilities, bringing the total public costs to around 30-40 percent of GDP (BOT, FIDF and MOF 2000, 26). This estimate was subject to various assumptions on economic growth, interest rates, and NPL recovery, which needed to be refined and updated over time.

The severity of the crisis and extensive deposit runs also forced the government to introduce in August 1997 a blanket guarantee for depositors and creditors of all remaining FIs. The blanket guarantee was in effect the largest liability that the government has incurred since the crisis occurred, and its existence has largely dictated the framework of subsequent financial-sector restructuring measures, especially those dealing with insolvent FIs. Because the authorities promised under the guarantee to compensate depositors and creditors within 30 days after an official intervention in an FI or if it fails to honor its payment obligation, the blanket guarantee made the option of closing down a troubled FI expensive for the authorities. With a view to avoiding making outright payouts to depositors and creditors, the authorities preferred to deal with insolvent FIs, especially the large ones, through other means, including merging them with other FIs or privatizing them, while guaranteeing yield maintenance and sharing losses. In effect, these measures postponed realization of public costs to the future through various forms of contingent liabilities. Theoretically, they should be less costly than closing down insolvent FIs, which would require outright compensation to depositors and creditors.

OBJECTIVES AND OVERVIEW OF THE STUDY

This study is intended to document and review a wide range of approaches and measures adopted by the Thai authorities in addressing financial-sector problems since the crisis began in 1997 (table 1.1). The study discusses the rationale and main features of key financial-sector restructuring measures and, with the benefit of hindsight, attempts to review their effectiveness, incentive structure, operating constraints, associated public costs, and subsequent impact on the Thai financial system. It is hoped that the menu of issues discussed in this study will assist the authorities of other crisis-affected countries in designing effective and least costly restructuring measures.

Financial-sector restructuring measures adopted by the Thai authorities could be categorized into two main groups: (1) measures intended to address FIs' solvency and capital adequacy problems and (2) those intended to address the problems of distressed assets and NPLs. These two sets of measures were highly interrelated and, in effect, two sides of the same coin. Recapitalization would increase FIs' capability in realizing losses from their NPLs, thereby facilitating NPL resolution. On the other hand, a reduction in NPLs would lower FIs' capital requirements and enable them to resume their normal financial intermediary functions.

Table 1.1: Timeline of key financial-sector restructuring measures (1997 – 2002)

Timing	Key restructuring measures
1997	
March	BOT ordered 9 finance companies and 1 credit foncier to raise capital.
June	BOT suspended the operations of 16 finance companies.
July	BOT floated the baht.
August	BOT suspended the operations of 42 finance companies. Blanket guarantees for depositors and creditors were introduced.
October	FRA and AMCorp were established.
November	BOT intervened in BMB. Liberalization of foreign ownership in FIs.
December	FRA ordered 56 finance companies closed.
1998	
February	BOT intervened in SCIB and FBCB. RB was established. The authorities recapitalized KTB with 16,750 million baht.
April	FRA conducted the first auction of core assets.
May	BOT intervened in 7 finance companies.
June	MOF issued bonds (worth 500,000 million baht) to fiscalize FIDF's losses. CDRAC was established. NPL restructuring guidelines were introduced.
August	BOT intervened in LTB, UB, and 5 finance companies. BT was established by merging UB, KTT, and 12 finance companies. LTB and RB were merged. BBC was closed down. FBCB was merged into KTB. The public capital support scheme was introduced. The Individual AMC Law was enacted.
December	FRA conducted its largest auction of core assets. FIDF recapitalized KTB with 77,000 million baht.
1999	
February	TFB issued SLIPS.
April	BBL issued CAPS. The new Bankruptcy Law was enacted.
June	The new Central Bankruptcy Court became operational.
July	BOT intervened in NTB.
August	FIDF recapitalized KTB with 108,000 million baht.
September	NTB was sold to Standard Chartered Bank.
October	RB was sold to UOB.
2000	
September	KTB's NPLs were transferred to SAM.
2001	
April	TAMC was established.
June	BMB's and SCIB's NPLs were transferred to PAM.
October	The first lot of NPLs were transferred to TAMC.
2002	
April	BMB was merged into SCIB.
September	MOF issued saving bonds (worth 300,000 million baht) to fiscalize FIDF's losses. FIDF attempted to privatize BT through a public offering.

During the past five to six years, the Thai authorities have adopted a number of key restructuring measures based on both market-driven and state-led mandatory approaches. When designing and implementing these measures, the authorities had to make a number of difficult policy decisions that involved economic and political tradeoffs. In dealing with insolvent FIs, the authorities had to decide on, for instance, (1) the appropriate degree of protection to be given to depositors and creditors, (2) whether the FIs should be closed down or allowed to continue operations under the authorities' control, (3) how best to recapitalize and restructure the FIs in which the authorities intervened, (4) who should manage and supervise the restructuring of these FIs, (5) how best to consolidate the FIs in which the authorities intervened and the existing state-owned FIs, and (6) whether the FIs in which the authorities intervened should be privatized early at a low price in order to limit public contingent liabilities or be kept under the authorities' control until the economy clearly recovered.

To address problems of private FIs that were potentially viable, the authorities, among others, had to balance appropriately the following aspects: (1) recapitalizating the private FIs through a public capital support scheme and measures aimed at safeguarding public funds; (2) the necessity of bringing prudential regulations and supervision up to international standards and maintaining certain regulatory forbearance to facilitate FIs' recovery and recapitalization; and (3) liberalization of foreign entries and the degree of protection that should be given to fragile domestic FIs.

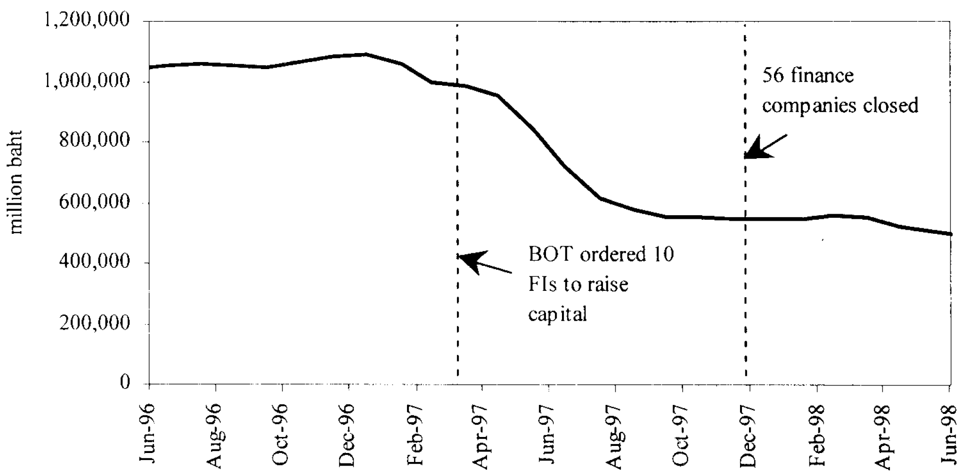
The resolution of NPLs and distressed assets also involved a number of crucial policy decisions. The authorities had to decide, for instance, (1) whether they should set up a central state-owned NPL resolution agency or play only supportive roles to facilitate decentralized market-driven efforts, (2) how best to design appropriate reward and penalty mechanisms, especially the legal framework, to ensure effective and timely cooperation from all parties involved, (3) appropriate levels of burden-sharing among the government, lending FIs, and debtors in NPL resolution, (4) whether the assets of insolvent FIs should be promptly liquidated or restructured gradually over time, (5) whether FIs should be encouraged to separate their good bank operations from bad bank operations by transferring NPLs into individual asset management companies (AMCs), and (6) how best to minimize the adverse impact of bailing out NPL debtors on performing debtors and the country's long-term credit culture.

The study discusses the above-mentioned issues as well as other policy and operational issues that had emerged during the past five to six years of financial-sector restructuring. Chapters 2-5 of the study address measures intended to deal with FIs' capital adequacy problems covering the suspension and closure of 56 finance companies in 1997, intervention in insolvent FIs, efforts to recapitalize private FIs, and recapitalization and restructuring of state-owned banks. Chapters 6-9 address measures related to the resolution of NPLs and distressed assets, including liquidation of closed finance companies' assets, legal reform to facilitate NPL resolution, market-driven approach to NPL resolution, and state-led efforts in NPL resolution. The last chapter summarizes the main lessons learned and the remaining challenges for the Thai financial system.

Chapter 2
Suspension and Closure of Finance Companies

Problems in finance companies were the first indicators of the Thai financial crisis. Market rumors on the capital inadequacy of various finance companies began to circulate around the beginning of 1997. The assets of such companies were concentrated in the real estate sector and stock-market margin lending, which had experienced declining asset values since the end of 1996. As a result, depositors lost confidence in these finance companies and started to withdraw their deposits on a large scale (chart 2.1). The rumors were confirmed as true in March 1997 when BOT ordered nine finance companies and one credit foncier to raise capital within two months. Owing to difficulties in raising capital in such a short period of time, BOT announced that financial assistance from FIDF would be made available to help recapitalize these institutions, if need be.[6] Furthermore, it was publicly announced that FIDF would provide adequate liquidity support to other FIs, all of which were then deemed to be sound and solvent by BOT.

Chart 2.1: Finance company deposits (Jun 1996-Jun 1998)



Source: BOT.

Unfortunately, the BOT's action did not succeed in restoring public confidence and ending deposit runs, in part because the number of finance companies ordered to raise capital was well below prevailing market expectations.[7] The action was also perceived as selective, not transparent, and politically motivated as no clear criteria for identifying undercapitalized FIs were announced. In June 1997, BOT had to suspend the operations of 16 finance

[6] BOT press release 10/2540 (March 3, 1997).

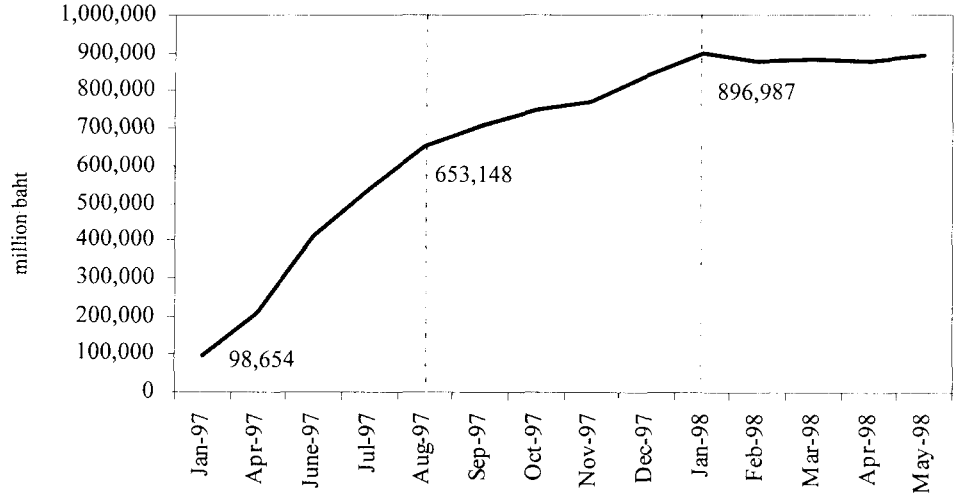
[7] BOT also announced on the day that it ordered 10 FIs to raise capital that banks and finance companies needed around 50,000 million baht to meet its new provisioning requirement for substandard loans over the ensuing two years (BOT press release 10/2540 (March 3, 1997)).

companies, including Finance One—the largest finance company at that time—whose financial strength had been previously guaranteed by the BOT. After the suspension in June, economic conditions and public confidence deteriorated further, especially after the flotation of the baht in July 1997. In response to increasing deposit runs and rapidly expanding liquidity support from FIDF, the authorities decided to suspend the operations of 42 more finance companies in August 1997.

The decision to suspend almost two thirds of the finance companies in Thailand was mainly intended to: (1) end deposit runs and bring FIDF's liquidity support under control; (2) restore public confidence in the remaining FIs by separating solvent from insolvent ones; and (3) eliminate distortions in the financial system.

The need to end deposit runs and control the growth of FIDF's liquidity support was urgent. Since BOT ordered 10 FIs to raise capital, the range of FIs affected by deposit runs had expanded from a limited number of finance companies to almost all finance companies and small banks. FIDF had to operate as the lender of "first" resort in providing these FIs with liquidity support. Liabilities, excluding contingent liabilities, of FIDF increased from less than 100 billion baht in January 1997 to more than 400 billion baht in June 1997 and around 650 billion baht (around 14% of GDP) in August 1997 (chart 2.2) (MOF 1999, 35). Almost 60 percent of the FIDF liabilities were in the form of very short-term borrowing through repurchase agreements, most of which had to be refinanced on a daily or weekly basis mainly by FIs receiving flight deposits.[8] Flowchart 2.1 illustrates the distorted flow of funds among Thai FIs during that period.

Chart 2.2: FIDF liabilities (Jan 1997-May 1998)



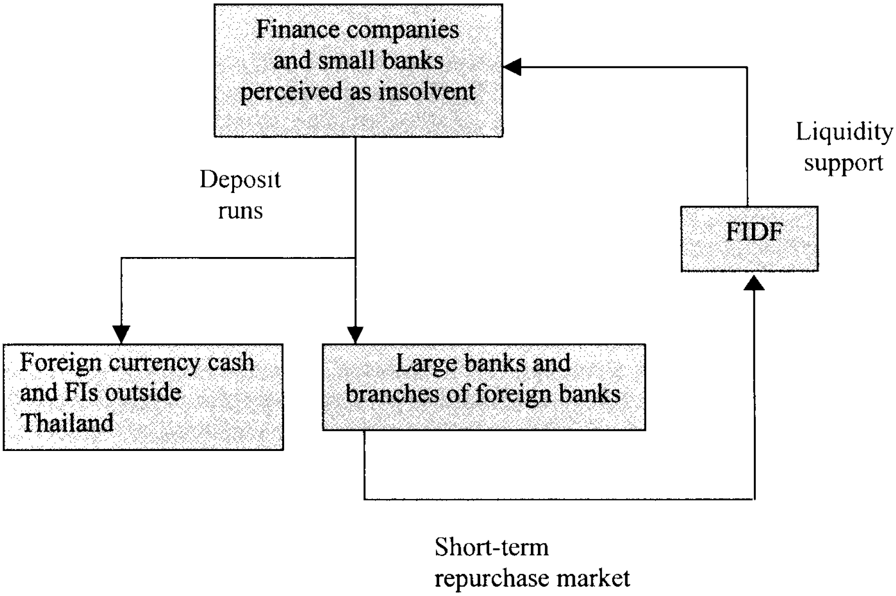
Note: Excluding contigent liabilities.

Source: MOF (1999, 35).

[8] Initially, FIDF required government bonds as security against its liquidity support. As deposit runs intensified and finance companies ran out of government bonds, liquidity support was made against risky collateral, including promissory notes issued by finance companies' borrowers. These promissory notes turned out to be valueless as many of the issuers went bankrupt.

Flowchart 2.1

Flow of funds during the 1997 financial crisis



The prolonged liquidity support did not only incur substantial liabilities for FIDF, which would eventually become public debt, but also caused severe distortions in the financial system. Insolvent FIs experiencing deposit runs had to offer higher deposit rates to retain their depositors, thereby driving up the whole interest rate structure. To generate sufficient funds for its expanding lending operations, FIDF also had to offer high interest rates in the short-term repurchase market. Consequently, interest rates remained high, leading to further deterioration of FIs' soundness as they faced higher funding costs and riskier borrowers. Subsequently, a number of FIs that were initially solvent but illiquid became insolvent.

The continued existence of unsound finance companies also contributed to an economy-wide credit crunch as the deposit bases of all FIs were fragile. Ailing FIs were competing for deposits, which were then used to repay their costly FIDF borrowing. During this period of uncertainty and rising interest rates, sound FIs receiving flight deposits preferred lending to FIDF over lending long-term to the real sector because lending to FIDF had very short maturity and carried little interest rate risks. Furthermore, FIDF was considered to be a risk-free state agency and, hence, lending to it required no capital backing.

EFFECTIVENESS OF THE SUSPENSIONS

The fact that BOT had to suspend 42 more finance companies in August 1997 indicated that the suspension of 16 finance companies in June did not meet its objectives. The suspension in June had at least three main elements that contributed to worsening public confidence and failure to end deposit runs.[9]

[9] In addition to problems specifically related to the suspension in June, deteriorating economic conditions and the floatation of the baht in July also contributed to failure in restoring public confidence.

First, the number of finance companies suspended in June was perceived as inadequate. The suspension was also considered as selective and not transparent. The authorities failed to announce the criteria used to trigger the suspension, and not all of the 10 FIs ordered to raise capital in March were suspended, although most of them had failed to recapitalize within the given timeframe.[10] Consequently, the public continued to doubt the true condition of the remaining FIs.

Second, the finance companies suspended in June 1997 included FIs whose financial strengths had been repeatedly guaranteed by BOT, especially Finance One which BOT and FIDF had endeavored to merge with a small bank. The suspension was perceived as a confirmation of the validity of market rumors about the condition of FIs, thus severely impairing BOT's credibility. The public then became increasingly concerned over the solvency of remaining FIs in spite of new reassurance by BOT.[11]

Third, depositors and creditors of the suspended finance companies were directly affected by the suspension. Initially, the public believed that their deposits would be protected because FIDF had promised to provide unlimited liquidity support to all FIs. On the contrary, deposits of the suspended finance companies were exchanged for promissory notes from a state-owned finance company, Krung Thai Thanakit Finance Company (KTT), and the maturity of the promissory notes—i.e., the length of time that the deposits were frozen—depended on the size of each depositor's deposits.[12] The creditors of these suspended companies were not protected and, therefore, incurred substantial losses. Although the freezing of deposits might have been appropriate at that time, it intensified public concern and resulted in continuing deposit runs, especially among large depositors.

Because of its comprehensive coverage, the suspension in August 1997 was more effective than the June suspension in separating insolvent finance companies from healthy ones.[13] Despite the fact that deposits of the 42 suspended finance companies were also frozen as promissory notes of a state-owned bank, Krung Thai Bank (KTB), with conditions similar to those of the finance companies suspended earlier, the August suspension was more successful in slowing deposit runs among the remaining FIs. On the day of the August 1997 suspension, the authorities introduced a blanket guarantee for the depositors and creditors of all remaining FIs. Under the guarantee, FIDF agreed to compensate depositors and creditors within 30 days if the authorities intervened in an FI or if an FI failed to honor its payment obligations.[14] It should also be noted that, unlike the June suspension, certain classes of creditors of the finance companies suspended in August were partially protected. They were allowed to exchange their outstanding credit for long-term promissory notes from KTB paying below-market interest rates.

Experience from the two suspensions highlighted the need to separate ailing FIs from solvent FIs as early as possible. Allowing ailing FIs to continue their operations could undermine public confidence and create distortions in the financial system, which could in turn adversely affect the solvency of otherwise healthy institutions. In addition, such a suspension needed to be carried out in a transparent manner in order to end deposit runs and restore stability in the financial system. Any action that is considered by the public as

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10 In part, the suspension was considered to be politically influenced because the Finance Company Act required approval from the Minister of Finance before BOT could suspend a finance company.

11 After the June suspension, BOT issued another public guarantee stating that it would not intervene in any more FIs (BOT press release 44/2540 (June 29, 1997)).

12 Deposits less than 1 million baht were changed into six-month promissory notes. Those between 1 million and 10 million baht and those more than 10 million baht were changed into three-year and five-year promissory notes, respectively. All the promissory notes paid market interest rates. Subsequently, the authorities allowed for an early discount of these notes to minimize liquidity shortage.

13 It should be noted that none of the small banks were suspended, although some of them had also been perceived as insolvent from the beginning.

14 After the blanket guarantee was introduced, limited deposit runs continued until the authorities intervened in the first bank without producing any adverse effect on the depositors. (see details in Chapter 3).

selective and politically motivated could severely undermine the authorities' credibility and the effectiveness of their subsequent measures.

STEPS TAKEN AFTER THE SUSPENSIONS

The suspension of ailing finance companies was only the first step required to end deposit runs and restore the financial system's stability. Apart from protecting depositors of the suspended finance companies, the authorities had to review their long-term business viability and deal with their assets if they were considered unviable and needed to be liquidated.

After the 16 finance companies were suspended in June 1997, the Ministry of Finance (MOF) immediately established a special committee to supervise and facilitate their merger and consolidation. Among others, the committee was asked to identify a few core institutions into which other suspended companies would be merged. Between the suspensions in June and August, the committee failed to identify the core institutions, and the future of all suspended companies was unclear. The work of the committee was also perceived as being not transparent and as being politically influenced, thereby further undermining the government's credibility. In response to eroding public confidence, all members of the committee were changed in September 1997.

The fact that the authorities failed to decide on the future of these suspended companies in due course also raised doubts among the public about BOT's knowledge of these institutions' true condition. The delay in making necessary decisions was detrimental to the authorities' credibility as well as public confidence in the remaining FIs.

Although most of the 16 finance companies suspended in June were insolvent from the beginning, some of the 42 companies suspended in August could have been suspended because they had been adversely affected by the economy-wide liquidity shortage and prevailing high interest rates, which resulted from the general lack of public confidence and prolonged distortions in the financial system. In a normal operating environment, these companies might have been viable and therefore would be allowed to resume their operations.

The new members of the MOF committee that was established in September 1997 concentrated on reviewing the long-term viability of the 58 suspended finance companies and making decisions on their future. To ensure that the work was carried out in a transparent and professional manner, the committee was institutionalized as the Financial Sector Restructuring Authority (FRA) in October 1997. That authority was established by an emergency decree empowering it to make final decisions on the business viability of the suspended companies, to order unviable companies closed, and to liquidate assets of the companies ordered closed.[15]

In view of the experience of political interference in implementing key measures in early 1997 and in consolidating the 16 finance companies suspended in June, FRA was established as an independent agency with full legal power to carry out its tasks. After the FRA chairman and secretary general were appointed by the Cabinet, they could not be dismissed. Furthermore, the FRA Board set its own policy and was not required to follow any policy guidance from MOF.

After FRA was established, the 58 suspended finance companies were required to submit their business and recapitalization plans to FRA for review. Criteria used to screen each institution's business viability covered sources of funds for recapitalization, liquidity management procedure, credibility of the plan to repay the FIDF's liquidity support, and credibility of the management.[16] All of these plans, together with the value of their assets, were tested by FRA for sensitivity to further economic deterioration.

[15] Chapter 6 discusses the liquidation process of closed finance companies' assets.

[16] FRA (1999, 44).

In December 1997, FRA decided to allow only two of the 58 suspended finance companies to resume their operations provided that they could recapitalize as planned within 90 days. The two finance companies were initially allowed to operate with certain limitations and under close monitoring before gradually resuming their full operations.[17] The other 56 suspended finance companies were closed down, and their assets, totaling around 851,000 million baht (14.3% of the banking system's total assets, or around 18% of GDP), were subsequently liquidated by FRA.[18]

KEY PROBLEMS ASSOCIATED WITH THE SUSPENSIONS

The suspensions of the finance companies, especially the one that took place in June 1997, were not well planned, particularly with regard to the method for preserving the value of assets and the lengthy period used to decide on the companies' future.[19] The asset quality of the suspended companies deteriorated quickly as the management of the companies were focusing their efforts on recapitalization and their capable staff were leaving. Loan monitoring and collection efforts were given relatively low priority. Moreover, the authorities had limited capability to ensure that all loan contracts and collateral documents were well protected after the suspension.[20] During this period of uncertainty, the management also had the incentive to destroy documents related to connected lending activities, and the staff had the incentive to cooperate with certain debtors in destroying loan documents.

The lack of proper care of assets and associated legal documents continued to be a problem after FRA had appointed new directors for the 56 finance companies to take care of their liquidation process. Given that most Thai bankers and financiers were struggling to ensure their companies' survival, it was very difficult to find banking experts to serve as directors of these companies. As a result, most, if not all, of these companies' directors were appointed from a body of senior MOF and BOT officials, who had a limited background in finance and banking. Moreover, these directors were unable to ensure proper care of assets and associated legal documents because they concurrently served on the board of directors of a number of companies while pursuing their full-time jobs at MOF or BOT.

The asset quality of the suspended finance companies also deteriorated quickly because debtors were cut off from financial services. As the suspended companies could neither extend additional credit nor release the unused portion of debtors' collateral, debtors were unable to meet their financing requirements, especially working capital. Furthermore, they could not switch to other FIs as their collateral was locked in the suspended companies. In this context, the suspension of 56 finance companies had contributed to a deeper credit crunch in Thailand at a time when liquidity was severely needed to alleviate the adverse effects of the financial crisis. These problems were acute among those customers whose unused credit lines, collateral, and deposits were simultaneously frozen.

With the benefit of hindsight, the asset quality of the closed finance companies could have been better preserved and the government's financial-sector restructuring costs could have been lowered if a bridge bank facility had been provided at the outset to performing debtors. Good loans of the closed companies should have been transferred to a bridge bank to ensure proper monitoring and provide performing debtors with continued financial services.

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17 Despite deteriorating economic conditions during the following years, the two finance companies remain in operation, thereby suggesting that the FRA screening criteria were tough and effective.

18 The total assets consisted of 771,000 million baht of loans and 80,000 million baht of non-core assets (FRA 2001, 2).

19 For those companies suspended in June, it took the authorities six months before they ordered them closed in December, and almost one year before the first lot of core assets were auctioned off.

20 A large number of cases with incomplete legal documents emerged during the FRA liquidation process. However, it was not possible to distinguish between cases with missing documents from the outset and those whose documents went missing after the suspension.

The government that assumed power in November 1997 realized the need to assist performing debtors of the closed finance companies, and therefore established the Radhanasin Bank (RB) as a bridge bank. Unfortunately, the idea of establishing RB came too late and it was not set up until February 1998. By that time, around 80 percent of all commercial loans of the suspended finance companies were already non-performing (FRA 1999, 3-4).[21] The authorities were then of the view that transferring such a small amount of performing assets to RB would not be economical and would delay the FRA auction process further. As a result, none of the closed companies' assets were transferred to the bridge bank, and all of them were subsequently put through the FRA liquidation process.

END REMARKS

The Thai experience highlights the fact that the authorities' credibility is crucial for restoring public confidence and ending deposit runs during a financial crisis. To maintain a high degree of credibility, the authorities must act in a transparent manner and be decisive in carrying out their restructuring measures, particularly those that may adversely affect depositors. Denial and underestimation of the crisis' severity would only magnify the problems and lead to other forms of economic distortion. To this end, insolvent and solvent FIs should be separated as early as possible. By keeping insolvent FIs afloat, their operations could create financial distortions, especially high interest rates and a system-wide credit crunch, which in turn could cause illiquid FIs that would otherwise be solvent to fail.

Although the suspension of a large number of finance companies in August 1997 was needed to help restore public confidence and bring FIDF's liquidity support under control, the suspension contributed to the severe liquidity shortage among these companies' borrowers and led to a sharp deterioration of these companies' assets. As asset quality is the key for recovering public costs, necessary measures should have been adequately implemented at the outset to safeguard these companies' assets.

[21] Although non-commercial loans (e.g., mortgage loans and leasing) had a much higher proportion of performing loans, there was no need to transfer these loans to the bridge bank as they generally required no further financial services. By the time the FRA auctioned its first lot of commercial assets in December 1998, 95 percent of commercial loans were NPLs (FRA 1999, 73).

Chapter 3
Intervention in Insolvent Financial Institutions

The financial system's conditions continued to deteriorate after the suspension of 58 finance companies. Public confidence in the economy and the remaining FIs was declining. Despite the introduction of a blanket deposit guarantee in August 1997, some small banks and finance companies continued to experience deposit runs and had to depend on the FIDF for further liquidity support.

CHANGE IN APPROACH

It should be pointed out that before November 1997 the authorities had not undertaken any action against small banks even though some of them were perceived as insolvent from the beginning. Although these banks were comparable in size with the large suspended finance companies, the government feared the psychological impact and possible systemic consequences.

When the Bangkok Metropolitan Bank (BMB), the ninth largest bank at that time, showed clear signs of weaknesses in November 1997, BOT, with approval from the new government that had just assumed office, decided to intervene and take control of the bank. That intervention was a major shift in approach from the previous method of suspending and closing insolvent FIs.[22] Under the intervention approach, the bank, pending a decision on its future, was allowed to service its depositors and debtors as normal, thereby minimizing the impact on the real economy and preventing the government from compensating depositors and creditors outright under the blanket guarantee. After it became evident that depositors in the FIs in which the authorities intervened were not adversely affected, public confidence in the blanket guarantee scheme strengthened substantially and deposit runs ended. The stability of the financial system was then restored, thereby ending distortions caused by prolonged deposit runs.

If the intervention approach, together with the blanket guarantee, had been adopted earlier, it might have helped to mitigate the magnitude of the crisis and reduce the number of failed FIs. In addition, the intervention approach might have helped to contain FIDF's liquidity support, thereby limiting the authorities' up front borrowing needs amid a financial crisis. The authorities have estimated that FIDF had lent around 817,000 million baht in 1997 to bail out insolvent FIs with deposits and liabilities totaling around 855,000 million baht. After the intervention approach had been adopted, FIDF used only 319,000 million baht during the period 1998-1999 to handle the problems of the FIs in which the authorities intervened, with deposits and liabilities totaling around 1,004,000 million baht (BOT and MOF 2000, 50). These up front costs, however, did not reflect all the public costs incurred under each restructuring approach, which also needed to include losses incurred from asset resolution and restructuring of the FIs in which the authorities intervened.

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[22] To facilitate the intervention approach, the BOT Act and the Banking Act were amended in October 1997 to provide BOT with the legal authority to intervene in a bank.

The decision to intervene in an ailing FI was only the first crucial step of a long and complicated resolution process. Ideally, the authorities should have at the outset a clear road map on the steps to be taken in each of the FIs in which the authorities intervened. When the intervention at BMB took place, it was unclear to the public how the authorities would deal with the bank, partly because the new government was in the process of settling in.

The policy on FI intervention was subsequently spelled out based on five main principles: (1) minimizing public costs, especially up front costs, by avoiding outright deposit compensation; (2) not bailing out the FIs' existing shareholders and management; (3) recapitalizing the FIs up to the regulatory requirement to enable continuing operations; (4) realizing the need for consolidating small FIs; and (5) restructuring the FIs keeping in view the principle that the government's involvement was intended to be temporary.[23]

Between November 1997 and February 1998, BOT intervened in two more banks: Siam City Bank (SCIB) and First Bangkok City Bank (FBCB).[24] After intervening in these FIs, the authorities immediately removed their board of directors and management with a view to: (1) preventing the management from protecting their own interest and covering up their past wrong doings; (2) restoring public confidence in the FIs in which the authorities intervened; and (3) minimizing moral hazards among the management of the remaining FIs.

As in the case of the 56 closed finance companies, it was difficult to find appropriate bankers to serve as new directors and managers of the banks in which the authorities intervened amid the financial crisis. The authorities then requested assistance from large private banks to lend temporarily their senior staff to serve as the top management of the banks in which the authorities intervened, and appointed most of the new directors from senior officials of the government and state enterprises. Unfortunately, it became evident afterward that the limited number of qualified bankers and business persons on the boards and management of these banks was one of the main obstacles for their effective restructuring, especially in addressing their NPL problems.

To reflect the banks' insolvent condition and negative net worth, and to eliminate their cumulative losses, the authorities penalized their existing shareholders by writing their shares down to almost no value. Because the Thai banking law required that all operating banks meet the minimum capital requirement, the authorities had to recapitalize adequately the banks in which the authorities intervened to enable their continuing operations.[25]

Because the government had limited financial resources available and FIDF had already given large liquidity support to such banks, the authorities then decided to recapitalize the banks by converting FIDF loans into equity.[26] The banks in which the authorities intervened then no longer needed to pay interest on their FIDF loans after the conversion, and their net interest income was allowed to improve over time at FIDF's expense.

After the intervention at the three banks, the Thai economy contracted further, i.e., by 10.5 percent in 1998, and the quality of the FIs' assets deteriorated rapidly. Consequently, the authorities had to intervene in five finance companies in May 1998, two banks and seven

[23] The intention to provide only temporary support conformed with the new constitution, which allowed the government to compete with the private sector only in a crisis situation. Owing to deterioration of economic conditions, the authorities had difficulties in privatizing the FIs and their initial intention partially materialized.

[24] Their total loans, together with those of BMB, accounted for around 14.3 percent of the total banking system's loans in June 1998.

[25] In some countries, when an FI is placed under conservatorship, it might be allowed to operate certain businesses without maintaining the minimum capital requirement. However, conservatorship was intended to be temporary pending a final decision on the institution's future. Realizing problems related to the lack of a conservatorship concept in the Thai banking law, the government incorporated this concept into the new Financial Institutions Act, which is currently awaiting parliamentary approval.

[26] For these three banks, recapitalization by debt-equity conversion totaled around 147,590 million baht. See Chapter 5 for more details.

finance companies in August 1998, and one bank in July 1999.[27] All together, loans of the FIs in which the authorities intervened accounted for around 24 percent of the banking system's total loans at that time (table 3.1). Although steps undertaken in subsequent rounds of intervention were broadly similar to those taken in the first round, the authorities became more transparent as to the criteria used to trigger an intervention. Furthermore, they had decided on the future of the institutions in which they intervened prior to their intervention.

Table 3.1: Banks and finance companies in which the authorities intervened

Institutions involved in intervention	Timing of intervention	Gross loans at the end of June 1998 (million baht)
BBC	May-96	145,018*
BMB	November-97	195,937
FBCB	February-98	296,589
SCIB	February-98	244,963
UB	August-98	59,322
LTB	August-98	45,240
NTB	July-99	62,940
Total of banks in which intervention took place		1,050,009
(percentage of total banking system's loans)**		20.39
7 Finance companies	May-98	77,852*
5 Finance companies	August-98	96,452*
Total of finance companies in which intervention took place		174,304
(percentage of total banking system's loans)**		3.38
Total of FIs in which intervention took place		1,224,313
(percentage of total banking system's loans)**		23.77

Notes: * July 1998 figures.

** Banking system loans in June 1998 totaled 5,150,841 million baht, of which private banks accounted for 3,373,676 million baht.

Source: Compiled from various sources.

CRITERIA USED TO TRIGGER AN INTERVENTION AND SOLUTIONS FOR THE FIS CONCERNED

In August 1998, BOT publicly announced that it would intervene in any FI that was either illiquid or insolvent or both. On the liquidity front, the authorities would intervene in an FI if its borrowing from FIDF exceeded twice its net capital. With regard to solvency, BOT would intervene in any FI that: (1) had a Bank for International Settlements (BIS) capital adequacy ratio below 4 percent after meeting BOT's end-1998 provisioning requirement; (2) had or would have negative ownership capital over the ensuing six months; and (3) had no

27 The two banks in which the authorities intervened in August 1998 were Union Bank (UB) and Laem Thong Bank (LTB); the bank in which this process took place in July 1999 was Nakornthon Bank (NTB). In addition to these FIs, five other finance companies and credit fonciers failed but, owing to their small size, the authorities decided to close them and compensate their depositors outright. It should be noted that one of the five companies, Phatra Thanakit Finance, was a subsidiary of a major private bank. FIDF then entered into a burden-sharing agreement with the bank on deposit compensation and NPL resolution.

credible recapitalization plan in sight.[28] It should be noted that when these criteria were applied to the two banks and five finance companies in which intervention took place in August 1998, the authorities also wanted to ensure that only solvent FIs remain to benefit from the government's capital support scheme.

Unlike when intervention took place at the first three banks in early 1998, the authorities decided on how to deal with each FI in which they intervened prior to subsequent rounds of intervention. The decision was institution-specific, keeping in view the need to consolidate small FIs and minimize up front public costs either by means of privatizing them or merging them with other state-owned institutions.[29]

As regards consolidation, the authorities decided to merge the five finance companies in which they intervened in May 1998 with KTT, a state-owned finance company. When the authorities intervened in seven additional finance companies and two banks in August 1998, the seven finance companies and Union Bank (UB) were also merged into the enlarged KTT, which was subsequently formed into Bank Thai (BT). The other bank in which intervention took place in August 1998, Laem Thong Bank (LTB), was first merged with RB—the bank that was set up as a good bank for assets of the closed finance companies but did not materialize—and subsequently made available for privatization. The last bank involved in intervention, Nakornthon Bank (NTB), was sold to the Standard Chartered Bank shortly after the intervention as the authorities had been negotiating the sale with a number of interested buyers well before the intervention.

With respect to the three banks in which the authorities intervened in the first round and the Bangkok Bank of Commerce (BBC) which was taken over by FIDF in May 1996, the authorities had engaged a financial advisor to explore alternative approaches in dealing with them.[30] Given that there were many nationalized banks awaiting privatization in all crisis-affected countries in Asia and the demand was limited, the authorities realized that not all of the four banks in which they had intervened could be privatized successfully.[31] To this end, BMB and SCIB were selected for sale to foreign strategic partners hoping to partially recover public costs from their franchise values. Compared with BBC and FBCB, BMB and SCIB had managed to maintain a larger share of their deposit base after their intervention. Furthermore, they had relatively better management, more extensive networks in the Bangkok area, and larger base of commercial clients.[32]

The authorities decided to merge FBCB with KTB because it had relatively large loans outstanding with FIDF and its branch network well complimented that of KTB. Its loans from FIDF were subsequently converted into KTB equity as a means of recapitalizing the latter.[33] As to BBC, the authorities decided to close it because of its poor reputation and extensive fraud had been uncovered. Its deposits, liabilities, and performing assets were transferred to KTB with a view to minimizing disruption to its depositors and good borrowers. Its bad assets were then transferred to a specially established asset management company, the Bangkok Commerce Asset Management (BAM).[34]

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[28] BOT press release 55/2541 (August 19, 1998).

[29] It was believed that the decision to merge the FIs in which the authorities intervened with existing state-owned FIs was intended partially to help recapitalize the latter. See chapter 5 for a detailed discussion on this issue.

[30] BBC had liquidity and capital inadequacy problems in 1995 and was put under FIDF's control in May 1996, prior to the emergence of the crisis. FIDF was asked to recapitalize the bank, resulting in its share of ownership reaching around 65 percent at the end of 1996. After the bank was put under control, FIDF commissioned the Industrial Finance Corporation of Thailand to manage the bank under a certain loss-sharing arrangement.

[31] The banks in which intervention took place did not compete for capital with only nationalized banks in other countries, but also with remaining private banks in needs of massive recapitalization.

[32] BOT press releases 51/2541 (August 14, 1998) and 55/2541 (August 19, 1998).

[33] See Chapter 5 for further discussion on recapitalizing state-owned banks.

[34] Given that the amount of BBC assets transferred to KTB was less than the amount of deposits and liabilities transferred, BBC had to issue bonds with an FIDF guarantee to compensate for the difference.

PROBLEMS WITH FORCED MERGERS

As mentioned previously, the mergers of FIs in which the authorities intervened with state-owned KTB and KTT helped to consolidate the Thai financial system and reduced the up front public costs as compared with the option of closing them and compensating their depositors and creditors outright. Furthermore, such mergers provided a low-cost means for recapitalizing KTB and KTT because the FIs in which the authorities intervened had large outstanding loans from FIDF, and these loans could be converted into equity for KTB and KTT.

Nevertheless, the task of merging a large number of ailing FIs amid a financial crisis was substantial and could not be completed in a short period of time as intended by the authorities.[35] Such mergers could also jeopardize the government's long-term objectives of strengthening the competitiveness of state-owned banks and minimizing the government's role in the financial system. The forced mergers had contributed to, among others, the following problems, especially at KTB.

First, the mergers of BBC's good assets and liabilities and the whole of FBCB with KTB markedly enlarged KTB's size in terms of assets, deposit base, staff, and branch network.[36] Such an immediate expansion not only strained KTB's existing management, but also made the bank too large for future privatization, especially if the authorities wanted to sell their equity stakes to a strategic partner. A decision to privatize FIDF's holding of KTB shares could also disrupt the Stock Exchange of Thailand (SET) because KTB's paid-up capital after the merger accounted for around 11 percent of total stock market capitalization at that time.[37]

Second, the folding of insolvent FIs into KTB further complicated and delayed KTB's restructuring efforts. KTB's management faced difficulties in integrating, and upgrading to its standards a number of aspects of the institutions in which the authorities intervened: for instance, their front- and back-office operations, workflows, risk management procedures, computer systems, and their paper and electronic databases. At BT, the merger was even more complicated as it involved 14 small FIs. These tasks required substantial efforts in view of the fact that most intervened institutions had poor and outdated systems to begin with.

Furthermore, such mergers were constrained by the government's policy to minimize the impact on staff of the institutions where intervention had occurred. Although BBC's staff was partially laid off, KTB and BT had to take on all the staff of the institutions concerned. The problem was quite severe at KTB because it already had an excessive workforce.[38] Both KTB and BT had to spend the following years rationalizing their inflated workforce at their own expense.

Third, the mergers did not incorporate sufficient safeguards to prevent further deterioration of the FIs' assets. As in the case of the suspended finance companies, the staff of the FIs in which the authorities intervened had little incentive to look after assets following the intervention. The managers of KTB and BT were also under pressure to complete the mergers in a short period of time, and relatively limited efforts were spent to ensure that the good assets of the FIs concerned were handled appropriately. In addition, activities related to the mergers strained KTB resources in tending to its own assets. Therefore, the quality of KTB's

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35 However, the accounting mergers were done overnight to ensure depositors' confidence.

36 For instance, FBCB's 2,920 employees and 101 branches were merged with KTB.

37 Subsequently, part of KTB's capital was reduced and returned to FIDF. See Chapter 5 for more details.

38 KTB's staff increased by 13.4 percent between 1998 and 1999.

and BT's assets deteriorated quickly after the mergers and their original recapitalization plans via debt-equity conversion turned out to be inadequate.[39]

Fourth, the new BT, established by merging with KTT, 12 finance companies in which the authorities intervened and one such bank, had no clear comparative advantage over other private banks. Given that BT's branch network is smaller than that of other banks, its strategy has had to be focused on corporate banking rather than retail banking. However, competition in corporate banking has intensified, especially after the entry of foreign banks and the establishment of the corporate bond market. Corporate banking has earned a declining interest margin, and banks have had to compete for fee income, which generally requires costly investment in technology infrastructure and product development. As BT's capital base is limited, its competitiveness and long-term sustainability are questionable. Since its inception in 1998, BT has suffered continuing operating losses.[40]

ISSUES RELATED TO PRIVATIZATION OF THE FIS IN WHICH THE AUTHORITIES INTERVENED

During the period 1999-2000, the authorities opened for bid the majority of its shareholding in four banks in which they had intervened, namely BMB, SCIB, RB, and NTB. The privatization was intended to recover part of the public investments in these banks, and to minimize future public burdens by returning the banks and their assets to professional management.[41] The authorities intended to sell between 51 and 75 percent of these banks' equity to a strategic partner, with a view to enjoying a future upside gain from its remaining minority shareholding.[42]

The authorities had encountered a number of difficulties in selling the banks in which they had intervened when the economic recovery was still fragile. International banks had become more concerned about emerging markets' risks, resulting in limited demand from potential buyers. On the other hand, the number of nationalized banks and private FIs available for sale increased over time in all of the crisis-affected countries.

Because the assets of the banks concerned were largely non-performing, the authorities had to provide new investors with loss guarantees in the form of yield maintenance and gain/loss sharing.[43] As the banks had to pay interest on their deposits while their interest income was constrained by the existence of large NPLs, yield maintenance was provided to ensure that each bank's yields on assets were sufficient to cover its deposit interest expenses. Initially, FIDF would compensate the banks for the difference between their actual yields on NPLs and their carrying cost. If the banks could collect interest payments from their NPLs, the yield maintenance would be reduced proportionally. Yield maintenance was provided for only five years, with a view to limiting future public liabilities and encouraging the new management of the banks to quickly address their NPL problems.

The gain/loss sharing scheme was intended to provide new investors with a loss guarantee against further deterioration of NPLs and to provide the government with an opportunity to benefit from NPL recovery if the economy were to recover more strongly than

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[39] In the case of KTB, the ratio of NPLs in the doubtful loss category to total loans (after deducting collateral value) increased from 45.7 percent at the end of 1998 to 61.6 percent at the end of 1999. For BT, the ratio stood at 81.2 percent at the end of 1999.

[40] In 2001, BT registered a net profit of 1,071 million baht. The profit was contributed by yield maintenance revenue from FIDF of around 5,890 million baht.

[41] To this end, the authorities preferred selling the banks in which they had intervened to foreign banks over selling them to investment funds or those specializing in distressed asset management.

[42] The authorities also intended to privatize KTB and BT, but they preferred to sell their equity stakes in the two banks through the stock exchange.

[43] Provision of yield maintenance and loss sharing is a standard practice for privatizing an ailing bank, especially during a financial crisis.

expected.[44] In the investors' view, loss sharing was crucial to their investment decisions because it provided them with a backstop for potential losses. The gain/loss sharing scheme for each bank covered a predetermined pool of assets, which consisted of all prevailing NPLs and a small portion of performing assets; the latter was intended to provide new investors with a cushion against possible deteriorating macroeconomic conditions.[45] It should also be noted that the exact nature of gain and loss sharing agreements differed across privatized banks depending on each bank's asset quality and investors' interest in the bank.

Since the privatization scheme was announced, the public has questioned the rationale for providing yield maintenance and loss sharing to new investors. They failed to understand that the government had incurred unlimited yield maintenance and loss-sharing burdens from the day the authorities intervened in these banks. Indeed, privatization with such guarantees helped to limit the public burden to a given period of time. If the government had failed to privatize the banks and had to maintain its majority shareholding, the government would be fully liable for all interest expenses and NPL losses incurred by the banks. The yield maintenance and gain/loss sharing provided to new investors not only limited the government's period of responsibility but also incorporated incentive mechanisms to expedite NPL resolution. The new investors would need to address NPL problems early in order to be able to generate adequate real earnings before the yield maintenance contract expires at the end of the fifth year.

Despite the provision of yield maintenance and gain/loss sharing guarantee, the government had succeeded in privatizing only two banks by the end of 2001: RB and NTB.[46] As for the other two banks available for sale, BMB and SCIB, the authorities failed to agree with interested buyers because the prices offered were perceived to be too low.[47] Furthermore, fewer investors were interested in BMB and SCIB than in the other two banks because of BMB's and SCIB's larger size and poorer asset quality.

It should be pointed out that the two banks that were successfully privatized, RB and NTB, were much smaller than BMB and SCIB; their size was less than one fourth that of BMB and SCIB. Contrary to the authorities' initial expectation, BMB's and SCIB's large franchise had relatively limited value as compared with that of small banks. Their extensive branch networks were perceived by foreign strategic investors as liabilities that needed to be subsequently rationalized. In addition, the new investors would need to upgrade the banks' operations to their international standards so that they could gain leverage on their advanced technology for aggressive competition. To this end, it would be more costly and time consuming to upgrade the operations and staff of a larger bank.

As for BT and KTB, the authorities remain committed to privatizing them through public offerings as opposed to selling them to a strategic partner. Unfortunately, they failed in an attempt to privatize 51 percent of BT's shares in September 2002, partly because of a fragile stock-market environment. Privatization of FIDF's equity holding in KTB was expected to begin in 2003.

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[44] In most cases, FIDF would accept all losses from NPLs, for a period of five years, up to BOT's provisioning requirements for these NPLs. To encourage the new investors in carrying out effective NPL restructuring, the bank would receive 5 percent of the saving if actual losses turn out to be less than the required provision. On the contrary, the bank would be liable for 15 percent of the loss in excess of the required provision.

[45] Determining the asset pool for yield maintenance and gain/loss sharing could be carried out in one of the following two forms: a covered asset pool or an AMC. Under the covered asset pool, the guaranteed assets remain on the bank's balance sheet and the yield maintenance and gain/loss sharing were done through contracts. Under the AMC approach, a new AMC was set up to buy the guaranteed assets with FIDF-guaranteed bonds paying interest equal to the agreed yield maintenance rate.

[46] The government sold 75 percent of RB's equity to UOB Bank of Singapore, and 75 percent of NTB to Standard Chartered Bank.

[47] After the authorities failed to sell BMB and SCIB to potential foreign strategic partners, they began negotiation with the Civil Servants' Pension Fund. Unfortunately, they also failed to conclude a sale with that Fund. On April 1, 2002, the authorities decided to merge BMB with SCIB. See Chapter 5 for more details.

END REMARKS

The change of approach in dealing with insolvent FIs from suspension to intervention had succeeded in restoring depositors' confidence in the blanket guarantee scheme and, hence, stabilized the financial system. The intervention approach not only enabled customers of insolvent FIs to continue their normal banking operations and minimize a potential credit crunch, but also prevented the authorities from incurring substantial up front costs in compensating depositors and creditors under the blanket guarantee scheme.

Nevertheless, intervention in insolvent FIs requires a number of subsequent steps to ensure that the overall public costs are well contained. Most importantly, the FIs in which the authorities intervened need to be restructured effectively and privatized to minimize the government's long-term burden. The Thai experience has demonstrated that restructuring and privatizing the FIs in which the authorities intervened could be obstructed by a number of policy and market-related factors. Furthermore, their efforts have incurred substantial contingent liabilities that will have to be realized over time.

With the benefit of hindsight, the Thai authorities could have avoided prolonged complications in merging and privatizing the FIs in which they had intervened by separating them and forming them into a good bank and a bad bank at the outset and merging only their good loans and liabilities—i.e., only the good bank—into existing state-owned banks similar to the approach used for BBC. Under this approach, NPLs of the FIs in which the authorities intervened—i.e., the bad bank—would have been managed by professional asset managers from the beginning. In this context, the management of state-owned banks would have been less burdened by forced mergers and restructuring, especially NPL restructuring, and the number of state-owned FIs available for privatization would have been reduced to suit market demand.

Chapter 4
Recapitalization of Private Financial Institutions

It was clear from the outset that Thai FIs, especially finance companies, were seriously capital deficient, resulting in limited capability to shoulder losses from increasing NPLs. Before the crisis, the authorities failed to ensure that Thai FIs had maintained adequate capital, in part, owing to regulatory forbearance and lenient supervision and regulations, especially on NPL definition and loan classification. When BOT ordered 10 FIs to raise capital in March 1997, the economy was entering the crisis and the baht had been repeatedly attacked by speculators. Consequently, it was difficult, if not impossible, to recapitalize weak FIs at that time. As the economy contracted further and NPLs increased markedly, especially after the floatation of the baht and the long period of high interest rates, the capital bases of all FIs were strained by loan loss provisioning. Capital inadequacy became a systemic problem leading to the closure of and intervention in insolvent FIs and massive recapitalization of the remaining FIs.

The amount of funds needed to recapitalize Thai FIs was substantial. Between 1997 and 1999, Thai banks had incurred losses of 688,452 million baht, almost double the size of total banking system's capital at the end of 1996.[48] As a result, all Thai FIs were in need of immediate recapitalization to meet the 8.5 percent BIS capital adequacy requirement. New capital was also needed to cushion against rising NPLs and enable FIs to realize losses from debt restructuring. Furthermore, recapitalization would help to facilitate FIs in extending new credit, thereby alleviating the credit crunch in the economy.

During the past five to six years, the authorities and FIs have undertaken serious efforts and various means in recapitalization. For the private banks that remained in operations at the end of 2001, Tier-1 and Tier-2 capital with a combined worth of around 393,000 million baht had been raised during the period 1998-2000.[49] This amount was equal to around 8 percent of GDP and 45 percent of SET's market capitalization at the end of 2000.[50] However, capital adequacy remains a concern as most private FIs still have a large amount of NPLs on their balance sheets.[51]

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48 Thai banks continued to make losses in 2000, but the total loss figure for 2000 was highly distorted by state-owned banks' profits arising from the transfer of NPLs to state-owned AMCs at inflated prices. At the end of 1996, the capital of all banks operating in Thailand, including branches of foreign banks, amounted to only 356,954 million baht (BOT website).

49 Private and state-owned banks together raised around 850,000 million baht in new capital during the period. Since the end of 2000, only a limited amount of Tier-2 capital has been raised.

50 SET's market capitalization (par value) at the end of 2000 amounted to 851,285 million baht (SET website). It should be noted that, although all banks were listed companies, certain types of their capital (e.g., Tier-2 capital) were not real equity and could not be counted toward SET market capitalization.

51 In the first quarter of 2002, two small banks sought shareholders' approval for a new round of recapitalization.

LIBERALIZATION OF FOREIGN OWNERSHIP

One of the first efforts to help recapitalize private FIs was the liberalization of foreign ownership in banks and finance companies. Before the financial crisis emerged, the Thai financial system had been highly protected, and no new banking license had been issued for more than 20 years. Furthermore, fully licensed FIs were required to be majority owned by Thai, and almost all foreign banks were allowed to operate only one branch in Bangkok.

It became clear after the 58 finance companies were suspended that domestic funds were not sufficiently available to recapitalize private FIs, particularly the banks. Moreover, prevailing economic conditions at that time, especially high interest rates and a system-wide liquidity shortage, were not supportive to recapitalization using domestic funds. Therefore, the government decided in November 1997 to relax the ownership restriction by allowing foreigners to hold a majority stake in FIs for up to 10 years.[52] After the tenth year, the share of foreign ownership in these FIs would not be allowed to be increased, and any capital increase would have to be made available to Thai parties until the foreign equity stake falls below 50 percent.

The liberalization of foreign ownership provided a significant ground for recapitalization of private FIs later on. Foreign equity stake in Thai FIs has increased markedly during the past four years through either one of the following forms: (1) foreign banks purchasing a majority stake in private FIs from their large Thai shareholders; (2) foreign banks purchasing a majority stake in the privatized banks; or (3) foreign investors participating in new capital injection of FIs, especially the large private banks. Between January and May 1998, the three largest private banks succeeded in their first round of recapitalization after the crisis emerged by selling most of their newly issued shares to foreign investors.

At the end of June 2002, there were four fully-licensed foreign banks operating in Thailand as opposed to none before the crisis. Besides the two banks in which the authorities intervened that were privatized (NTB and RB), two small banks and one large finance company were taken over by foreign FIs during the period 1997-1998.[53] These three foreign FIs enter Thailand early with the objective of seizing market share when Thai FIs were struggling to survive and other foreign FIs were reluctant to enter. But it turned out that they were in a disadvantaged position to those that came in later through the government's privatization scheme; the three foreign FIs paid high prices for their shares before the economy reached its bottom and they received neither yield maintenance nor a gain loss sharing guarantee for the NPLs. The two foreign banks that took over Thai banks have incurred heavy losses from NPL resolution, and only one of them began registering slight after-provision profits in 2001.

THE GOVERNMENT'S CAPITAL SUPPORT SCHEME (THE AUGUST 14 PACKAGE)

At the beginning of 1998, private banks managed to issue a large amount of straight equity to recapitalize on their own.[54] Afterward, economic conditions in Thailand and in the region deteriorated markedly, and confidence in emerging markets, especially those in Asia,

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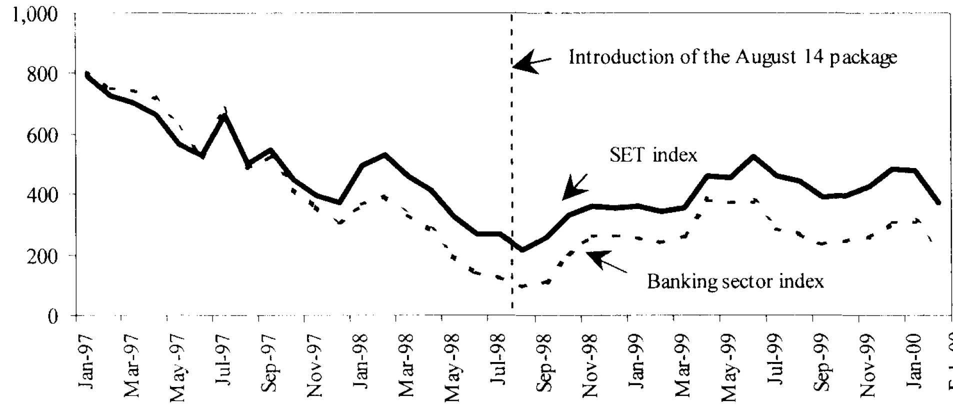
52 When foreign ownership was liberalized, the government also allowed Thai FIs to hold shares of other FIs for a period up to three years provided that the two institutions share the same top management. This permission was intended to facilitate the consolidation of small FIs as well as to help large banks to recapitalize their financial subsidiaries.

53 DBS and ABN Amro bought the majority stake of Thai Dhanu Bank and Bank of Asia, respectively. GE Capital also bought the majority stake of Asia Finance Company.

54 For instance, Bangkok Bank (BBL) and Thai Farmers Bank (TFB), respectively, raised 43,000 million baht and 33,000 million baht in new capital between March and May 1998. During the same period, Bank of Ayudhaya also succeeded in raising around 12,000 million baht in new capital.

continued to decline. The regional currencies were also volatile following the weakening of the yen against the US dollar in June 1998. NPLs in Thailand continued to increase, and most FIs had not fully provisioned against their NPLs. All Thai banks made substantial losses and needed to be recapitalized urgently. When the market perceived that the whole financial system could become insolvent, the SET's banking-sector index dropped by more than 70 percent during the second quarter of 1998 (chart 4.1).

Chart 4.1: SET index and banking sector index (Jan 1997-Feb 2000)



Source: SET.

Because of the declining macroeconomic environment, the remaining FIs had very limited, if any, likelihood of recapitalizing on their own. The authorities then realized the need to help protect the financial system's solvency by offering to recapitalize FIs using public funds. On August 14, 1998, the authorities introduced a plan committing up to 300,000 million baht in public funds to help to recapitalize private FIs until the end of 2000.[55]

Capital support by the government could be in the form of Tier-1 or Tier-2 capital. While the Tier-1 scheme was intended to help raise genuine capital which could be used to shoulder losses, the Tier-2 scheme was linked to FIs' performance in extending new credit and in NPL restructuring. In providing both Tier-1 and Tier-2 capital support, the government injected no cash into the FIs. The recapitalization was done by exchanging 10-year non-tradable government bonds for FIs' preferred shares in the case of Tier-1, and exchanging 10-year non-tradable government bonds with FIs' subordinated debt in the case of Tier-2. Although the bond-equity exchange did not improve FIs' liquidity, it helped to increase FIs' interest income because the government bonds paid market-related interest rates.[56]

With a view to protecting public funds and minimizing potential losses, the plan incorporated two major elements. First, it allowed for only potentially viable FIs to participate in the Tier-1 scheme. To this end, intervention would take place in FIs that were deemed unviable, just before the plan was announced. Each FI applying for Tier-1 capital support also needed to have positive capital left after fully provisioning against their classified assets at once rather than phasing in gradually as allowed by BOT. The up front provisioning requirement was needed to ensure that costs associated with existing NPLs were borne by existing shareholders prior to the recapitalization. Furthermore, the Tier-1 capital support

[55] It should be noted that when BOT ordered 10 FIs to raise capital in March 1997, the authorities also intended to help recapitalize these FIs through FIDF. However, the plan was not formalized and 16 finance companies were subsequently suspended in June 1997.

[56] The bonds paid fixed interest rates equal to the average one-year deposit rates of the five largest banks at the time of issue minus 1 percentage point.

scheme required that public funds be matched by new private capital injection of equal or greater value.[57] To this end, the government partially relied on the market in screening for viable FIs and in pricing the new shares issued, which was largely based on each FI's book value.

To encourage private investors to participate in the scheme, the government allowed participating investors to benefit from potential upside gains by giving them a three-year option to buy the government's shares at an exercise price equal to the government's investment cost plus carrying costs for the three-year period. This option also reflected the authorities' intention to hold shares in these FIs for only a temporary period and to provide the government with an automatic exit opportunity should the market price rise above the exercise price.[58]

Second, the plan consisted of the following elements to explicitly safeguard public funds: (1) for Tier-1 capital injection, new shares issued to both the government and new investors had preferred status over existing shares; (2) returns from the government's investment in preferred shares and subordinated debts were structured to cover the government's financing costs;[59] and (3) although the government would serve as a passive shareholder, the government or the participating investors had the right to change the management of FIs receiving Tier-1 capital support to avoid moral hazards. In most cases, the top management of the FIs receiving Tier-1 capital support was changed, and the government appointed only one to two directors for each FI despite its large share in its ownership.

By the time the capital support program expired at the end of 2000, 10 FIs had participated in the scheme with total capital support amounting to only 70,628 million baht, consisting of 61,304 million baht of Tier-1 capital and 9,324 million baht of Tier-2 capital. However, only one large bank, one medium-sized bank, and two finance companies utilized the Tier-1 capital support scheme.[60] The limited number of FIs applying for Tier-1 capital support could be attributed to the fact that other FIs were controlled by a small group of shareholders within connected families that, together with the management, preferred to stay away from potential government interference. Given the lack of political stability in Thailand, these banks feared possible changes in government policy and practice should there be a change in government. Furthermore, transactions between the FIs and their connected businesses could be subject to tighter scrutiny once the government became a major shareholder.

It should be noted that two out of four FIs receiving Tier-1 capital support did not apply for it until late 1999. The delayed participation in the capital support scheme could be partly attributed to the phasing in of BOT's loan loss provisioning requirement over a two-year period ending at the end of 2000. With this relaxation, FIs were allowed to buy time hoping for an improved market condition and a possibility to recapitalize from the market.

Despite the fact that only a limited number of FIs applied for the government's capital support scheme and that only 24 percent of the committed funds were utilized, the plan did succeed in improving confidence in the Thai financial system by establishing a backstop for Thai FIs. Politically, it also helped to prevent Thai FIs from being taken over by foreigners at too low a price. The SET's banking-sector index turned around after the plan was

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57 If an FI's Tier-1 capital fell below 2.5 percent of its risk-weighted assets after having fully provisioned against NPLs, the government was prepared to recapitalize the FI up to 2.5 percent in all. The matching fund requirement would apply only to the portion beyond the 2.5 percent.

58 It was crucial to have an exit strategy for the government incorporated within the plan because selling state assets in general is subject to stringent regulations and procedures. Furthermore, the option helped to ensure participating investors that the government would not sell its shares to other parties during the three-year period.

59 In the case of Tier-1 capital support, if the FI pays out dividends, the dividend rate must be at least 1 percentage point higher than the interest rate of government bonds. Similarly, the interest rate of the subordinated debts issued by FIs needed to be 1 percentage point higher than that of government bonds.

60 The four FIs were Siam Commercial Bank, Thai Military Bank, SG Asia Finance Company, and TISCO.

introduced. Improved confidence, together with declining interest rates, had enabled the remaining private FIs to raise a substantial amount of capital from the market afterward.

Up to the end of 2002, the government had incurred interest costs from its Tier-1 capital support scheme because the four FIs receiving capital support continued to have cumulative losses and, thus, could not pay out any dividend to cover the interest expenses of the government bonds as intended.[61] It should be noted that the government could have also made capital losses if its shares were required to be marked to the market as the market prices of these shares, with the exception of TISCO's, had largely been below their purchase prices.

The fact that the market prices of these shares had been below the purchase prices for most of the past three years also implied that only a limited number of participating investors had exercised options to buy the government's shares.[62] Given that the three-year options of the first bank receiving Tier-1 capital support expired in May 2002, the authorities had to explore new exiting alternatives.

RECAPITALIZATION EFFORTS USING HYBRID CAPITAL

Although it was clear when the government introduced the capital support scheme that the market environment was not supportive of recapitalization, some large private banks preferred to recapitalize on their own. As mentioned previously, these banks were owned and managed largely by connected family members, who would prefer to distance themselves from potential government interference.

Given that there was limited opportunity to recapitalize by issuing a large amount of regular equity, Thai Farmers Bank (TFB) and Bangkok Bank (BBL), the country's two largest private banks, decided to issue hybrid capital in February and April 1999, respectively. The hybrid capital combined preferred shares with subordinated debts. The instruments offered investors highly attractive returns commensurate with their risks while minimizing the diluting effects on existing shareholders.[63]

In both cases, the preferred shares and subordinated debts were structured as a mutual fund, and investment units of the mutual fund were then offered to institutional and large individual investors. The mutual fund consisted of two groups of assets. Assets in group 1 were non-cumulative preferred shares and perpetual subordinated bonds, which together were counted as Tier-1 capital. Group 2 assets comprised subordinated bonds, with a maturity up to seven years, paying very high interest rates (flowchart 4.1). If the maturity of subordinated bonds in group 2 was longer than five years, the bonds could also be counted toward Tier-2 capital.

By structuring the instruments as a mutual fund, the banks could guarantee investors an annual minimum return, paid by the high-yield subordinated bonds in group 2, as long as the issuing bank remains in operation. If the bank generates profits and accumulates sufficient retained earnings over time, investors will also receive additional return paid by the assets in group 1, and the rate of return would be more favorable than that paid to ordinary shareholders. In the case of TFB's SLIPS, the group-2 subordinated bonds paid a 22 percent interest rate per annum. As assets in group 2 accounted for half of the total issue value, the mutual fund offered a minimum return of 11 percent to investors. Similarly, the assets of group 2 in BBL's CAPS paid a 44 percent interest rate per annum, resulting in a minimum return of 11 percent as the assets of group 2 accounted for a quarter of BBL's total issue value.

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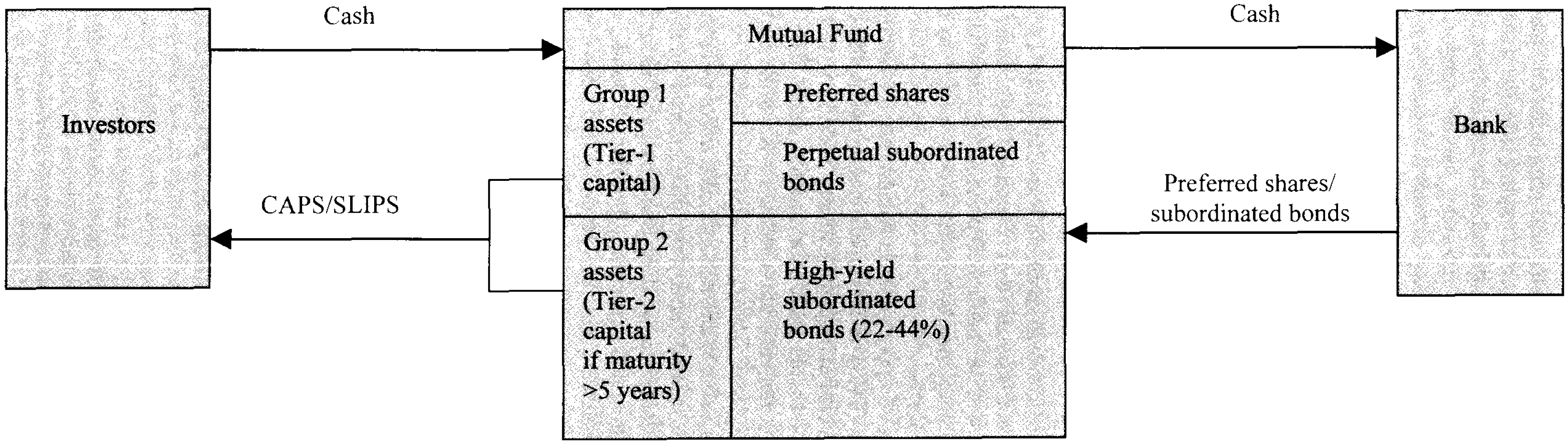
61 The government incurred no cost from the Tier-2 capital support scheme because the subordinated debts were required to pay interest at a rate higher than that of the government bonds.

62 Only TISCO's participating investors had purchased all shares from the government.

63 The hybrid instruments were called "Stapled Limited Interest Preferred Stock" (SLIPS) in the case of TFB and "Capital Augmented Preferred Securities" (CAPS) in the case of BBL.

Flowchart 4.1: Recapitalization through the use of hybrid instruments



By BIS' standards, the subordinated bonds in group 1 were qualified as Tier-1 capital because they had perpetual life, could not be separated from the preferred shares, and could be used to absorb losses of the issuing banks. In the event that the bank's Tier-1 capital falls below the BOT regulatory requirement, the redemption amount of the subordinated bonds shall be reduced proportionately to the bank's shortfall in Tier-1 capital. Although the features of hybrid capital in Thailand fit well with the BIS capital securities guideline, BOT allowed for a much larger share of hybrid instruments in banks' capital fund than did BIS. While BIS allowed hybrid Tier-1 capital to be counted only up to 15 percent of total Tier-1 capital, BOT allowed such an instrument to account for up to 33 percent of Tier-1 capital when they were issued by TFB and BBL, before reducing it to 25 percent of Tier-1 capital in June 1999.

From the perspective of the issuing banks, such a hybrid instrument was preferred to straight equity because its Tier-1 capital component could be structured to minimize the dilution effect on existing shareholders.[64] In the case of BBL's CAPS, its Tier-1 component consisted of only 3.5 million baht in preferred shares with voting rights and 34,497 million baht in non-voting perpetual subordinated bonds.

The hybrid instruments were well received by domestic investors, especially large depositors, because the deposit rates had declined quickly throughout 1998.[65] Apart from the two largest private banks, three small banks also issued similar hybrid capital during the first half of 1999, and the hybrid instruments had significantly helped Thai private banks to recapitalize up to the regulatory requirement.[66] In total, private banks issued hybrid capital worth of around 82.4 billion baht in 1999, and the share of hybrid instruments to each bank's Tier-1 capital at the time of issue ranged from 32 to 50 percent.[67]

The hybrid instruments have incurred high costs for the issuing banks, especially when comparing their guaranteed rates of return with the saving deposit rates that fell to only 1.75 percent at mid-2002. However, the guaranteed rate of return reflected the cost of capital rather than the cost of funds. In this context, the hybrid instruments could be viewed as low-cost capital when the issuing banks had very limited or zero opportunity to recapitalize using straight equity.

To ensure that their future costs of capital are appropriate, the issuing banks structured the subordinated bonds in asset group 2 with a maturity up to seven years. After these bonds mature, the investors will receive only returns from instruments in asset group 1, which will depend solely on the profits of the issuing banks. In addition, the issuing banks had incorporated redeeming features in these hybrid instruments. With approval from BOT, the instruments can be redeemed five years after their issue date.[68] In making such a decision, the issuing banks have to weigh the impact of the high interest expenses on the banks' profits against the potential dilution effects from replacing such hybrid instruments with straight equity. After all, these hybrid instruments provided Thai private banks with a temporary and flexible capital structure when the market environment was not supportive of recapitalization by straight equity.

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64 The subordinated bonds in asset group 1 had no voting rights.

65 Six-month time-deposit rates declined from 13 percent in January 1998 to only 6 percent at the end of 1998. For comparison, the hybrid instruments issued in early 1999 guaranteed a minimum return of 11 percent provided that the issuing banks remained in operation.

66 The three banks were Bank of Ayudhaya, DBS Thai Dhanu Bank, and Thai Military Bank. In the case of the Thai Military Bank, the hybrid capital was issued before the bank applied for the government's capital support scheme.

67 Stotz (2002, 40).

68 Initially, the BOT would allow an FI to redeem assets in group 2 if the FI either immediately replaced the redeemed assets with new Tier-1 or Tier-2 capital or demonstrated that its capital adequacy after the redemption did not fall below 12 percent of the risk-weighted assets. To further facilitate the redemption, BOT relaxed the second condition to 9 percent in March 2002.

END REMARKS

The Thai authorities have played a supportive role in facilitating the massive recapitalization of private FIs. Relevant regulations—e.g., liberalization of foreign ownership, phasing in of provisioning requirements, and hybrid capital features—were relaxed in line with changing market conditions to ensure that private FIs can meet their recapitalization needs from available sources of funds, ranging from foreign funds to domestic deposits.

The authorities also provided capital support using public funds when it became evident that market conditions were not supportive of recapitalization. Assistance under the scheme was intended to be temporary, and the scheme relied on market mechanisms in pricing and screening for viable FIs. The public capital support scheme succeeded in restoring confidence in the Thai financial system and providing a backstop for Thai FIs. However, direct utilization of the scheme was limited as family-controlled FIs feared possible government interference through elements incorporated in the scheme to safeguard public funds. Indeed, it was difficult to design a public capital support scheme that would be well received by FIs while at the same time sufficiently safeguarding public funds, especially in the eyes of the general public.

Chapter 5
Recapitalization and Restructuring of State-owned Financial Institutions

The need for recapitalization during the crisis was not limited to private FIs only. Indeed, capital deficiency of state-owned FIs was more serious.[69] State-owned FIs were required to serve various government policies—e.g., extending subsidized credit to specific sectors, providing liquidity support to weak state enterprises, providing banking services in rural areas, and participating in investment programs to support the SET—which had incurred losses and had not been compensated by the government. Furthermore, state-owned FIs had weaker management and less advanced banking infrastructure than most private FIs, resulting in higher operating costs and lower competitiveness. All of these factors led to under-capitalization of state-owned FIs when the crisis emerged; in addition, they limited the possibility of recapitalization by private funds during the crisis.[70] Therefore, recapitalization of state-owned FIs during the crisis was solely the burden of the government, the priority of which had to be weighed against that of other government spending programs, which could be more crucial during an economic crisis.

Before the crisis emerged, the authorities had a majority stake in two banks, KTB and BBC.[71] KTB in turn had a majority stake in a finance company, KTT. As the crisis unfolded and BOT intervened in a large number of FIs, the authorities had to recapitalize a number of these FIs to ensure that they remained in operation with adequate capital; these FIs then became state-owned institutions. At mid-2002, they included BT and two other banks in which the authorities intervened and failed to privatize, i.e., BMB and SCIB.[72]

RECAPITALIZATION OF KRUNG THAI BANK

KTB had capital adequacy problems from the outset of the crisis and needed successive rounds of recapitalization (table 5.1). The amount of recapitalization needed was substantial as KTB was the second largest bank. In early 1998, KTB began its first round of recapitalization by issuing new shares to existing shareholders, of which MOF and FIDF accounted for around 57 percent. The authorities had to purchase around 16,100 million baht in new shares issued by exercising their shareholders' rights and around 470 million baht in shares that were unsubscribed by other shareholders. The undersubscription by private shareholders was one of the first signs of declining public confidence in KTB, partly because

[69] In this study, state-owned FIs cover only commercial banks and finance companies.

[70] It should be noted that the need for state-owned FIs to serve government policies generally increases during an economic crisis. For instance, the Thai authorities used the two state-owned FIs in protecting depositors of the 58 suspended finance companies.

[71] The authorities had a majority stake in BBC after the bank was put under BOT's control in 1996 and subsequently recapitalized by FIDF.

[72] The authorities decided to merge BMB with SCIB on April 1, 2002.

it had been designated by the government to help protect the depositors of the 42 finance companies suspended in 1997.[73]

Table 5.1: KTB's recapitalization by the authorities

Timing	Methods of recapitalization	Amount of capital received (million baht)
1998		
February	Cash injection	16,570
December	Debt-equity conversion	77,000
1999		
August	Debt-equity conversion	108,000
2000		
September	Transfer NPLs to SAM	108,000
	Total capital increase	309,570
September	Return capital to FIDF	108,000
	Net capital increase	201,570

Source: Compiled from KTB's annual reports.

As in the case of private banks, the first round of KTB's recapitalization was not sufficient to shoulder losses as the economy deteriorated further, NPLs rose quickly, and loan classification and provisioning requirements were tightened. KTB had to be recapitalized in three subsequent rounds solely by the authorities, thereby raising MOF's and FIDF's share of ownership from around 57 percent at the end of 1997 to 95.4 percent at the end of 1999.[74]

Nevertheless, only the recapitalization in early 1998 involved injection of new money into KTB. In effect, the three subsequent rounds of recapitalization employed accounting techniques based on asset/liability swaps to raise KTB's capital to the regulatory requirement. These techniques were appropriate at that time as that bank had no liquidity shortage and the new capital could be used to realize additional losses from NPLs. In addition, such techniques helped to lower the government's financing needs when the government had significant borrowing requirements to stimulate the economy and mitigate the social impact of the crisis.

There were two main accounting approaches employed by the authorities in recapitalizing KTB: (1) merging two banks in which they had intervened, FBCB and BBC, with KTB and converting their outstanding loans from FIDF into KTB equity and (2) transferring KTB's NPLs to a government-owned asset management company, Sukumvit Asset Management Company (SAM), at an inflated price. The second and third rounds of recapitalization took place in late 1998 and 1999 and were based on the first accounting approach. The fourth round of recapitalization, utilizing the AMC approach, occurred in mid-2000 after SAM was established.

As discussed in Chapter 3, the authorities decided on August 14, 1998 to merge the whole of FBCB with KTB and transfer BBC's good loans, deposits, and part of its other liabilities to KTB.[75] The decision was intended to consolidate state-owned banks, minimize the up front costs of compensating depositors under the blanket guarantee scheme, and

[73] Unlike private banks, KTB, as a state-owned bank, received little interest from foreign investors and had to rely mainly on domestic investors for recapitalization. Apart from declining public confidence in the bank, the domestic monetary conditions were not supportive of recapitalization as domestic liquidity was tight and prevailing interest rates were among the highest during the previous four years.

[74] After KTB's capital reduction following the transfer of NPLs to SAM in 2000, MOF's and FIDF's share of ownership declined to 90.9 percent. A detailed discussion on SAM and the capital reduction is provided in the later part of this chapter.

[75] As the amount of BBC's good loans was much less than the amount of deposits and liabilities transferred to KTB, BBC had to issue FIDF-guaranteed promissory notes to KTB to compensate for the difference.

provide a means by which FIDF could recapitalize KTB without injecting new funds. Given that FIDF had extended a substantial amount of liquidity support to both FBCB and BBC and the two banks were not in a position to repay, FIDF could then use part of the funds to recapitalize KTB by first transferring to KTB, FBCB's and BBC's liabilities to FIDF and then converting them into KTB equity as needed.

KTB's recapitalization through this debt-equity conversion method amounted to 185,000 million baht, or four times KTB's ownership capital at the end of 1997. Although the combined liabilities of FBCB and BBC to FIDF exceeded that amount, the authorities had no intention to recapitalize KTB beyond its capital requirement projected at that time.[76] The projected amount was believed to be sufficient for provisioning against KTB's and FBCB's NPLs as well as meeting the additional capital required for good assets transferred from FBCB and BBC.

The recapitalization of the 185,000 million baht was done in two rounds. In December 1998, 77,000 million baht in FBCB liabilities to FIDF were converted into KTB equity to ensure that the merged bank met the capital adequacy and provisioning requirements for additional assets transferred from FBCB and BBC. The authorities also set restructuring conditions that KTB had to complete before FIDF would recapitalize the bank with the remaining 108,000 million baht. Among others, KTB was required to put in place effective management from the board of directors level, establish an audit committee, and tighten its credit approval procedures using a committee format. In addition, the authorities also required that KTB work toward finding a strategic partner with up to a 20 percent equity stake by the end of 2000 and reducing the government's share of ownership to below 50 percent by the end of 2002.

Given that the recapitalization was done through debt-equity conversion with no new funds available, this method of recapitalization did not help to increase KTB's earning capability. Furthermore, KTB had incurred higher operating losses after the merger as most assets transferred from FBCB were NPLs, which could not generate sufficient earnings to cover the interest paid on the transferred deposits. To this end, the authorities also had to provide a yield maintenance and loss-sharing guarantee to KTB for assets and liabilities transferred from FBCB and BBC. Similar to those provided under the privatization of banks in which the authorities had intervened, the yield maintenance approach was to ensure that the bank would receive sufficient earnings from ex-FBCB assets to cover interest payments on ex-FBCB liabilities. The loss-sharing guarantee was also intended to compensate KTB for losses of ex-FBCB and ex-BBC assets beyond BOT's provisioning requirement.

After the recapitalization of the 77,000 million baht, the quality of KTB's assets, including those transferred from FBCB and BBC, deteriorated quickly. Furthermore, the bank's restructuring plan was not moving forward owing to management conflicts, large NPLs outstanding, and the number of tasks required to merge these banks. The authorities then realized that, even with the loss-sharing guarantee on the transferred assets, KTB's recapitalization would require more than the remaining 108,000 million baht. The authorities then began to explore alternatives for setting up an AMC for KTB with a view to separating the good bank from the bad bank and preserving the good bank's financial position from further asset deterioration. While alternative AMC ideas were explored, the planned recapitalization of 108,000 million baht was put on hold until August 1999, when it became evident that KTB was in urgent need of recapitalization.

The second accounting approach used to recapitalize KTB involved the transfer of KTB's NPLs to SAM. SAM was an AMC specially created to handle KTB's NPLs, and was wholly owned by the FIDF. The Cabinet approved the establishment of SAM in April 2000, and the first lot of assets transferred in September 2000.

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[76] Because the whole of FBCB was merged with KTB, all of its liabilities to FIDF were then converted into KTB equity. On the other hand, only part of BBC's liabilities to the FIDF were converted into KTB equity.

The establishment of SAM was intended to meet three main objectives: (1) minimizing FIDF's overall financial burden in recapitalizing KTB as well as in suffering future losses from KTB's NPLs; (2) ensuring that KTB as a good bank would have sufficient financial strength with a low NPL ratio, low cumulative losses, and adequate capital for future operations; and (3) ensuring that NPL restructuring be carried out in an effective and efficient manner with little interruption. In effect, the authorities wanted to prepare KTB for privatization and tried to avoid the up front cost of recapitalizing KTB further by delaying realization of its NPL losses through SAM's operation.[77]

In order to meet the above objectives, the AMC design that was adopted for SAM had the following main features. First, NPLs transferred to SAM had to be sufficiently large. The authorities eventually decided to transfer to SAM KTB and ex-FBCB loans that had been past due for more than 12 months.[78] However, NPLs transferred did not include retail loans of less than 5 million baht because the handling of such loans would require KTB's branch network. In total, 519,380 million baht in NPLs were transferred to SAM, thereby reducing KTB's NPL ratio from 58 percent at the end of 1999 to 8.4 percent at the end of 2000.[79]

Second, the transfer price was structured to ensure that KTB had sufficient capital going forward and that it could reduce a large amount of cumulative losses by reversing its existing loan loss reserves into revenue.[80] Because the Thai Public Company Act prohibits listed firms with cumulative losses from paying dividends, the reduction in cumulative losses was crucial for the future price of KTB shares and, therefore, privatization proceeds that FIDF would receive. To this end, the government allowed KTB to transfer ex-FBCB NPLs to SAM at their original book value—i.e., the book value when FBCB was merged with KTB—despite the fact that additional provisions had been set against these loans after the two rounds of KTB recapitalization totaling 185,000 million baht.[81] As for KTB's NPLs, the loans were required to be fully provisioned up to BOT's provisioning requirements before transfer to SAM. KTB was then allowed to meet the full provisioning requirement by shifting part of the reserves previously set against FBCB's NPLs to be those of its own NPLs. In effect, the NPLs were sold to SAM at 61.8 percent of their face value.[82] KTB was then allowed to reverse 108,000 million baht of its existing reserves into revenues and use them to provision against remaining NPLs, lower its cumulative losses, and recapitalize the bank. In net terms, this accounting technique allowed KTB to register profits of 76,261 million baht in 2000 as opposed to losses of 91,972 million baht in 1999.

Third, SAM purchased NPLs from KTB by exchanging non-transferable five-year bonds guaranteed by FIDF. Similar to the concept of yield maintenance used in privatizing the banks in which the authorities intervened, the bonds issued by SAM were also intended to assist KTB in meeting its interest payments to depositors. Therefore, the bonds were structured to pay coupons every six months at a rate equal to KTB's average deposit rate plus other related fees, e.g., specific business tax and FIDF contribution fee. These bonds are callable by SAM as permitted by its cash flows generated from NPL resolution.

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77 Unlike a bank, an AMC that was not a bank's subsidiary was not required to meet the 8.5 percent capital adequacy requirement and could accumulate losses over time.

78 It should be pointed out that the criterion used in determining NPLs to be transferred to SAM was on a customer basis rather than an account basis. If a customer had many loan accounts with KTB, all loan accounts would be transferred to SAM provided that more than half of the total loans outstanding had been past due for more than 12 months. This customer-basis criterion was intended to help facilitate debt restructuring by SAM.

79 KTB's Annual Report for 1999, 23, 34.

80 At the end of 1999, KTB had cumulative losses of around 156,560 million baht.

81 FBCB's loans were largely under-provisioned when the authorities intervened in FBCB and merged it with KTB. With total loans of around 260,000 million baht, it had only 43,000 million baht of loan loss reserves. When KTB was recapitalized through debt-equity conversion totaling 185,000 million baht, more than half of the recapitalized amount was intended to be used as an additional provision against ex-FBCB loans.

82 For the 519,378.2 million baht of NPLs transferred to SAM, provisions amounted to only 198,126.2 million baht (KTB's Annual Report for 1999, 35).

Fourth, given that KTB transferred NPLs to SAM at an inflated price and that SAM and eventually FIDF would incur future losses from NPL resolution, KTB was therefore required to reduce its paid-up capital by 108,000 million baht and return that amount to FIDF.[83] The reduction of capital was also made possible by the reduction in KTB's risk assets of around one half after transferring NPLs to SAM and the bonds that it received in exchange for NPLs had an FIDF guarantee and, therefore, carried zero risk weight. Without the return the 108,000 million baht in capital to FIDF, KTB would be unnecessarily over-capitalized at FIDF's expense.

Fifth, the return of capital to FIDF in effect reduced the ownership stake of FIDF in KTB from 93.5 percent to 87.2 percent, which would in turn lower FIDF's share of potential upside gains from KTB despite the fact that it had assisted KTB and other private shareholders through various rounds of recapitalization. To ensure that FIDF would receive a fair share of KTB's upside gain, KTB issued warrants to FIDF entitling FIDF to buy KTB shares at 10 baht per share up to a total of 108,000 million baht within 10 years. Although the warrants enable the FIDF to recover its losses gradually by exercising its rights whenever the market price of individual KTB shares exceeds 10 baht, the warrants have in effect prevented KTB share price from rising and to some extent limited the government's privatization options.

After transferring NPLs to SAM and returning capital to FIDF, the Tier-1 capital-to-risk asset ratio of the new KTB stood at around 9.6 percent, well above the 4.25 percent required by BOT. KTB's cumulative losses also declined by around 60,000 million baht.[84] FIDF-guaranteed bonds accounted for around 32 percent of KTB's total assets, and the yield maintenance provided by these bonds partly contributed to the increase in KTB's net interest income from around 0.6 percent in 1999 to 1.4 percent in 2000. In effect, the government subsidized KTB's operations through SAM for a period of at least five years, i.e., the initial maturity period of the bonds.

To ensure that KTB will not incur an additional burden for FIDF in the future, KTB needs to be effectively restructured and to prepare itself for increasing competition in the Thai banking system. Furthermore, FIDF will have to structure the phasing out of SAM bonds in a gradual manner in order to avoid having any undesirable impact on KTB's liquidity, especially at the time of maturity.

RECAPITALIZATION OF BANK THAI AND THE BANKS IN WHICH THE AUTHORITIES INTERVENED AND FAILED TO BE PRIVATIZED

Apart from KTB, there were three other state-owned banks that needed further recapitalization by FIDF. They included BT—a bank that was formed by merging a bank in which the authorities intervened (UB) with 12 similarly treated finance companies and KTT—and two banks in which intervention was necessary and the government had failed in its privatization attempts during the period 1999-2000, i.e., BMB and SCIB. In April 2002, the authorities decided to merge BMB with SCIB.

Before BMB was merged with SCIB, FIDF had recapitalized each of them twice by converting their FIDF borrowings into equity (table 5.2). Nevertheless, they had remained undercapitalized since the authorities began their privatization process in 1999. During the privatization process, the two banks were allowed to maintain loan-loss provisions below BOT's requirements in the hope that, once they were privatized, new investors would inject new capital into the banks and the bank would also receive from the authorities yield maintenance and a loss-sharing guarantee for NPLs. When it became clear in the first half of

[83] It should be noted that the authorities have not revealed any projected losses that FIDF may incur through SAM.

[84] KTB's cumulative losses did not decline by 108 billion baht or the amount of provisions reversed because KTB had to make additional provisions against NPLs that remained with the bank.

2001 that the privatization efforts failed, the authorities had to find measures to recapitalize the two banks.

Table 5.2: Recapitalization of state-owned banks by the authorities (1998-2002)

(million baht)

Institution	Direct equity injection	Debt/equity conversion	Reversal of reserves from NPL transfer	Total recapitalization	Capital returned to FIDF
KTB	16,570	185,000	108,000	309,570	108,000
BBC		10,000		10,000	
BMB		64,190	54,039	118,229	29,410
SCIB		51,400	45,229	96,629	20,855
FBCB		32,000		32,000	
BT (including 12 finance companies)		86,982	63,519	150,501	37,068
Total	16,570	429,572	270,787	716,929	195,333

Note: Including capital increase that was written down to realize losses during the period.

Source: Compiled from the banks' annual reports and various other sources.

Given the lack of funds available to recapitalize the two banks up front, the authorities decided to follow the SAM model and recapitalized them using accounting techniques by transferring their NPLs to an AMC at inflated prices. For this purpose, FIDF established Petchburi Asset Management Company (PAM) in early 2001 to buy NPLs from BMB and SCIB. In June 2001, NPLs amounting to 101,237 million baht and 159,444 million baht were transferred from BMB and SCIB, respectively, to PAM. As a result, the NPL ratio of BMB and SCIB declined to 1.6 percent and 0.1 percent, respectively, at the end of 2001.

The basis for pricing BMB's and SCIB's NPLs transferred to PAM was indeed more generous than that used in transferring KTB's NPLs to SAM. In the case of BMB and SCIB, their existing loan loss reserves were first used to ensure that the banks had sufficient reserves for normal and special-mentioned loans left with them before reversing the remaining reserves in order to eliminate all of their cumulative losses.[85] Leftover reserves, if any, were then used to discount the value of NPLs transferred to PAM. Given that these two banks had limited reserves and high cumulative losses to begin with, there were no reserves left after they were used to eliminate their cumulative losses. Indeed, NPLs of these two banks were transferred at prices slightly below their loans' face values, implying that PAM would likely incur substantial losses in the future (table 5.3).

Like KTB, both BMB and SCIB had little loans left in their portfolios after transferring NPLs to PAM, and the FIDF-guaranteed bonds issued by PAM to purchase NPLs accounted for a large share of their assets, thereby lowering their capital adequacy requirements (table 5.4). Furthermore, the reversal of reserves to eliminate their cumulative losses resulted in over-capitalization of the banks. As a result, both BMB and SCIB reduced their paid-up capital to the level required by BOT and returned excess capital amounting to 29,410 million baht and 20,855 million baht, respectively, to FIDF.[86]

85 In the case of KTB, not all of the bank's cumulative losses were eliminated.

86 Unlike the case of KTB, BMB and SCIB did not issue any warrant to FIDF after the return of capital because the two banks were almost wholly owned by FIDF.

Table 5.3: NPLs transferred from state-owned banks to AMCs or CAPs

(million baht)

Institution	Date of transfer	Receiving institution	Amount of NPLs transferred to AMCs or CAPs	Transfer price*	Amount of reserves reversed	Amount of capital returned to FIDF
KTB	Sep-00	SAM	519,378	321,252	108,000	108,000
BMB	Jun-01	PAM	101,237	102,347	54,039	29,410
SCIB	Jun-01	PAM	159,444	162,914	45,229	20,855
BT	Feb-01	CAP	188,690		63,519	37,068
Total			968,749		270,787	195,333

Note: * Transfer prices of BMB's and SCIB's NPLs reflected the amounts of bonds issued by PAM at the time of their first transfer. As the amounts of NPLs transferred were less than originally envisaged, they will have to be revised accordingly. The adjusted transfer prices will be slightly below the NPLs' face values.

Source: Compiled from the banks' annual reports.

Table 5.4: Share of FIDF-guaranteed bonds and CAP assets held by state-owned banks (at the end of 2001)

(million baht)

Institution	Total gross loans (before provision)	Total assets	FIDF-guaranteed bonds	Assets in CAPs	Share of FIDF-guaranteed bonds or CAP assets to total assets (percentage)
KTB	411,021	976,741	298,344		30.54
BMB	61,150	189,946	72,937		38.40
SCIB	41,351	297,838	142,059		47.70
BT	237,935	271,202		180,671	66.62

Note: Including FIDF-guaranteed bonds issued by AMCs and Thai Asset Management Corporation (TAMC).

Source: Compiled from the banks' annual reports.

In the case of BT, FIDF also converted the debts of the FIs in which the authorities intervened into BT's equity. As with the other state-owned banks, the initial round of recapitalization had proven to be insufficient, and the authorities had to subsequently come up with additional recapitalization methods. Given BT's relatively small loan portfolios and the fact that it had limited cumulative losses to begin with, the authorities decided to use the covered asset pool (CAP) approach, rather than the AMC approach, to help ensure its capital adequacy. Under this approach, BT's NPLs amounting to 180,671 million baht were kept within the bank, but separated into a CAP, of which their future losses were guaranteed by FIDF for a period of five years.[87] To this end, BT did not have to make provision against NPLs in CAP, and could reverse provisions that had been previously provided against those NPLs to eliminate its cumulative losses. As in the case of the other three state-owned banks, BT was overcapitalized after the provisions were reversed, and thus returned 37,068 million baht in capital to FIDF in 2001. Given that the capital reduction lowered FIDF's share of

[87] BT's NPLs under CAP accounted for around 75 percent of the bank's total loans at the end of 2001 (BT's Annual Report for 2001, 45).

ownership in the bank from 98.9 to 96.3 percent, BT issued warrants to FIDF allowing the latter to buy shares at 10 baht each up to the amount of capital reduction. These warrants were intended to enable FIDF to benefit from potential upside gains from BT's restructuring.

In addition, FIDF provided BT with a yield maintenance guarantee similar to that provided to the privatized banks.[88] This was to ensure that BT would have sufficient interest income for paying interest on its deposits.

Despite the different methods used by the authorities to recapitalize state-owned banks, both the AMC and CAP approaches helped to defer realization of the financial burden to the future.[89] Furthermore, they helped to reduce FIDF's financing costs in present value terms as compared with borrowing funds for up front recapitalization. However, the real financial burden for FIDF would depend on the effectiveness of NPL resolution and the ability to privatize its equity stake in these banks, which would in turn rely on their restructuring outcomes.[90]

RESTRUCTURING OF STATE-OWNED BANKS

Given that the FIDF had substantial investments in the state-owned banks and incurred sizeable contingent liabilities in these banks, the only way to minimize public costs would be to restructure these banks effectively with a view to maximizing their values from privatization. Unfortunately, the authorities had concentrated their efforts during the first four years after the crisis on designing appropriate recapitalization and privatization modalities for these banks rather than on their restructuring. In addition, KTB, BT, and subsequently SCIB had to make considerable efforts in completing the mergers of other FIs with their institutions. These mergers have affected all aspects of the banks, encompassing, among others, the branch networks, databases, information technology (IT) systems, human resources, work procedures, back-office operations, and customer services. They required considerable resources and time, and placed a heavy burden on the core institutions.

The only evidence of restructuring of the state-owned banks was making three of them "good banks" by transferring almost all of their NPLs to AMCs. However, the separation between good banks and bad banks did not materialize until late 2000 in the case of KTB and mid-2001 in the case of BMB and SCIB.[91] Furthermore, it appeared that the separation of assets was intended mainly to facilitate the accounting recapitalization of the banks rather than implementing an effective and comprehensive restructuring plan. In all cases, the staff of these banks remained responsible for restructuring NPLs at least during the first year after their NPLs were sold to AMCs.[92] As a result, the resources of the good banks could not be reallocated and restructured effectively.

To maintain their competitiveness and prepare themselves for intensifying competition in the Thai banking system, especially from more-advanced global players, all

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88 In the case of BT, the yield maintenance interest rate was 1 percentage point higher than BT's average deposit rates. The yield maintenance also covered a period of five years.

89 In most cases, the financial burden will have to be realized between 2005 and 2006 during which time the authorities will have to avoid potential bunching repayments of FIDF-guaranteed bonds.

90 In terms of NPL resolution, it is unclear which model would yield a better result. In the case of CAP, NPLs remain with the original FI and therefore could be addressed with little interruption. Although there could be difficulties related to NPL transfer in the AMC approach, the AMC could be more effective in NPL restructuring if it is run by professional asset managers. Bank management could then focus only on restructuring the good bank.

91 As mentioned above, BT's NPLs remained with the bank under a CAP.

92 Chapter 9 discusses in detail NPL restructuring by state-owned banks and AMCs.

private banks have restructured their operations on a large scale.[93] By contrast, the restructuring of state-owned banks had been sluggish and less evident, and their competitiveness had eroded over time. If their restructuring efforts continue to lag behind those of private banks, the authorities will have difficulties in privatizing them and recovering their investments. Indeed, these banks may require further recapitalization and the authorities will not be able to contain public costs as planned.

During the past four years, there have been a number of crucial factors contributing to the delay in the restructuring of these state-owned banks. First, the authorities faced difficulties in finding appropriate senior managers and directors for these banks. Even before the crisis, Thailand had only a limited number of qualified professional bankers. After the crisis emerged, they were in high demand by their own institutions struggling to survive and the new foreign entries. The top management of the FIs in which the authorities intervened and those that had been suspended was also wiped out from the financial circle as many of them had been under criminal investigation and, hence, prohibited by BOT from taking up management positions in other FIs. Furthermore, finding top management and directors for the state-owned banks was constrained by state regulations. Employees of the state-owned banks would be considered as state employees and had to comply with related laws and regulations. Among others, they had to declare their own and their family members' assets to the Counter Corruption Commission and were liable to criminal lawsuits if they had caused the state to incur any loss.[94] In addition, past experience tended to suggest that the top management of the state-owned banks had a high chance of being replaced and investigated when there is a change in government.

In the face of all these difficulties, the authorities could not find a professional banker to head KTB until mid-2002, and that banker became KTB's third president during the four-year period.[95] There was also a period of around 11 months during the period 1998-1999 when KTB had no chief executive officer. As for the banks in which the authorities intervened, the authorities had to borrow senior managers of private banks to serve as their temporary chief executive officers.[96] In most cases, there was an understanding that their terms would be temporary and they would be able to return to their original banks after the authorities had succeeded with privatization. When it became clear that the authorities had failed to privatize BMB and SCIB, they had to find long-term management for the two banks and they experienced similar difficulties as in the case of KTB. In addition, the board of directors of these state-owned banks consisted mainly of government officials, who have little knowledge of banking and tended to supervise the operations of these banks by strictly following rules and regulations.

Second, restructuring of the banks in which the authorities intervened, especially BMB and SCIB, was hindered by their uncertain future. Because the authorities had intended to privatize them from the beginning, their transition management was charged mainly with taking care of their daily operations and facilitating the privatization process. Moreover, the authorities felt that it would be better not to make any drastic changes to the banks, assuming that the new investors would need to restructure them to suit their own requirements. The

[93] For comparison, large private banks had cut their employees by around 20-30 percent, invested heavily to upgrade their information technology systems, improved their risk-management capability, reorganized their branch networks, and centralized their back-office operations.

[94] This potential criminal liability was also one of the crucial factors obstructing debt restructuring in state-owned banks.

[95] By appointing the banker as the head of KTB, the authorities relaxed its standard after the change of government in February 2002. The banker was previously a chief executive officer of a finance company that had been suspended and closed by BOT in 2000.

[96] BT and NTB were exceptions. In the case of BT, it was managed by the management of KTT. For NTB, a BOT official was sent to head the bank for a short period pending finalization of a privatization agreement with Standard Chartered Bank.

authorities were also reluctant to approve any large investment in the banks owing to their tight capital constraints.

Unfortunately, the privatization process had taken a long time before it became evident that the privatization of BMB and SCIB would fail. As a result, the restructuring process of these two banks only began in early 2002, at least three years later than that of private banks. Given that they had limited competitiveness from the beginning, one may wonder whether these state-owned banks will be able to recover their lost ground, particularly in view of the fact that their restructuring efforts are being guided by government officials. Recently, their restructuring programs were severely disrupted by the decision in April 2002 to merge BMB with SCIB.

Unlike BMB and SCIB, BT's future was decided from the outset in that it would not be privatized in a take over by a large investor or a strategic partner. On the contrary, the authorities wanted to privatize BT among small shareholders, through the stock exchange, after the bank had undergone restructuring. Despite the fact that BT's management had to spend most of its efforts in merging 13 FIs in which the authorities intervened with KTT, they have succeeded in moving ahead of BMB and SCIB in restructuring.

Third, the restructuring of all state-owned banks has been hindered by political interference. The banks were required to support various government policies, including, among others, maintaining high deposit rates and extending special credit to certain economic sectors. These policies were intended to alleviate the social impact of the crisis as well as to facilitate an early economic recovery. Moreover, the authorities were reluctant to allow the banks to lay off redundant staff amid an economic crisis. Given that these banks lost their capable staff during the period of uncertainty, they ended up being over-staffed with relatively lower quality staff than that of private banks.

It should be pointed out that direct political interference was highly evident in the case of KTB. In the early stage of restructuring, the management of MOF, FIDF, and KTB had conflicting views on their authority over KTB as well as on KTB's restructuring approach. In addition, investigation into KTB's past lending practices had unveiled certain suspicious cases linked to politicians. As a result, the conflicts escalated into political issues, and KTB's president had to step down. This incident had greatly obstructed KTB's restructuring efforts as well as damaged the bank's reputation.

Fourth, the recapitalization of state-owned banks through accounting techniques resulted in distorted balance sheets. After their NPLs were transferred to AMCs, the banks in exchange received FIDF-guaranteed bonds, which accounted for 30-47 percent of their total assets at the end of 2001 (table 5.4). Although the bonds were preferred to NPLs in terms of the interest received and capital requirements, having a large portion of bonds on their balance sheets could hinder their long-term growth and competitiveness. Among others, the bonds are non-tradable and, therefore, cannot be exchanged for real liquidity, if need be. Furthermore, these bonds have an unclear future after they mature. The market is fully aware that FIDF will not be able to retire all of these bonds when their terms expire, and they may have to be rolled over many times.

The large proportion of bonds on these banks' balance sheets also limits the banks' future profitability. The bonds pay returns just to cover the deposit costs of the banks, with no contribution to banks' profits. As most banks earn an increasing share of profits from fee-based income by offering services to their borrowers, the state-owned banks have much more limited sources of fee income as compared with private banks of similar size. Therefore, they will likely have a relatively limited ability to compete and grow income in the long term.

As mentioned previously, the successful restructuring of the state-owned banks is crucial for the authorities to recover their investments in these banks and to contain public costs. The competitiveness of these banks needs to be clearly strengthened so that they can be privatized at relatively high prices. Furthermore, the authorities should explore whether or not they will be able to privatize all state-owned banks within a given timeframe. If the privatization is unlikely to materialize, they may need to find alternative plans to deal with these banks. For instance, they may need to further reduce the number of state-owned banks and concentrate their efforts on restructuring the remaining banks rather than allowing them to compete among themselves.

END REMARKS

As compared with other funding needs during the economic crisis, recapitalizing state-owned FIs was not the Thai authorities' top priority. Furthermore, state-owned FIs were not in need of liquidity after the financial system had stabilized. The authorities had, therefore, recapitalized state-owned FIs using a number of accounting techniques, including debt-equity swaps and selling NPLs to state-owned AMCs at inflated prices. While these accounting techniques helped to limit the authorities' up front recapitalization costs, the authorities will have to realize their actual costs over time. To this end, the total public costs will be subject to various policy and economic risks, especially if the necessary measures are not subsequently implemented as planned.

The Thai experience has demonstrated that recapitalization alone is not sufficient to contain public costs. The authorities also need to restructure state-owned FIs, especially those FIs in which they had to intervene, from the outset with a view to minimizing future losses and maximizing recoveries from privatization. In addition, the authorities need to retire gradually a large amount of captive bonds, issued to recapitalize state-owned FIs, in order to reduce distortions in their balance sheets. As restructuring the FIs in which the authorities intervened requires a lot of effort, it is important that the authorities be committed to taking drastic measures. Most importantly, FIs need to be managed by professional bankers with limited government interference.

Chapter 6
Liquidating Assets of the Closed Finance Companies

After FRA decided in December 1997 to close 56 of the 58 closed finance companies, FRA had to embark on the major task of liquidating closed companies' assets, totaling around 851,000 million baht (or around 18% of GDP). The authorities intended to complete the liquidation process in a short period of time with a view to returning assets locked in these FIs to productive use and preventing FRA from becoming an NPL warehouse.[97] It was also hoped that early liquidation of these assets would help to limit further deterioration of their quality and, therefore, maximize recoveries for creditors of these FIs. Because the closed FIs owed around 84 percent of their total liabilities to FIDF, maximizing recoveries from these assets would also help to contain public costs.[98]

It should be emphasized that FRA was set up as the liquidation agency for the assets of the closed finance companies. When FRA was established, the authorities also set up another state-owned agency, the Asset Management Corporation (AMCorp), as the bidder of last resort in FRA's asset auctions. In so doing, AMCorp would provide floor prices in auctions and purchase assets that could not be sold to private bidders at higher prices. AMCorp would then restructure the assets with a view to maximizing recoveries for the government over a longer time horizon. The existence of AMCorp was also expected to help minimize collusion among private bidders.

Liquidating a large amount of assets amid a financial crisis was an enormous and challenging task. It also required substantial preparation by FRA and the other relevant agencies. Furthermore, there was limited domestic demand and limited domestic funds available for these assets during the financial crisis. Given that the economic recovery was highly uncertain, FRA's asset liquidation process had drawn a lot of criticism from the public, especially for incurring high public costs. The remainder of this chapter summarizes FRA's operations and results as well as addresses key concerns over the FRA's liquidation outcomes.

FRA OPERATIONS AND THE ASSETS OF THE CLOSED FINANCE COMPANIES

As of December 1997, FRA estimated that it had on hand 851,000 million baht of assets, which could be classified into core and non-core assets.[99] Core assets comprised different types of loans totaling around 771,000 million baht (90.6% of total assets). Non-core assets—e.g., investments in securities, real estate, automobiles—amounted to around 80,000 million baht. Subsequently, the asset values were revised upward slightly as shown in table 6.1.

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97 FRA's conceptual design was largely influenced by IMF, following the approach used in Sweden during the early 1990s.

98 Most of these FIs' liabilities were due to FIDF because FIDF had provided them with enormous liquidity before they were suspended. In addition, FIDF had provided them with a deposit protection scheme by exchanging deposits for promissory notes of state-owned FIs with FIDF's guarantee.

99 The amount of assets was based on accounting values as of December 1997 (FRA 2001, 2).

Table 6.1: Assets of closed finance companies under FRA operation

	Outstanding balance (million baht)
Core assets	772,521.4
- Commercial loans	522,519.1
- Leasing loans	51,812.2
- Housing loans	24,617.0
- Construction loans	1,295.4
- Unclassified core assets	172,277.8
Non-core assets	96,438.4
Total	868,959.8

Source: FRA (2002, 76)

It should be emphasized at the outset that the 56 finance companies were closed down largely because of the poor quality of their assets. For instance, the largest lot of commercial loans that were auctioned by FRA in December 1998 already had a high NPL ratio (based on the three-month definition) of 78 percent when they were taken over by FRA in December 1997. The NPL ratio subsequently rose to 97 percent when they were auctioned off one year later (FRA 1999, 4). Furthermore, an independent auditor tasked with auditing FRA's assets estimated in December 1997 that FRA would recover only around 42 percent of the assets' face value (FRA 2000, i).[100] Given that the assets were of very poor quality from the beginning and the economy continued to deteriorate sharply after the finance companies were closed down, it would be unjustified to simply evaluate the effectiveness of FRA operations by comparing its asset recoveries with their face value.

As for methods used in liquidating FRA's assets, the FRA Emergency Decree empowered the FRA Board to select the most appropriate method for each type of asset. However, the decree was in favor of open bidding. Out of total core assets of 670,690 million baht that had been settled by the end of 2001, assets worth 600,244 million baht were liquidated through open bidding (FRA 2002, 76). For the remainder, FRA had entered into restructuring agreements with debtors, recovered assets through loan collection, and pursued legal cases against strategic NPLs.

FRA auction operations were indeed one of the largest operations of this type in the world that had been completed in a short period of time. Such operations required substantial preparation efforts. For instance, FRA had to group assets governed by around 446,000 contracts to suit investors' interests. FRA also had to prepare databases and data rooms of credit files and collateral to facilitate asset examination by potential bidders. Preparing such databases and credit files was further complicated by the fact that most of the suspended finance companies' databases and documentation systems, especially those related to their connected loans, were poor and incomplete. In addition, FRA had to prevent further deterioration of asset quality, conduct a number of international road shows, prepare a number of necessary contracts, deal with legal issues involving debtors and creditors of the suspended finance companies, respond to domestic public relations and political issues, and downsize the operations of the 56 closed finance companies. Despite these difficulties, FRA managed to conduct its first auction of core assets (hire-purchase loans) in June 1998, i.e., only six months after the closure of the 56 finance companies. The first auction of commercial loans was conducted in December 1998, or one year after the finance companies were closed down.

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[100] To facilitate effective asset liquidation and measure performance of an NPL disposing agency, it is crucial that the agency assess the real values and conditions of its assets when taking them over. Unlike FRA, other state-owned AMCs in Thailand failed to assess the quality of their assets when taking them over, resulting in difficulties in evaluating their effectiveness in NPL resolution.

By the end of 2001, FRA had made settlement on assets worth 748,091 million baht, or 86 percent of the FIs total assets, and recovered cash, including returns on investments, of around 264,148 million baht, or 35.3 percent of the assets' face value (FRA 2002, 76). Around 600,244 million baht of core assets had been auctioned off, with the average recovery rate being 25.0 percent.[101] Among the core assets, hire-purchase loans and mortgage loans yielded the highest recovery ratios of 48.0 percent and 46.8 percent, respectively, in part because they had been well secured with collateral and they were auctioned off early on in FRA's liquidation process. Table 6.2 provides details of recoveries from each asset type.

Table 6.2: Recoveries from FRA auctions up to the end of 2001

	Value of assets sold	Recovery (million baht)	Recovery rate (percentage)
Core assets	600,243.6	150,026.3	25.0
- Commercial loans	522,519.1	113,489.7	21.7
- Hire purchase loans	51,812.2	24,858.8	48.0
- Mortgage loans	24,617.0	11,520.0	46.8
- Construction loans	1,295.4	157.8	12.2
Non-core assets	77,401.6	35,291.7	45.6
Total	677,645.2	185,318.0	27.3

Source: FRA (2002, 76).

FRA had around 120,870 million baht (original accounting values) of assets left at the end of 2001, consisting of around 101,830 million baht in core assets and 19,000 million baht in non-core assets (FRA 2002, 76). Most of the remaining core assets were in the court process, and their recoveries would largely be determined by court rulings. As for the remaining non-core assets, their real current values would be much lower than their December 1997 accounting values when taking depreciation into account.

FRA was designed to have a limited life. It began the process of winding down in early 2000 or three years after its establishment. To complete the legal liquidation process, all 56 finance companies had been brought into the bankruptcy proceedings by early 2002. Between November 2000 and mid-2002, FRA had distributed among the creditors of 50 closed finance companies its net cash recoveries of around 218,056 million baht, of which FIDF received 87.5 percent (FRA 2002, 80). FRA was expected to have distributed the remainder of its cash recoveries to the creditors of the other six closed finance companies by the end of 2002.

CONCERNS OVER THE FRA LIQUIDATION OPERATIONS

It may be argued that FRA's mission has been completed as designed. FRA managed to auction off around 80 percent of the assets within three years of the 56 finance companies being closed down, and most of its operations were expected to end in 2002, or six years after FRA's establishment. Through these auctions, FRA had returned the assets equivalent to around 14.7 percent of the 2001 GDP to the market for productive uses. FRA also managed to recover around 35.3 percent of the assets' face value as compared with the benchmark of 42

[101] For some lots of commercial loans, FRA entered into a profit-sharing agreement with the winning bidder because the prices offered were considered too low. Therefore, the actual recovery rate will likely be higher than the average rate mentioned above when taking into account potential returns from such profit-sharing agreements.

percent estimated in late 1997 before the economy contracted further. Nevertheless, despite these achievements FRA operations have been heavily criticized for incurring excessive public costs, mainly based on the following three arguments.[102]

First, the public was of the view that FRA favored a few large foreign bidders over Thai bidders in its sale of core assets. For the core assets totaling 600,243 million baht in value that had been auctioned off, foreigners, AMCorp, and Thai private bidders won, respectively, around 50.2 percent, 32.8 percent, and 17 percent of the total auctioned amount (table 6.3). Furthermore, foreigners that won the auctions consisted of only three to four large institutional players, some of which were connected and perceived to have colluded in the process.

Table 6.3: Core assets sold at FRA auctions by groups of purchasers

	Value of assets (million baht)	Share of total core assets sold (percentage)	Average recovery rate (percentage)
Total amount sold	600,243.6	100.0	25.0
- Purchased by foreign entities	301,063.7	50.2	27.2
- Purchased by Thai entities	299,179.9	49.8	22.8
- AMCorp	197,047.9	32.8	17.1
- Thai private entities	102,132.0	17.0	33.8

Source: FRA (2002, 77).

In practice, the FRA auctions were open to all bidders on an equal basis. However, when FRA conducted its auctions of core assets in 1998, the Thai economy was at its bottom and most Thai FIs were struggling to recapitalize. None of the large Thai FIs participated in FRA auctions because they lacked capital that could be used to cushion against FRA's assets if they were to win the auctions. Furthermore, Thai FIs already had a large amount of NPLs on their balance sheets and had no experience in making profits from managing non-performing assets. Consequently, only a few small Thai finance and leasing companies participated in the FRA auctions.

That more than half of FRA's assets were purchased by large foreign bidders could also be attributed to the fact that FRA's assets were allocated in large lots.[103] It is believed that more bidders, especially Thai bidders, could have participated in the FRA auctions and perhaps this might have resulted in higher recoveries if the assets had been auctioned off in smaller lots. Nevertheless, allocating assets in smaller lots could have had some drawbacks. In particular, small lots may have facilitated collusion between debtors and potential bidders, which could in turn have generated economic distortion.

Second, FRA was criticized for not allowing debtors of the suspended finance companies to bid for their own loans. The public perceived that public costs could have been lower if the debtors were allowed to bid for their own loans. This belief was substantially enhanced when they learned that some foreign bidders had encouraged debtors to enter into pre-auction loan buy-back agreements.

The authorities and FRA had a solid policy of not allowing debtors to participate in FRA auctions because they wanted to minimize moral hazards and restore a good credit

[102] It should be noted that critics tend to compute FRA's losses based on the assets' original face value. As pointed out previously, face value cannot be used as appropriate benchmarks for FRA's operations because most assets were already non-performing when they were transferred to FRA.

[103] The majority of commercial loans were allocated into lots larger than 10,000 million baht (FRA 2002, 60).

culture in the Thai financial system.[104] The authorities believed that, if the debtors of the closed finance companies were allowed to buy back their own loans at a discount, the debtors of the remaining FIs would likely stop servicing their loans in the expectation that they could buy back their loans after their FIs failed. Such a practice would have been detrimental to the Thai financial system, which was highly fragile at that time.

Allowing debtors to bid for their own loans could also have adversely affected Thailand's corporate structure and damaged the country's long-term competitiveness. If debtors of the suspended finance companies could have bought back their loans at a discount, they would have had an advantage over their business competitors owing to their lower financing costs. In the end, good and competitive entrepreneurs that had fully honored their loan obligations would not have been able to compete. On the contrary, entrepreneurs who failed to service their loans to the suspended finance companies, because they were unable to pay or unwilling to pay, would have been bailed out. This practice would not only have undermined the integrity of Thai entrepreneurs, but also damaged the country's long-term competitiveness.

Furthermore, there was no guarantee that the FRA would have been able to sell assets at higher prices if the debtors had been allowed to bid, because they would have had an incentive to worsen the quality of their loans as much as possible prior to the auctions. In addition, debtors' participation in the auction would have discouraged other potential bidders from participating because other bidders would have had less information on the loans.

FRA tried to implement a number of safeguards to prevent borrowers from benefiting from the auctions, especially from colluding with potential bidders prior to the auctions. These safeguards included, among others, arranging assets in large lots to minimize collusion between potential bidders and debtors; requiring that bidders disclose to FRA all contracts made with debtors prior to each auction; prohibiting bidders from entering into a contract to sell assets to debtors within six months after each auction; requiring that winning bidders submit their asset management plan before finalizing their sale contracts; and reserving the right to cancel any auction if it had evidence of collusion among bidders or between bidders and debtors.

It should be pointed out that most of these efforts were introduced in response to a public outcry prior to the first commercial loan auction in December 1998 and were focused on preventing pre-auction colluding behavior. Indeed, FRA had neither legal authority nor control over bid winners after the transfer of assets and, therefore, could not effectively prevent bid winners from selling loans to debtors afterward.

Third, FRA was criticized for selling assets too quickly amid the economic crisis, during which asset prices were discounted heavily because of economic risks. The public was of the view that FRA could have managed the assets and sell them at higher prices after the economy clearly recovered.

As mentioned previously, FRA was set up with a specific legal mandate to liquidate the assets of the closed finance companies and, therefore, was not equipped with asset management capabilities. Furthermore, it was believed that asset management should have been handled by professional asset managers. The 56 closed finance companies had been suspended for a long period without proper care of their assets, resulting in sharp deterioration of their asset quality. Any delay in the FRA auctions could have resulted in further asset deterioration and higher public costs.

Delay in FRA auctions could also have created uncertainty among debtors of the closed finance companies. When the finance companies were suspended, debtors' collateral was frozen and many of them had no alternative FI, especially to fund their working capital. Early FRA auctions helped to release frozen collateral for productive use, which could in turn help to facilitate the economic recovery.

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[104] Debtors of the closed finance companies were not allowed to bid for any lot of assets in which the debtors' outstanding loans accounted for more than 10 percent of the lot's outstanding amount.

Because the closed finance companies had considerable exposure to the real estate sector, early FRA auctions would also facilitate the clearing of real estate stock and allow asset prices to recover.[105] Furthermore, early FRA auctions helped to facilitate corporate debt restructuring. In contrast to the slow pace of debt restructuring between operating FIs and debtors, FRA bid winners appeared to make decisions on debt restructuring, especially a "hair cut," at much faster speed. While operating FIs were trying to maximize their recoveries with a view to preserving their limited capital, FRA bid winners had simply used their purchase prices as their recovery benchmarks. In addition, foreign bid winners had the incentive to recover their investments in the shortest time horizon possible. These elements contributed to the fast pace of debt restructuring of the closed finance companies' loans.

OPERATIONS OF AMCORP

As mentioned previously, AMCorp was set up to complement FRA's operations. It was intended to serve as the bidder of last resort in FRA auctions and serve as the restructuring agent for assets that could not be sold to private bidders.[106] At the time of its establishment, the authorities were not certain of the magnitude of AMCorp's work. It was established with only 1,000 million baht of capital from FIDF.

When FRA had to cancel the sale of some commercial loans during its largest auction in December 1998, it became clear to the authorities that there was little interest from private bidders and AMCorp would have to participate actively in the subsequent auctions. AMCorp's capital was subsequently increased to 10,000 million baht, and it began participating in FRA auctions in March 2001. Altogether, AMCorp purchased 197,048 million baht in assets, or around 29.1 percent of total assets auctioned by FRA, and its payments were made in the form of AMCorp bonds guaranteed by FIDF. AMCorp paid an average price of 17.1 percent of the assets' face value, which was among the lowest recovery rates for FRA's core assets (table 6.3).

Most of the assets that AMCorp purchased from FRA were in the form of commercial loans and real estate loans. Given that AMCorp was the bidder of last resort, the quality of assets purchased by AMCorp was among the poorest of the suspended finance companies. Nevertheless, by the end of April 2002 AMCorp had dealt with assets worth around 195,239 million baht, or almost all the assets purchased from FRA.[107] Among these assets, debt restructuring accounted for 122,720 million baht (62.8%), and AMCorp had brought 71,926 million baht in assets under court proceedings. As part of the debt restructuring process, AMCorp had taken over a large amount of real estate through debt-asset swaps; these assets would need to be sold over time.

As with other winning bidders at FRA auctions, AMCorp made rapid progress in managing assets within its three years of operations. While other private bidders may simply add a required profit margin over their purchase prices, AMCorp should not follow this practice. By contrast, it should endeavor to maximize recoveries at arm's length, with a view to minimizing public costs. Unfortunately, AMCorp has released little information on its recoveries.

[105] During the FRA auction period, individuals feared a further decline in real estate prices and were reluctant to invest in real estate knowing that FRA had a large stock of properties waiting to be sold.

[106] Public costs incurred from closing down the 56 finance companies have to be computed based on recoveries by both FRA and AMCorp.

[107] AMCorp website. "An Interview with the AMCorp's Managing Director."

END REMARKS

The decision to close the 56 finance companies was only the beginning of FRA's long and complicated liquidation process. The FRA operations were designed with a view to quickly transferring assets back to private professional asset managers and unfreezing locked assets for productive use. Overall, FRA has fulfilled its mission as designed within its given timeframe.

Despite its market-clearing benefits, the FRA operations have attracted a lot of public criticism mainly because FRA's recoveries were much lower than the face value of its assets. Although the low recovery rate and resultant high public costs could be attributed mainly to the poor quality of the assets at the outset, certain elements of the FRA operations could have been tightened in order to lower public costs and minimize potential economic distortions, particularly those against the performing borrowers of operating FIs. Among others, assets could have been offered in smaller lots to attract more bidders, and more efforts could have been made to effectively prevent collusion among bidders and between bidders and debtors both before and after the auctions. Nevertheless, the FRA operations involved a lot of complicated economic and political tradeoffs, many of which could not be clearly evaluated amid economic uncertainties.

While FRA is in the process of winding down, AMCorp's operations will continue. To help minimize the overall public costs from the closure of the 56 finance companies, it is crucial that AMCorp operate transparently based on arm's length commercial relationships with its debtors.

Chapter 7
Legal Reform to Enhance NPL Resolution

An outdated legal framework, including court proceedings, was one of the major impediments to effective NPL resolution in Thailand. In particular, laws related to bankruptcy and foreclosure that were in effect when the crisis emerged were in favor of debtors. Court procedures were lengthy and offered a number of loopholes, which could be used by debtors to delay court consideration and foreclosure of their assets. Furthermore, the number of judges equipped with a strong financial background was limited, resulting in a backlog of complicated debt resolution cases. Consequently, non-performing debtors were reluctant to cooperate with FIs in NPL restructuring. The ineffective legal framework also contributed to the emergence of strategic NPL debtors, i.e., those who could have serviced their loans but were not willing to do so.

The authorities realized early in the crisis that an overhaul of the legal framework was needed to resolve the systemic NPL problems. Key legal reform measures included: (1) amendment of the Bankruptcy Law; (2) establishment of the Central Bankruptcy Court; and (3) amendment of the Code of Civil Procedures. The remainder of this chapter discusses the rationale, features, and remaining shortfalls of these legal amendments in detail.

AMENDMENT OF THE BANKRUPTCY LAW

The Bankruptcy Law that was in effect when the crisis emerged had been enacted in 1940; it was obsolete and had a number of shortfalls, including the lack of a legal basis for business rehabilitation. The original law allowed only for liquidation of debtors that had been declared bankrupt. To facilitate restructuring of potentially viable debtors, the law was amended in 1998 to incorporate the concept of business rehabilitation. However, that amendment was incomplete so it was amended again in April 1999 to address at least three main shortfalls.

First, the amended law provides a higher degree of protection for creditors assisting in the rehabilitation of viable firms. Prior to the amendment, creditors giving loans to highly indebted debtors, knowing the debtors' financial position, would not be able to seek repayment through the bankruptcy process. Consequently, creditors were not protected if they granted additional credit to help viable firms get through a temporary liquidity shortage. This element was particularly important in the context of the Thai financial crisis because a severe liquidity shortage and historically high interest rates prevailed during the initial stage of the crisis. In addition, many large firms became illiquid after the baht sharply lost value and their external debt obligations surged. The amendment of the Bankruptcy Law provides additional assurance and incentives to creditors willing to assist highly indebted firms to get through a liquidity shortage. Creditors are allowed to seek repayment of loans, especially working capital, that have been granted with the objective of rehabilitating debtors or keeping them in business.

Second, the amendment categorized payroll debts owed to workers in the same preferred status as those owed to the tax authorities, with a view to encouraging workers to continue working for highly indebted firms during their rehabilitation process. Prior to the amendment, workers were not specifically protected and, therefore, had little chance of recovering payroll debts owed by their employers. There was no incentive for them to continue working for highly indebted firms, and the firms in effect had to cease their operations when entering the bankruptcy process. In most cases, the discontinuity of their operations not only jeopardizes their rehabilitation process, but also results in a deterioration of their assets' value, especially those of high-tech machinery.

Third, the approval process of a rehabilitation plan was modified to reflect seniority and the rights of different types of creditors. Prior to the amendment, a rehabilitation plan needed approval from at least half of all creditors, which together must account for at least three quarters of a debtor's total loans. These requirements were complicated in practice and required a lot of coordinating efforts among creditors, especially among small suppliers giving trade credit. In effect, a rehabilitation plan that was approved by FIs accounting for more that three quarters of the firms' outstanding loans could be easily blocked by a number of small trade creditors. Furthermore, the old law treated all creditors equally without differentiating among them by unique features and the seniority of their loans. For instance, clean-loan creditors had the same rights in approving a rehabilitation plan as those giving loans secured with collateral.

The 1999 amendment categorizes creditors into four main classes: (1) large creditors with secured loans; (2) small creditors with secured loans; (3) unsecured creditors; and (4) other creditors.[108] A rehabilitation plan can then be approved either (1) by the majority of creditors in all four groups or (2) if it is approved by at least one group of creditors and all creditors approving the plan account for at least half of debts owed to all creditors present in the creditors' meeting.

It took the authorities more than one year before they could enact the amended Bankruptcy Law in April 1999. As the original law favored debtors, the amendment attracted heavy protests from a number of influential debtors who had strong connections with the legislature. The amendment was also highly debated among the public, fearing that a large number of Thai firms would become bankrupt and be taken over by foreign creditors. On the other hand, foreign investors seriously viewed the amendment as an indicator of Thailand's commitment to economic reform, and the amendment was incorporated as a key performance criterion for disbursement under the IMF financial support program.

Throughout the legislative process, some key aspects of the original law and the proposed amendment had been watered down. The most critical one was related to the length of time that a bankrupt person/entity could emerge from bankruptcy status.[109] In the original law, a bankrupt person could appeal for court withholding of bankruptcy status after 10 years of the last asset allocation by official receivers. The amended law allows for automatic emergence from bankruptcy status after three years of the court's bankruptcy ruling.[110] This amendment markedly impaired the effects of a bankruptcy threat against debtors, especially the strategic ones.

The shortening of the bankruptcy period has also discouraged FIs from filing a bankruptcy case against large non-performing debtors. If an FI believes that a large debtor has hidden assets—i.e., the basic practice of most debtors—the FI would prefer to bring the case to the Civil Court, under which it could pursue the hidden assets for up to ten years. As a result, most of the large cases that FIs have brought to the Bankruptcy Court are intended for

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[108] The law empowers the planner to classify creditors into different groups based on each debtor's total loan obligations.

[109] The other modifications included: (1) raising the minimum amount of debts that could be used as a basis for filing a bankruptcy case from 50,000 baht to 1,000,000 baht for an individual and 500,000 baht to 2,000,000 baht for a juristic person; and (2) increasing the amount of equipments and assets that a bankrupt person could retain from 3,000 baht to 100,000 baht.

[110] In general, it takes at least two years between the bankruptcy ruling and the last allocation of assets by official receivers. The new amendment in effect shortened the bankrupt period by at least nine years from the original law.

rehabilitation rather than liquidation.[111] Given that the Civil Court's procedure is lengthier than that of the Bankruptcy Court, the amended Bankruptcy Law could not contribute to speedy NPL resolution as initially intended.

In addition to the short bankruptcy period, the amended Bankruptcy Law continues to have a number of shortfalls. Among others, the criteria for commencing bankruptcy proceedings are based on each debtor's balance sheet insolvency—i.e., negative net worth—rather than debtor's cash flows. These criteria enable debtors to delay bankruptcy proceeding by contesting the true value of their assets and liabilities even though they cannot service their loans. The amended law also fails to provide for a procedure to quickly convert unsuccessful rehabilitation cases into liquidation. If a rehabilitation plan fails, the amended law requires a court's affirmation of the debtor's insolvency before the liquidation process can begin; this procedure can open a number of loopholes for debtors intending to fail their rehabilitation plans. Last but not least, the amended law fails to streamline the foreclosure and asset-disposal proceedings, through which debtors could mount a number of legal challenges to delay the process.

Despite the fact that the amended Bankruptcy Law is markedly superior to the original law that was in effect when the crisis emerged, the amended law still has a number of shortfalls that work against speedy NPL restructuring. The law needs to be further amended to enhance effective NPL resolution and ensure sufficient threats against strategic debtors; this is crucial for establishing a good credit culture in the Thai financial system.

ESTABLISHMENT OF THE CENTRAL BANKRUPTCY COURT

Before the establishment of the Central Bankruptcy Court, bankruptcy cases were heard in Civil Courts, the proceedings of which were not suitable for speedy NPL resolution and considering complicated financial cases. For instance, the Civil Courts required both creditors and debtors to be present during all evidentiary hearings and the courts did not have continuous hearing practice, which could result in higher interest costs to relevant parties and be cumbersome for complicated financial cases. Debtors could also easily delay the bankruptcy process through a number of loopholes in the court proceedings. In addition, the number of Civil Court judges who were equipped with an advanced financial background was limited; more such qualified judges were needed to preside over complicated bankruptcy cases.

With a view to expediting NPL resolution and discouraging strategic debtors, a law establishing the Central Bankruptcy Court and Bankruptcy Proceedings was enacted in April 1999. In essence, the law empowered the Bankruptcy Court to appoint its own judges and determine its own proceedings, which are much more flexible and appropriate to financial cases than those of the Civil Courts. Among others, the law requires that a bankruptcy case be considered continuously until its completion and that the ruling be rendered as soon as possible to minimize the financial burden and interest costs incurred by all parties. The law also shortens the appeal process for bankruptcy cases by allowing an appeal to be made directly to the Supreme Court, i.e., bypassing the appeals court, within one month from the date of the Bankruptcy Court's ruling. The court also initiated a number of intensive training programs to equip judges with appropriate financial knowledge and expertise. To minimize the court's backlog and accelerate NPL resolution, the authorities also established in 2000 the Mediation Center for Financial Disputes to provide proactive out-of-court mediation.

[111] In addition, FIs prefer not to file a bankruptcy case because they want to avoid the complication of coordinating among all debtors, especially small suppliers providing trade credit to the debtors.

Amendment of the Code of Civil Procedures

Between May 1999 and May 2000, the authorities succeeded in amending three laws on the Code of Civil Procedures with the objectives of expediting the Civil Court's proceedings and minimizing the loopholes that had been exploited by strategic debtors. Key issues amended by the three laws were related to: (1) execution of court orders and writs; (2) absence of plaintiffs and defendants in a court hearing; and (3) special proceeding for court consideration of petty cases.

As to the execution of court orders and writs, the amendments enlarged the jurisdiction of Civil Courts' writs from their specific geographical areas to the whole country, with a view to streamlining court procedures and minimizing court fees for the relevant parties. The amendment also eliminated the appeal process for certain court orders, which had been used in the past by debtors to delay repayment. In addition, the amendment limited appeals against asset disposal only to cases in which there is evidence of collusion among bidders or malpractice by related officials. Prior to the amendment, debtors could appeal against disposal of their assets on the ground that the disposal achieved too low a price.

With regard to the absence of the plaintiff or defendant in a court hearing, the amendment streamlined relevant court proceedings to facilitate the continued consideration and ruling by the court even though a relevant party is absent, while incorporating certain features to protect the rights of the absentee.

The amendment also introduced special legal proceedings for petty cases, i.e., cases involving amounts under 40,000 baht. Prior to the amendment, the Civil Court had to follow standard lengthy proceedings, resulting in a backlog in the courts and costly expenses for all the parties involved. The new amendment relies on an informal and speedy mediation process for petty cases.

End Remarks

To enhance NPL resolution, it is crucial that an effective legal framework, covering all relevant laws and court proceedings, be put in place to facilitate the restructuring of potentially viable debtors and to penalize strategic debtors. The Thai authorities had attempted to introduce a comprehensive legal reform during the crisis, which was time consuming and required a lot of effort. Unfortunately, a number of crucial legal elements, especially those of the Bankruptcy Law amendments, were watered down in the legislative process. As a result, the amended laws have not been effectively utilized and cannot contribute to the speedy resolution of NPLs as had been initially intended.

Chapter 8
Market-driven Approaches to NPL Resolution

Unlike some crisis-affected countries in East Asia that established a central NPL resolution agency in the early stage of their crisis, the Thai authorities preferred to have the private sector, especially FIs, take the lead in NPL resolution.[112] In this context, the role of the authorities was limited to providing appropriate market-driven incentives to debtors and creditors, assisting in coordination among relevant parties, and eliminating tax disincentives and other impediments to effective NPL restructuring.

The basic rationale for this decentralized approach was a practical one. The authorities strongly believed that NPL resolution required specific banking and financial skills that were difficult, if not impossible, to find among government officials.[113] Relevant government agencies also had a limited number of capable staff relative to their pressing tasks during the crisis. Furthermore, the authorities believed that NPL resolution required intensive knowledge of debtors. To this end, NPL resolution by the lending FIs would be more effective and speedier than setting up a new central state-owned NPL resolution agency. Establishing such an agency in the context of the Thai legal framework could also take time, and its operations would encounter a number of legal constraints.[114] Criteria for selecting the NPLs to be transferred, NPL pricing, and the restructuring decisions of the central NPL resolution agency could also be subject to political pressure and be overridden by objectives other than those of achieving effective NPL resolution and minimizing public costs.

To enable FIs to take the lead in NPL resolution, the necessary infrastructure and appropriate operating environment were put in place. Most importantly, the authorities ensured that FIs had adequate capital to shoulder losses from NPL resolution, partly by establishing the public capital support scheme.[115] Loan loss provisioning requirements and collateral appraisal standards were also tightened to reflect the true value of NPLs on FIs' balance sheets and, therefore, encourage FIs to realize actual losses of their NPLs. Last but not least, the legal framework that favored debtors was amended to encourage debtors' cooperation with FIs in NPL restructuring. To support this decentralized market-driven approach, the authorities needed to put in place appropriate "carrots and sticks" to ensure effective coordination among all the parties concerned.

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[112] The central asset resolution agencies include Danaharta of Malaysia and KAMCO of the Republic of Korea. In Thailand, the sale of the closed finance companies' assets by FRA was another example of the authorities' preference for market-based NPL resolution.

[113] It should be pointed out that political constraints at that time would not allow the authorities to import foreign professionals to run a central NPL resolution agency, if such an agency were established. In any case, such an agency would still be subject to supervision by government officials who have limited knowledge concerning banking and finance.

[114] Operational issues related to establishing a central NPL resolution agency are discussed in Chapter 9. It should be noted that the political capital of the government that was in office during the peak of the crisis was much less than that of the government that set up TAMC.

[115] If the authorities were to have established a central state-owned NPL resolution agency early on, they would have had to determine NPL pricing that would have offered a compromise between the effects on an FI's capital availability and future public costs. If FIs were required to sell NPLs at low prices, the authorities would have had to assist them in recapitalization or allow them to realize losses over a long period.

In addition to creating the necessary infrastructure and supportive environment, the authorities implemented three specific measures to enhance NPL resolution and eliminate impediments to NPL restructuring: (1) introducing NPL-restructuring guidelines and an NPL exit procedure; (2) establishing the Corporate Debt Restructuring Advisory Committee (CDRAC); and (3) encouraging the establishment of private AMCs. The remainder of this chapter discusses these issues in detail.

NPL RESTRUCTURING GUIDELINES AND NPL EXIT PROCEDURE

BOT announced NPL restructuring guidelines in June 1998, with a view to providing FIs with a framework for restructuring NPLs, especially loans extended to business entities. Implicitly, the guidelines forced the senior management of each FI to establish a clear NPL restructuring policy and step-by-step operating and decision-making procedures. The guidelines covered, among others, policies and procedures related to methods used in evaluating debtors' business viability, criteria for selecting appropriate NPL restructuring methods, a decision-making process for connected NPLs, collateral valuation by independent appraisals, documentation of related documents, accounting of losses incurred from NPL restructuring, and monitoring of post-restructuring repayments. The guidelines also required that all FIs establish a unit specifically tasked with NPL restructuring, and defined the scope of NPL restructuring under which the debtors and creditors would qualify for tax privileges and incentives. The guidelines has been amended many times to reflect the evolving environment.

The guidelines also determined an NPL exit procedure following the United States Comptroller of Currency's standards. Initially, NPLs in doubtful or doubtful loss categories could be upgraded to the substandard category after they had been restructured. They could be reclassified to a normal status and their provisions reduced only if the debtors had fulfilled payment obligations according to their restructuring agreements for at least three payment periods or three months, whichever was longer.[116]

In March 1999, BOT relaxed the NPL exit procedure to facilitate speedy reduction in NPLs and lower FIs' provisioning burden on restructured loans. In particular, the three-month waiting period for returning to normal status was abolished for restructured debtors that (1) could pay interest at the market rate without any interest-free period; (2) were given at least a 20 percent "hair cut" on the original face value of their loans; (3) received restructuring approvals from all syndicated lenders; (4) achieved a restructuring agreement with a court ruling; or (5) received endorsement from the Bankruptcy Court on its rehabilitation plan. These restructured debtors were exempted from the waiting period on the grounds that their restructuring methods required more careful consideration and analysis of the debtors' payment capabilities than other forms of restructuring.

CORPORATE DEBT RESTRUCTURING ADVISORY COMMITTEE

In June 1998, the authorities established CDRAC as a high-level advisory committee to help to facilitate coordination among debtors and creditors of targeted NPL cases, particularly those with multi-creditors. The committee was chaired by the BOT Governor and consisted of representatives of both the creditors and debtors, including those from the Thai Bankers' Association, the Finance Companies' Association, the Foreign Banks' Association, the Thai Chamber of Commerce, and the Federation of Thai Industries.

[116] If a debtor failed to honor his restructuring agreement, he would be reclassified back to his original loan classification.

CDRAC initially targeted approximately 350 of the largest NPL cases, selected by associations representing the creditors and debtors, with debts totaling around 676,740 million baht (CDRAC 2000, 6). To facilitate coordination among key parties within the decentralized market-based approach, CDRAC developed the Framework for Corporate Debt Restructuring in Thailand, the so-called Bangkok Approach, as a negotiation framework for restructuring multi-creditor NPLs of large corporations. The framework was based on voluntary participation by the parties concerned.

Progress made in loan restructuring of the initial 350 target cases was relatively slow. By the end of 1998, only 11 of the target cases, amounting to around 47,700 million baht, had been successfully restructured (CDRAC 2000, 37). The slow pace of NPL restructuring under CDRAC could be attributed to, among others, the voluntary principle. Initially, CDRAC's framework had no definite timeframe within which relevant parties had to comply, and most multi-creditor cases had taken a lot of time in negotiation.

To speed up the restructuring efforts, CDRAC developed in 1999 two major agreements to govern the debt restructuring process: (1) the Debtor-Creditor Agreement on Debt Restructuring Process (DCA) and (2) the Inter-Creditor Agreement on Restructure Plan Votes and Executive Decision Panel Procedures (ICA). Both agreements specified steps that relevant parties had to take within a given timeframe so that the restructuring process could be completed within a period of five to seven months of the first debtor-creditor meeting (BOT 1999, 8). For instance, each debtor was required to deliver detailed business information to the creditors' committee within two months of signing the DCA; the creditors' committee, together with the debtor, had to submit a restructuring plan to CDRAC within three months of signing the DCA; and a creditor's meeting to approve the plan needed to take place within 25 days after the plan's submission.[117]

The two agreements also entitled CDRAC to impose a fine on any party that failed to meet the timeframe allowed for each step of the restructuring process. They also spelled out guidelines for providing working capital to debtors and repayments of newly granted loans during the restructuring process. Furthermore, the agreements established a mediation procedure whereby CDRAC could appoint a mediator and an executive decision panel, i.e., an arbitrator, if the relevant parties had conflicting views on important matters. CDRAC could also initiate certain actions to ensure the continuity of the restructuring process.[118] Last but not least, the agreements required creditors to take legal action against debtors that (1) were either non-cooperative or unviable or (2) failed to obtain approval of their restructuring plans from the creditors or the executive decision panel.

The two agreements have markedly contributed to the shortening and continuity of the NPL restructuring process. Nevertheless, there were still at least two major drawbacks. First, the DCA was binding only after each debtor had entered into the agreement. In practice, debtors could delay the process by not signing the agreement, and there was no penalty against these debtors besides possible legal action, which could take time and had a number of loopholes. Second, CDRAC's restructuring process and the two agreements focused only on creditors that were domestic FIs. In many cases, trade credit given by suppliers and debt instruments—e.g., corporate bonds—accounted for a sizeable share of a debtor's total liabilities. These creditors often surfaced when FI creditors and debtors sought rehabilitation through the Bankruptcy Court. The restructuring plan that had been approved through CDRAC's process then needed to be modified to incorporate non-FI creditors. These modifications often took a lot of time, and there was no binding agreement and agreed timeframe governing the process.

[117] For certain steps, the agreements allowed CDRAC to give an extension, but the extension was also required to be within a timeframe specified in the agreement.

[118] For instance, if the creditors' committee and the debtor failed to submit a restructuring plan within a given timeframe, CDRAC could appoint a financial advisor to complete the restructuring plan within 30 days at the debtor's expense.

Following the DCA and ICA approaches, the Thai Bankers' Association and the Finance Companies' Association together developed the Simplified Restructuring Agreement (SRA) aimed at small and medium-sized debtors with a single or few Thai creditors. The SRA spelled out detailed restructuring steps with a specific timeframe similar to those in the DCA and ICA. In most cases, debt restructuring under the SRA was expected to be completed within 60-90 days after the signing of the agreement.

During the initial stage of the crisis, NPL restructuring was also hindered by a number of tax issues. For instance, the tax code considered a loan "hair cut" as part of a debtor's annual income, which was subject to income tax. The initial tax code also prevented FIs from treating loan loss reserves in excess of BOT's provisioning requirements as expenses for tax calculation. As a result, FIs were reluctant to agree on an NPL restructuring agreement that would incur larger losses than BOT's required provisions. This issue was further complicated by the fact that BOT allowed FIs to meet international provisioning standards over a period of two years during the period 1999-2000. Furthermore, many NPL-restructuring cases involved debt-asset swaps, which were subject to high asset-transfer and registration fees.[119]

To complement CDRAC's efforts on NPL restructuring, the authorities amended a number of tax impediments during the period 1999-2000. Key amendments included exemption of income taxes and value-added taxes, and exemption from fees related to collateral transfer and debtors' benefits that may arise from debt restructuring. BOT also relaxed a number of prudential regulations allowing FIs to hold foreclosed properties for a longer period to facilitate debt-asset swaps and increased the investment limit for investments in restructured companies to facilitate debt-equity swaps.

Nevertheless, relevant agencies took a lot of time in amending the necessary regulations. In addition, they were not effective in implementing the amended regulations through their nation-wide networks, resulting in delayed completion of restructuring cases outside the Bangkok area.

With all these efforts, restructuring of the first 350 target cases made substantial progress by the end of 1999, and CDRAC's coverage was widened further.[120] Chart 8.1 shows the rapid increase in NPLs that had been successfully restructured under CDRAC framework, especially in 2000.

As to the impact of the DCA and ICA on debt restructuring, by the end of 2001 there were 1,589 large NPL cases for which the relevant parties had signed the two agreements. Their total loans amounted to 1,465,651 million baht or 63 percent of total loans of CDRAC's large target cases.[121] Out of the 1,589 cases, 1,016 cases (64%) with loans totaling 1,145,876 million baht had completed the restructuring process by the end of 2001, and 571 cases with loans totaling 314,695 million baht had been brought into the legal process by creditors.

It should also be noted that progress in NPL restructuring under CDRAC's framework was made largely by private FIs (chart 8.1). The relatively slow restructuring performance of state-owned FIs could be attributed to their limited capital adequacy, uncertainties related to their future, and insufficient legal immunity for their directors and management.[122] Furthermore, their efforts were hindered by forced mergers with other FIs in

[119] The value of properties taken over by FIs went up from only 20,000 million baht at the end of 1997 to 145,000 million baht at the end of April 2002.

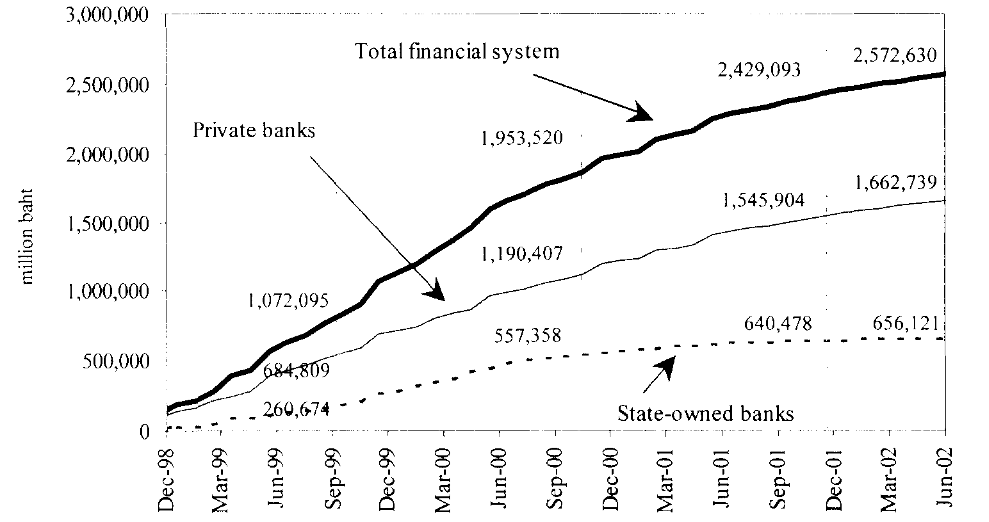
[120] CDRAC's target cases expanded from 350 large cases (676,740 million baht) initially to 5,570 cases (2,325,260 million baht) by the end of 1999, and to 12,020 cases (2,602,090 million baht) by the end of 2000 (CDRAC 2001, 66).

[121] By the end of 2001, CDRAC had targeted 2,859 large cases with loans totaling 2,317,276 million baht (CDRAC 2002, 17).

[122] Employees of state-owned banks are considered state employees who are obliged to follow strict rules and regulations, especially those related to state assets. As a result, they were reluctant to grant debt forgiveness or a "hair cut" to debtors, fearing that they could be made liable for incurring losses to the state.

which the authorities had intervened, whose credit operations and restructuring process had to be integrated into a single system.

Chart 8.1: Cumulative amount of loans that had been completely restructured (Dec 1998-Jan 2002)



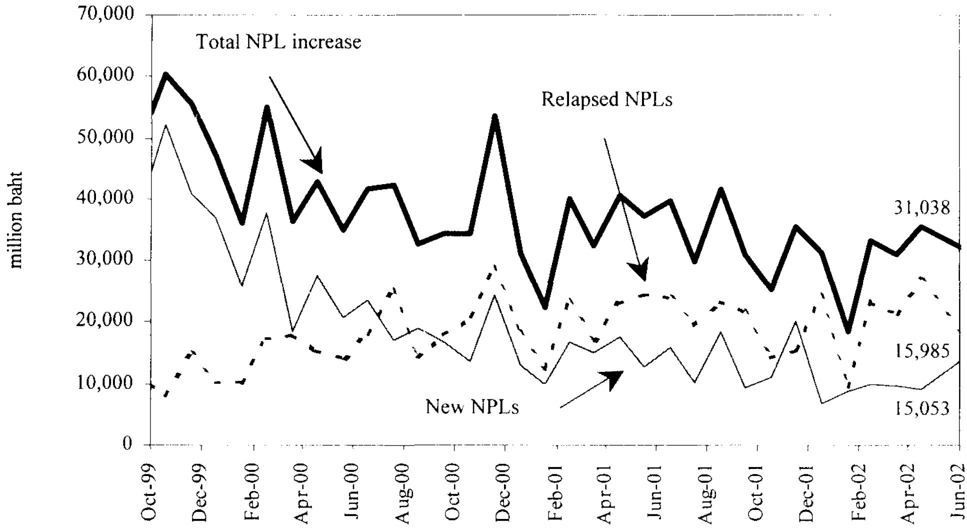
Source: BOT.

Despite the slow start, CDRAC's framework has contributed to the rapid pace of corporate NPL restructuring. However, the framework was based on a voluntary principle and could not adequately influence FIs concerning their restructuring methods. A large amount of restructured NPLs had relapsed and had become a major concern among FIs. In the second half of 2000, the value amount of relapsed NPLs began to exceed that of new NPLs and has since been on an increasing trend (chart 8.2). During the first half of 2002, relapsed NPLs averaged around 20,150 million baht per month. The total amount of relapsed NPLs in 2001 accounted for around 35.6 percent of the NPLs that had been successfully restructured in the period 1999-2000.

To a large extent, the relapse of restructured NPLs could be attributed to methods used in restructuring.[123] Only around 6-9 percent of NPLs restructured during the period 1999-2001 involved a "hair cut" on principle and accrued interest. Around 80 percent of the restructured NPLs achieved that status by extending loan maturity, or granting a grace period for interest and principle repayments, or reducing the interest rate (table 8.1). These restructuring methods were partly influenced by the FIs' limited capital cushion and expectations that the economy would recover strongly, resulting in improved debtors' cash flows over time. Unfortunately, the Thai economic recovery has not met these expectations. The large magnitude of relapsed NPLs not only raises doubts about the effectiveness of the market-driven approach for NPL restructuring, but also puts pressure on the loan-loss provisioning and capital adequacy of certain FIs. In 2002, all FIs have loan-loss provisioning in excess of BOT requirement, but many of them continue to increase their loan loss provisions to cushion against a relapse in NPLs.

[123] In 1999, the existence of relapsed NPLs could also be attributed to the sharp decline in interest rates. Debtors that had entered into a restructuring agreement in 1998, when the market interest rate was high, preferred not to honor their payment obligations in the hope that they could renegotiate a new payment term.

Chart 8.2: Monthly NPL increase (Oct 1999-Jun 2002)



Source: BOT.

Table 8.1: Breakdown of restructured loans by restructuring methods

Restructuring methods	Percentage of total amount restructured		
	1999	2000	2001
Extension of maturity	41	41	39
Provision of grace period on principle or interest payments	20	21	24
Reduction of interest rate	22	20	17
Forgiveness of principle or accrued interest	6	6	9
Debt-assets swap	6	5	6
Debt-equity swap	3	4	3
Other methods	2	3	2
Total	100	100	100

Source: CDRAC (2002, 16).

ESTABLISHMENT OF PRIVATE ASSET MANAGEMENT COMPANIES

As the number of NPLs continued to rise and bank credit was contracting during the first half of 1998, the authorities were concerned that NPL restructuring would place a heavy burden on FIs' management and obstruct credit growth, which was deemed crucial for alleviating the credit crunch and supporting the process of economic recovery. In this context, the authorities believed that transferring NPLs out of FIs would improve their effectiveness in NPL resolution and facilitate the extention of new credit. In addition, it would help to reduce the amount of NPLs left on the FIs' balance sheets, thereby increasing confidence in the financial system and indirectly facilitating the recapitalization of the FI's.

In line with the authorities' policy of decentralizing NPL resolution, the AMC Emergency Decree was enacted in August 1998 to enhance the efforts of individual FIs' in NPL resolution.[124] That decree was also intended to facilitate the start-up of the NPL resolution business by experts and provide a means for managing NPLs of the FIs in which the authorities had intervened.

The decree facilitated the establishment of private AMCs by eliminating legal obstacles to NPL transfers and NPL management. Most importantly, the decree allows an FI to transfer assets to an AMC without obtaining the debtors' consent if the FI continues to serve as the loan collection agent for AMC or if the transfer is deemed by BOT as crucial for the financial system's stability and public benefit.[125] On other issues, the decree: (1) allows AMCs to charge interest rates in excess of the usury limit; (2) entitles AMCs to continue legal proceedings initiated by the original FIs; (3) designates BOT as the supervisor for AMCs; (4) exempts fees and taxes related to asset transfers; and (5) puts in place certain safeguards against malpractice by AMC management as well as against the possibility that FIs may use AMCs to circumvent prudential regulations, particularly those related to provisioning requirements and capital adequacy.[126]

The first AMC, BAM, was established in late 1998 to manage the NPLs of BBC, a bank that had been closed down. By the end of 2001, there were 16 AMCs in operation, four of which were state-owned.[127] However, these four state-owned AMCs accounted for around 80 percent of all AMCs' assets, totaling around 1,200,000 million baht. In addition to these four AMCs, the authorities also had a gain-loss sharing arrangement in another AMC that was set up to manage the assets of a closed finance company, Phatra Thanakit Finance.

Among the 12 private AMCs, 10 of them were set up as FIs' subsidiaries with the intention of transferring NPLs from their mother FIs; the other two AMCs were set up to manage NPLs purchased from other FIs. However, most private AMCs were relatively small and only four of them had purchased NPLs exceeding 30,000 baht each. On average, NPLs were transferred to private AMCs at around 53 percent of their initial values.[128]

Despite the fact that many private FIs had established an AMC, most of them could not transfer a large amount of their NPLs to AMCs after the Institution of Certified Accountants and Auditors of Thailand issued in 2001 a new operation guideline on the transfer of financial assets.[129] Under this guideline, FIs would be worse off financially after transferring NPLs to their own AMCs because they would in effect be required to maintain capital adequacy against both the NPLs and AMCs' bonds issued to purchase the NPLs, resulting in double counting of required capital. As a result, the individual AMC approach was largely used by state-owned FIs and generated little benefit for private FIs in addressing their NPL problems.[130]

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124 The AMC Emergency Decree was enacted as part of the August 1998 financial restructuring package that included the government capital support program.

125 In general, the Civil Code requires that creditors obtain debtors' consent before transferring loans.

126 To this end, the provisioning and capital adequacy requirements were based on a consolidation basis.

127 Besides BAM, the other state-owned AMCs were PAM, SAM, and Radhanasin AMC. The last one was set up to separate NPLs under a yield maintenance and loss-sharing guarantee from the UOB Radhanasin Bank when the bank was privatized.

128 The lowest price for NPLs transferred to private AMCs was 20.9 percent of their face value. These NPLs were sold by a private FI to a third-party AMC.

129 The operation guideline sets accounting standards that need to be followed by certified auditors and accountants.

130 As discussed in Chapter 4, the state-owned AMCs were also set up as a means to help recapitalize state-owned FIs.

END REMARKS

The Thai authorities decided to pursue a decentralized market-driven approach for NPL resolution fearing practical difficulties and potential political interference in the operations of a central state-owned NPL resolution agency, if one were to be established. However, CDRAC and individual AMC frameworks have demonstrated that voluntary, decentralized NPL restructuring could progress slowly, but would require substantial coordination efforts among the creditors, debtors, and government agencies involved.

To ensure proper incentives for voluntary participation in NPL restructuring, such an approach needs to be time-bound and offer appropriate "carrots and sticks." The legal framework must also be effective, and non-cooperating debtors be adequately penalized. Furthermore, the authorities may need to exert influence on the restructuring methods used by FIs to avoid a relapse in NPLs and to prevent FIs from postponing NPL problems so that they would be dealt with in the future.

Chapter 9
State-led Efforts in NPL Resolution

As discussed in the previous chapter, the Thai authorities concentrated their efforts on establishing the necessary frameworks to support the decentralized market-driven approach to NPL resolution during the early stage of the crisis. Although the idea of setting up a central state-owned AMC to purchase NPLs from FIs had often been proposed, the authorities at that time were of the view that such an AMC would encounter a number of operational and political constraints, all of which would not contribute to effective NPL restructuring.

One of the most important constraints to establishing a central state-owned AMC during the peak of the crisis was related to FIs' capital adequacy and NPL pricing. As discussed in Chapter 4, all private FIs lacked capital and were allowed to recapitalize gradually during the period 1998-2000, when the new provisioning requirement was being phased in. If a central state-owned AMC were set up then to buy NPLs from private FIs, the FIs would not be in a position to realize losses from NPL transfer and the authorities would have to buy NPLs at inflated prices, thereby incurring additional costs for the public.[131] In this context, pricing of NPLs would need to offer a compromise between NPLs' fair values and each FI's capital adequacy; it could not be done in a transparent manner and could be detrimental to the authorities' political support.[132] To this end, the authorities preferred providing FIs with capital support and allowing them to take the lead in NPL resolution rather than set up a central state-owned AMC. Such recapitalization support could also depend on market mechanisms for screening for viable FIs and pricing FIs' shares, which would partly reflect market expectations of each FI's NPL problems and its effectiveness in NPL resolution.

Operational and political constraints for setting up a central state-owned AMC were not limited to NPL pricing. With the then relatively fragile political stability existing in Thailand, the authorities feared potential political interference in the process of selecting debtors to be transferred to AMC as well as in making NPL restructuring decisions. If the central AMC were not operating on arm's length commercial basis or certain debtors were given preferential treatment, AMC could easily magnify the problem of moral hazards. Furthermore, if NPLs were purchased by AMC at inflated prices, AMC officials would be reluctant to make any decisions that could be interpreted as incurring losses for the state and the AMC would likely end up as an NPL warehouse. Such an AMC would also encounter difficulties in recruiting an adequate number of capable staff amid the crisis, extending additional working capital to potentially viable debtors, and establishing costly IT systems and a new debt-workout network.[133] Last but not least, the authorities feared that transferring

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[131] In practice, the authorities could have purchased NPLs at fair prices, forced FIs to incur up front losses, and allowed them to amortize the losses over time. This practice, however, would imply a policy reversal from the gradual provisioning requirement. Exposing losses from NPLs up front could also hinder FIs' recapitalization efforts.

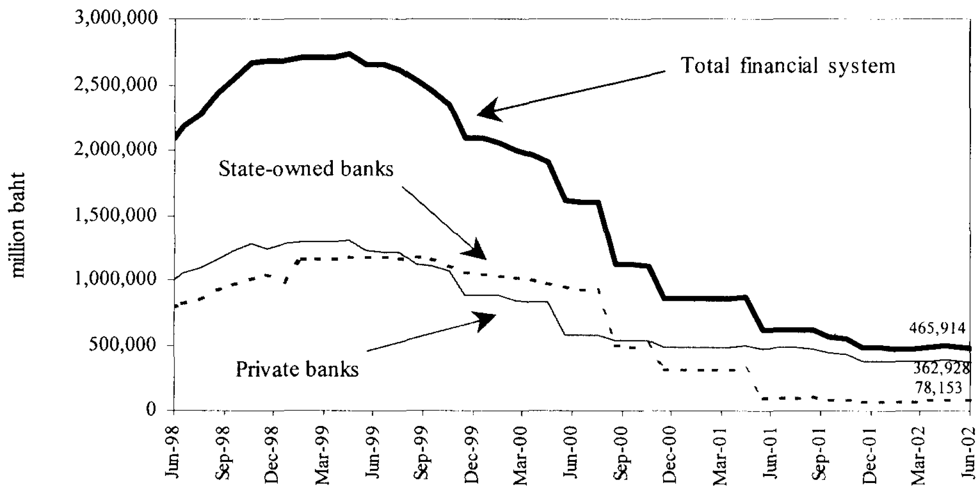
[132] It should be noted that it was already very difficult to assess the fair value of NPLs. Such valuation could be done by different pricing mechanisms—e.g., forced-sale valuation, collateral valuation, or cash-flow valuation—and its outcome would depend on key macroeconomic assumptions. It is also believed that market prices of NPLs during the peak of the crisis often underestimated their fair value.

[133] For a detailed discussion on the difficulties in setting up a central state-owned AMC, see the subsection on TAMC.

NPLs to a central AMC would disrupt and delay the ongoing NPL restructuring process because AMC staff would have to acquire knowledge about the debtors.

Although the authorities decided not to take the lead in NPL resolution during the peak of the crisis, they have increased their direct involvement in NPL resolution over time in at least two ways. First, they set up individual AMCs for state-owned banks to expedite NPL resolution and provide a means for recapitalizing the banks. Second, the government that assumed office in February 2001 decided to establish a central state-owned AMC, the Thai Asset Management Corporation (TAMC), to deal with the remaining NPLs, which had been relatively stagnant (charts 1.3 and 9.1). The remainder of this chapter discusses in detail these two state-led efforts.

Chart 9.1: Amount of NPLs outstanding (Jun 1998-Jun 2002)



Source: BOT.

ESTABLISHMENT OF STATE-OWNED AMCS FOR STATE-OWNED BANKS

During the period 1998-2002, the authorities established four individual AMCs to handle the NPLs of five state-owned banks. These AMCs were fully owned by FIDF and issued bonds, guaranteed by FIDF, to purchase NPLs from the state-owned banks. The four FIDF-owned AMCs could be divided into three main categories according to their main objectives. Table 9.1 shows the value amount of NPLs that were transferred to these state-owned AMCs.

Table 9.1: NPLs transferred to state-owned AMCs

AMC	Original sources of assets	Year established	Amount of assets transferred (million baht)
BAM	BBC	1998	153,082
SAM	KTB	2000	519,378
RAMC	UOBR	1999	45,099
PAM	BMB & SCIB	2001	260,681

Source: Compiled from various sources.

The first category consisted of BAM, which was set up in late 1998 after the authorities decided to close down BBC, a state-owned bank in which the authorities intervened prior to the crisis. While the good loans and deposits of BBC were transferred to KTB, all BBC's NPLs were moved to BAM at an average price of around 33 percent of their face value. Part of BBC's staff was also transferred to manage NPLs in BAM, while BAM's top executives were recruited from the Industrial Finance Corporation of Thailand (IFCT), a semi-state-owned specialized financial institution.

The second category of FIDF-owned AMC was set up to facilitate privatization of a bank in which the authorities intervened, RB. As discussed in Chapter 3, the authorities provided privatized banks with a gain-loss sharing and yield maintenance guarantee on their existing NPLs. Investors that purchased the banks could choose either to keep NPLs within the banks under a CAP or transfer them to an AMC set up by FIDF.[134] It turned out that only one AMC, Radhanasin Asset Management Company, was set up for this purpose. In effect, almost all of RB's loans were transferred out of the bank to the AMC when it was privatized. That AMC has been managed by RB's new investor, i.e., UOB of Singapore, under a gain-loss sharing arrangement with FIDF.

The third category of state-owned AMCs comprised SAM and PAM. NPL transfers to SAM and PAM began in September 2000 and June 2001, respectively.[135] These two AMCs were set up in response to the fact that state-owned banks had been slow in NPL restructuring. Apart from having limited capital to shoulder losses, the directors and managers of these banks were considered state employees and, therefore, had to follow strict rules and regulations on matters related to state assets. They feared possible criminal and civil liabilities, especially when there was a change in government. Furthermore, the management of KTB was distracted by the forced mergers with FBCB and part of BBC, while the managers of BMB and SCIB concentrated their efforts on prolonged privatization negotiations.[136]

The two AMCs were initially set up with a view to expediting NPL resolution by engaging professional asset managers. Furthermore, FIDF-owned AMCs, unlike banks or bank-owned AMCs, were not required to maintain minimum capital and, therefore, their NPL resolution would not be constrained by their capital adequacy.[137] It was also hoped initially that NPL purchase prices of these AMCs would reflect the fair value of the loans and could be used as benchmarks for NPL resolution.

Unfortunately, the two AMCs ended up purchasing NPLs at inflated prices to eliminate the banks' cumulative losses and recapitalize the banks up to the regulatory requirement.[138] With a view to facilitating future privatization of these banks, the authorities also made the two AMCs purchase most of the banks' NPLs. To this end, little consideration was paid to AMCs' effectiveness in restructuring certain types of NPLs, particularly retail loans that required an extensive servicing network.

These two AMCs were the largest state-owned AMCs, with initial combined assets totaling around 759,519 million baht or 11.4 percent of the banking system's total assets at the end of 2001. The criteria for selecting NPLs to be transferred to the AMCs were based on a

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[134] Both options could be structured to provide the same degree of loss guarantee and yield maintenance. While guarantee settlements under the CAP approach are done through direct payments between the banks and FIDF, yield maintenance and loss sharing payments under the AMC approach are done in the form of coupon payment and settlement of FIDF-guaranteed bonds issued to purchase NPLs, respectively.

[135] PAM was set up after it became clear that the authorities failed to privatize BMB and SCIB.

[136] During the protracted period of privatization negotiation, the managers of BMB and SCIB were reluctant to decide on large loan restructuring cases as such actions might incur additional losses to the banks and affect the banks' balance sheets that needed to be kept relatively stable during the negotiation.

[137] It should be noted that an AMC that is majority owned by a bank is required to be consolidated into the bank's balance sheet and is in effect constrained by the bank's capital adequacy. In the case of state-owned AMCs, they are fully owned by FIDF.

[138] Chapter 5 provides a detailed discussion on how the AMCs were used to recapitalize state-owned banks.

customer basis in order to facilitate effective NPL restructuring.[139] In the case of SAM, debtors that had failed to service more than half of their total loans outstanding at KTB for at least 12 months were transferred to AMC. However, small debtors with total loans outstanding less than 5 million baht were left with the bank as the collection and monitoring of these loans would be better dealt with using the bank's extensive network. In total, around 52 percent of KTB's total loans were transferred to SAM, and the bank's NPL ratio declined from 58 percent at the end of 1999 to 8.4 percent at the end of 2000.

In the case of PAM, the criteria for selecting debtors were largely dictated by BMB's and SCIB's recapitalization needs and the amount of their cumulative losses that the authorities wished to eliminate. As a result, the criteria for selecting BMB's and SCIB's NPLs were more generous than those used in the case of KTB because both BMB and SCIB had a much higher NPL ratio and their recapitalization needs were greater than that of KTB.[140] To ensure that BMB and SCIB could recapitalize adequately by writing back provisions, all BMB's and SCIB's loans, including small loans, that had been past due for more than three months were transferred to PAM. Their NPL ratio declined from a range of 55-60 percent of total loans at the end of 2000 to almost zero at the end of 2001. Moreover, BMB and SCIB were also allowed to transfer to PAM pre-specified debtors that might become non-performing during the one-year period after their first asset transfer in June 2001.

That the criteria used in selecting NPLs to be transferred to the state-owned AMCs, especially in the case of PAM, were largely dictated by the banks' recapitalization needs raises concerns over the AMCs' effectiveness in NPL resolution. For instance, PAM, unlike the banks, has no nation-wide network to deal with retail loans. Furthermore, BMB and SCIB may not have monitored and restructured their NPLs effectively, knowing that they could transfer additional NPLs to PAM within one year of their initial NPL transfers.

Successful NPL resolution in PAM and SAM also depends on the quality and adequacy of their staff. Given that the amounts of NPLs transferred to these AMCs were substantial and they accounted for a large portion of their original banks' assets, both SAM and PAM initially engaged the original banks to manage and service these NPLs on their behalf. The original banks were also asked to extend additional working capital, guaranteed by PAM and SAM, to debtors that were considered viable.

SAM initially engaged KTB to manage its NPLs for the first six months, during which SAM was hoping to complete the process of selecting professional asset managers. Unfortunately, the selection process took a long time and was disrupted when the new government announced a policy of establishing TAMC. When TAMC became operational in the second half of 2001, almost 75 percent of SAM's NPLs were transferred to TAMC.[141] It was only in March 2002 that SAM decided to engage a finance company, TISCO, to manage its remaining NPLs, amounting to around 130,000 million baht.[142] Altogether, SAM's NPLs were left unattended by serious asset managers for around 18 months after they were transferred from KTB in September 2000.[143]

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[139] Each customer may have more than one loan account and only some of them could be non-performing. If only non-performing accounts were transferred to AMCs, NPL restructuring could be hindered because NPL restructuring required assessment of the debtor's total liability and overall loan servicing capability. Furthermore, their loan accounts may be secured by the same piece of collateral. Therefore, effective NPL restructuring required that the transfer be based on a customer basis, i.e., once a debtor was designated to be transferred to AMCs, all of his loan accounts had to be transferred regardless of the status of an individual account.

[140] As discussed in Chapter 5, NPLs were transferred to PAM at face value. Therefore, the more NPLs that BMB and SCIB transferred to PAM, the larger were the loan loss reserves that the banks could write back as capital.

[141] See detailed discussion on the criteria for selecting loans to be transferred to TAMC in the following subsection.

[142] The asset management contract was for a period of three years with gain sharing between SAM and the asset manager.

[143] During the period, SAM extended the temporary asset management contract with KTB. Given that the contract was for a short period and there were uncertainties as to future asset managers and the timing of TAMC's establishment, KTB was relatively passive in restructuring SAM's NPLs during the period.

Given that the majority of SAM's and PAM's NPLs were transferred to TAMC and that state-owned AMCs are not required to publicly disclose any information, it is not possible to analyze PAM's and SAM's effectiveness in NPL resolution. However, one could argue that NPLs were simply warehoused in SAM during the long period of uncertainty related to the selection of professional asset managers and TAMC's establishment. This warehousing period definitely contributed to further deterioration of KTB's NPLs, higher interest costs for the relevant parties, and eventually higher public costs.

ESTABLISHMENT OF THE THAI ASSET MANAGEMENT CORPORATION

Around the end of 2000, system-wide NPLs remained high and the pace of debt restructuring slowed. While NPLs of state-owned banks declined to around 22 percent of total loans after KTB transferred NPLs to SAM, NPLs of private FIs remained stagnant at around 17-20 percent of total loans at the end of 2000 (chart 1.3).[144] It was perceived among the general public that the existence of large NPLs was obstructing the economic recovery in at least two ways. First, NPLs undermined the credit growth of private FIs as they had to concentrate their efforts on NPL resolution rather than extending new credit. Furthermore, some private FIs were concerned over additional loan loss provisions that could arise from the remaining NPLs. Second, non-performing debtors were of the view that private FIs were not sufficiently supportive of NPL restructuring, especially in agreeing on debt forgiveness. As a result, debtors pending NPL restructuring could neither expand their business nor invest in new projects. Based on these arguments, effective NPL resolution was deemed crucial for the economic recovery to take place and, therefore, became a major policy issue in the general election that took place in January 2001.

The political party that won the general election in January 2001 had included the establishment of a central state-owned AMC as one of its key campaign promises. Initially, the central AMC was designed on a large scale with the objectives of (1) relieving all FIs from the burden of NPL resolution, (2) expediting NPL resolution by empowering AMC to bypass certain court and legal procedures, and (3) facilitating industrial restructuring by consolidating excess capacity through the merger and acquisition of debtors.

After assuming office in February 2001, the new government spent four months designing the main features of TAMC, and enacted the TAMC Emergency Decree in June 2001. TAMC was set up with the initial capital of 1 billion baht from FIDF. Owing to a number of operational constraints, many of TAMC's main features differed from those publicized during the election campaign. Table 9.2 summarizes TAMC's main features as set out in the emergency decree.

[144] As mentioned previously, the declining pace of NPL restructuring was attributed to the fact that FIs had filed legal cases against almost all of their remaining NPLs. Therefore, their resolution had to follow the pace of court proceedings, which could be lengthy.

Table 9.2: Main features of TAMC operations

Key aspects	Main features
1. Criteria for selecting assets to be transferred to TAMC	State-owned FIs and AMCs were required to transfer assets in the sub-standard class (i.e., more than three months past due) and below as at the end of 2000, with the exception of those (1) that had already obtained a court ruling, (2) that had already been put under temporary or permanent receivership, or (3) whose rehabilitation plan had been endorsed by the Bankruptcy Court. Initially, TAMC did not purchase eligible NPLs that had only one creditor and had loans outstanding of less than 50 million baht. Such loans were expected to be transferred to TAMC beginning in the second half of 2002. Private FIs and AMCs were required to transfer all assets in the sub-standard class and below as of the end of 2000 provided that: • The assets had been secured by collateral; • The debtor is a juristic entity indebted to at least two FIs or AMCs; • The debtor's outstanding loans at all FIs and AMCs exceeded 5 million baht; • The debtor and FIs had not entered into a debt restructuring agreement within 30 days after the emergency decree came into force; • The debtor's rehabilitation plan had not been endorsed by the Bankruptcy Court when the emergency decree came into force; • The court had not made a ruling on the asset; and • The debtor had not been put under temporary or permanent receivership. The emergency decree also required that FIs transfer to TAMC loans connected with the transferred debtors, e.g., loans of their subsidiaries.
2. Transfer price	The transfer price was set as equal to the value of collateral used to secure the loans. In the case of clean loans from state-owned banks and AMCs, the transfer price was set at zero. The emergency decree also required that the prices of loans transferred from private FIs and AMCs not exceed the amount of the loans outstanding net of the required provisions. The emergency decree initially required that TAMC use the Land Department's reference prices for valuing land collateral. Owing to operational constraints, the decree was amended to use valuation methods approved by BOT. FIs and TAMC may request a new appraisal of collateral within 30 days of receiving the initial transfer prices.
3. Forms of payment	TAMC paid for the assets with 10-year TAMC bonds guaranteed by FIDF. The bonds are not transferable, and pay interest once a year at a rate equal to the average deposit rate of the five largest commercial banks. TAMC is entitled to redeem the bonds before maturity.

(Continued on page 71)

Key aspects	Main features
4. Penalty imposed on private FIs not transferring assets to TAMC	All private FIs deciding not to transfer assets to TAMC were required to reappraise by independent appraisals all collateral used to secure NPLs within 120 days, and provision for NPLs in the sub-standard class and below up to their uncollateralized portion within the following 90 days. This provisioning penalty is stricter than BOT's standard provisioning requirement.
5. TAMC's special legal power and immunity	• Unlike actions and decisions of other state agencies, those of TAMC cannot be challenged in the Central Administrative Court. • The emergency decree provides immunity for TAMC staff against criminal liability if they act professionally within the decree's mandate. • For cases under court consideration, TAMC may withdraw them from court proceedings if they wish to restructure the debtors through other means. • In the event that a debtor or guarantor attempts to hide assets or does not cooperate with TAMC in NPL restructuring, TAMC may ask the Bankruptcy Court to put the debtor or the guarantor under permanent receivership without investigation. • In the event that TAMC wants to foreclose the debtors' collateral, TAMC has to inform the debtors of its intention. If the debtors fail to repay the loans within one month, TAMC is entitled to liquidate the assets. • For corporate restructuring cases, the Bankruptcy Court may consider TAMC's rehabilitation plan without the debtors' participation. • Decisions by TAMC's executive board can be used in lieu of a company's shareholders' resolution and bypass certain procedures required by the Public Company Law.
6. Gain and loss sharing from NPL resolution between TAMC and original FIs	Gain and loss are calculated from each loan's actual recovery less its transfer price and other related costs, including bonds' interest payments. • In the event that there is a gain: - If it falls within the first 20 percent of the transfer price, it will be shared equally between TAMC and the FI concerned; - Any gain in the next 20 percent of the transfer price will go to the FI provided that all payments received by the FI, including the transfer price, do not exceed the FI's original legal claim on the loan; - Any remaining gain will go to TAMC. • In the event that there is a loss: - If it falls within the first 20 percent of the transfer price, it will be the sole responsibility of the FI; - Any loss in the next 20 percent of the transfer price will be shared equally between TAMC and the FI; - Any remaining loss will be accepted by TAMC. Gains and losses will be calculated at the end of the fifth and tenth years of TAMC operations. Those calculated at the end of the fifth year will cover only cases that have been restructured or liquidated by then.

(Continued on page 72)

Key aspects	Main features
7. Objectives of and methods used in NPL resolution	It is indicated in the emergency decree that TAMC is intended to help honest debtors remain in business or resume their business with a view to supporting the economic recovery. As a result, TAMC places priority on speed, debtors' payment capability, and TAMC's costs in carrying out NPL resolution. There are two main classifications of NPL resolution embedded in the emergency decree: debt restructuring and corporate restructuring. TAMC officials or lead asset managers have to provide a preliminary recommendation on the most appropriate method for each debtor, i.e., debt restructuring, corporate restructuring, or liquidation. • Debt restructuring is intended to help debtors continue their business and service their debts within a given timeframe. Debt restructuring can be carried out in various forms, e.g., granting a "hair cut," debt-equity conversion, interest rate reduction, etc. • Corporate restructuring is intended to increase the efficiency and debt servicing capability of corporate debtors whose debts outstanding to TAMC exceed half of their total debts outstanding. With debtor consent, corporate restructuring could be carried out by means of merger, consolidation, rehabilitation by a third party, change of management, etc. The emergency decree limits the term of corporate restructuring to five years with the possibility of a three-year extension. To support corporate restructuring, the firm is protected during the term of the restructuring plan against legal trial, bankruptcy proceedings, execution of court order, etc. TAMC can engage professional asset managers. However, the emergency decree prohibits TAMC from paying any fees or reimbursing original FIs for any expenses related to asset management. TAMC also requires that original FIs provide addition working capital to the debtors, if need be, with TAMC's guarantee.
8. Debt forgiveness principles embedded in the emergency decree	To ensure speedy NPL resolution, the emergency decree explicitly incorporates the following clauses that would facilitate TAMC in granting debt forgiveness and releasing guarantors. • If a debtor provides appropriate collateral to TAMC, the guarantor is released from any remaining debt obligations. • During the term of a debt restructuring agreement, the debtor and guarantor will be released if a debtor has no other assets to service the remainder of the loans and the guarantor agrees to pay at least two thirds of the remaining debt obligations or less, as determined by TAMC. • If a debtors' corporate restructuring does not proceed according to plan and both TAMC and the debtor agree that it would be better not to pursue the plan, the debtor will be liquidated and the debtor will be released from remaining loan obligations after the liquidation. • If a corporate restructuring plan proceeds to the end of its term, the debtor and guarantor will be released from any remaining loan obligations.
9. TAMC's life	TAMC is intended to be in operation for 10 years from the date that the emergency decree came into effect. The emergency decree requires that TAMC begin its process of winding down at the end of the seventh year and complete its liquidation process within the twelfth year.

TAMC began its operations in June 2001 and purchased most of its assets between October and December 2001. Since the time it began operations, TAMC has encountered a number of difficulties and its performance has not been adequately disclosed to the public. The remainder of this section attempts to review problems embedded in TAMC's features and operations.

First, TAMC failed to achieve its utmost objective of relieving FIs from the burden of NPLs. As indicated in table 9.3, around 80.9 percent of NPLs purchased by TAMC came from state-owned institutions, especially from PAM and SAM. NPLs purchased from private FIs amounted to only 137,012 million baht of the legal claims or around 72,000 million baht in terms of private FIs' book value, i.e., the value of loans after deducting provisions. Despite the fact that the emergency decree imposes a heavy penalty on private FIs that decided not to sell NPLs to TAMC, the amount of NPLs purchased from private FIs accounted for only 15 percent of all private FIs' NPLs outstanding at the end of June 2001. To this end, TAMC not only failed to assist private FIs in eliminating their NPL burden, but also contributed to the delay in the restructuring of NPLs that had already been transferred to PAM and SAM.

Table 9.3: NPLs transferred to TAMC by the end of June 2002

	Single creditor		Multiple creditor		Total		Average transfer	Effects on FIs' book
	Amount (mil. baht)	No. of debtors	Amount (mil. baht)	No. of debtors	Amount (mil. baht)	No. of debtors	price (percentage)	values (mil. baht)
From private FIs	–	–	137,012	1,022	137,012	1,022	52.5	71,986
From state-owned FIs and AMCs	301,902	1,097	278,742	2,988	580,644	4,085	29.2	169,258
Total	301,902	1,097	415,754	4,010	717,656	5,107	33.2	237,903

Note: TAMC has not disclosed transfer prices for the last lot of assets transferred on December 28, 2001. Transfer prices broken down by private and state-owned FIs are based on those of the previous three transfers.

Source: TAMC press releases No. 3/2001 and No. 1/2002.

The limited size of the NPLs purchased from private FIs was influenced by TAMC's NPL selection criteria. Among others, the emergency decree prohibits TAMC from purchasing NPLs that already had a court ruling or those that had been restructured and the debtors had fully complied with their restructuring agreements.[145] As TAMC was set up in the fourth year of the economic crisis, the majority of NPLs on the balance sheets of private FIs had either been restructured or achieved a court ruling; therefore, they were not qualified to be transferred to TAMC.

The authorities realized after the emergency decree was enacted that TAMC would fail to eliminate the majority of FIs' NPL burden as it was initially intended to do. They contemplated the idea of expanding the criteria to allow for a second round of NPL purchase, but feared creating moral hazards in the system, especially among strategic debtors who believed that TAMC would be more lenient than private FIs. Indeed, TAMC could have been more helpful if it were allowed to purchase NPLs with court rulings and were granted special legal power to expedite the foreclosure process, which remains one of the main obstacles for speedy asset liquidation in Thailand.

[145] The court-ruling criterion applies to all types of courts. Because certain types of financial instruments—e.g., letters of credit and promissory notes—had a limited prescription period, most FIs had therefore pursued legal cases against debtors on these instruments and received court rulings on most cases before TAMC was established.

Second, the transfer price for private FIs' NPLs as indicated in the original emergency decree was impractical and contributed to the delay in asset transfer. The original emergency decree required that NPLs secured by land collateral be transferred to TAMC at the Land Department's reference prices. The fact that such a pricing principle was established in the emergency decree reflected the authorities' limited knowledge about asset valuation and on the capability of the Land Department. Subsequently, the emergency decree was amended to incorporate a new pricing principle that was based on valuation methods allowed by BOT.

The amended pricing principle neutralizes the impact of asset transfers on private FIs' capital. In effect, most NPLs were sold to TAMC at book value, i.e., the NPL's face value minus required provisions for the un-collateralized portion of the loan. Although this pricing principle was closer to the market value for collateral than the Land Department's reference prices, it was in favor of FIs that had overvalued their collateral with a view to minimizing provisions and preserving capital. In practice, it was difficult for TAMC to assess the accuracy of FIs' appraisal techniques. By the end of August 2002, TAMC still could neither confirm the prices of all the NPLs transferred in October 2001 nor issued bonds to the FIs.[146]

Third, contrary to the authorities' original intention to relieve FIs from NPL restructuring burdens, TAMC increased FIs' workload markedly, especially during the initial stage. Because TAMC was set up with limited staff and most of them were ex-BOT officials, TAMC's asset management capability was severely limited. Consequently, TAMC had to appoint the lending FI that had the largest loan outstanding to each debtor as the debtor's lead asset manager, and in effect it relied on the lead asset manager for almost all restructuring tasks. In many aspects, the burden imposed on the lead asset managers is higher than before they transferred NPLs to TAMC. The lead asset managers have to comply with TAMC's guidelines and requirements in addition to their own internal procedures, and work with other lenders within a clearly specified timeframe similar to that of CDRAC. Most FIs also need to maintain their loan account officers on these NPL cases after the loans are sold to TAMC. It should be pointed out that private FIs did not agree with TAMC on the lead asset manager's role and responsibilities until mid-March 2002, i.e., almost six months after they first transferred NPLs to TAMC.

Fourth, recoveries by TAMC could also be impaired by the fact that TAMC provides lead asset managers with few incentives not commensurate with their tasks. In the case of private FIs, the emergency decree explicitly prohibits TAMC from paying them any fees or reimbursing them for any expenses related to asset management.[147] The only incentive for the private FIs is to limit their potential loss sharing, which is capped at 30 percent of the transfer price. Lead asset managers may spend little effort on NPL cases that, in their view, have little possibility of gain sharing. These NPL cases could contribute to higher public costs than need be.

Fifth, establishing a central NPL resolution agency, such as TAMC, could incur very high sunk costs and its operations may be constrained by a number of operational and legal issues. For instance, to be able to compute gain and loss sharing accurately, TAMC needs to have an IT system that is more sophisticated than a standard banking system. Such an IT system must be capable of accounting for recoveries from all types of financial instruments and allocating recoveries and costs to original FIs according to revenue and cost-sharing rules, which also depend on the seniority of the collateral used to secure each loan. It is unlikely that such a system can be developed in a short period of time. Without such a system in place, TAMC's calculation of gain and loss sharing will likely lead to future legal disputes. Furthermore, TAMC's operations could have a number of loopholes that can be exploited by

146 It should be noted that the transfer agreement requires that TAMC and FIs settle transfer prices within six months of the transfer.

147 State-owned FIs could circumvent this clause because most of their NPLs were transferred to TAMC via PAM or SAM. Therefore, the state-owned banks were not considered by the emergency decree as the original lenders.

relevant parties, especially strategic debtors, if it has no effective back office and control system in place from the outset.

Besides the IT system, successful TAMC operations also require close and effective coordination between TAMC and other government agencies including, among others, the Civil Courts and the Bankruptcy Court on cases under court proceedings, the Land Department on collateral transfer and registration, the Institution of Certified Accountants and Auditors on relevant accounting standards, and BOT on issues related to FI supervision and prudential regulations. As in the past, coordination among different Thai agencies has not been effective; it caused a lot of confusion among original FIs, debtors, and other relevant parties during TAMC's initial period.

Given that TAMC has not disclosed detailed information related to its NPL resolution—particularly on the restructuring methods used, recoveries, and enforcement of its special power—it is difficult to evaluate TAMC's performance during the past six months. Nevertheless, TAMC's operations have generated a number of public concerns, particularly on public costs and effects on the credit culture.

The foremost concern relates to the fact that TAMC has been under political pressure to restructure a large amount of NPLs in no time. For 2002, TAMC had the target of settling NPLs amounting to 500,000 baht, or around 70 percent of its total NPLs. State-owned banks that serve as the lead asset managers for single-creditor NPLs transferred from PAM and SAM have been given a nine-month timeframe to settle all NPL cases. With this short timeframe, TAMC has a tendency to use the transfer price of each NPL as a benchmark for restructuring rather than pursuing the debtor at arm's length. Such a practice does not only benefit certain debtors unfairly at FIs' expense, but can also incur substantial public costs, particularly on NPLs transferred from PAM and SAM.[148]

By June 2002, TAMC had met the NPL completion target of 200,000 million baht set for the first half of the year. Most of the completed cases involved relatively large debtors.[149] In addition, around 60 percent of the completed amount involved potentially viable debtors, that were either allowed to enter into a restructuring agreement with TAMC or rehabilitated under the Bankruptcy Court's jurisdiction (table 9.4). TAMC decided to liquidate and foreclose the remaining 40 percent.

Table 9.4: TAMC's NPLs that were settled by the end of June 2002

Resolution method	Number of debtors	Amount (million baht)	Percentage of amount settled
Debt restructuring	241	83,001.0	41.32
Rehabilitation under the Bankruptcy Court	42	36,111.0	17.98
Foreclosure	222	79,383.0	39.52
Civil court ruling	6	2,389.0	1.19
Total	511	200,884.0	100.00

Source: TAMC press release no.8/2002.

It should be pointed out that many of these completed cases were not the work of TAMC. For most cases that were rehabilitated under the Bankruptcy Court's jurisdiction, their rehabilitation plans were prepared and submitted to the court before the debtors were

148 PAM and SAM purchased NPLs from state-owned FIs at relatively high prices before selling them to TAMC at relatively low prices. To minimize public costs, it is important that TAMC take into account overall public costs as opposed to its own purchase price when restructuring these NPLs.

149 While the amount of completed cases accounted for around 28 percent of NPL values transferred to TAMC, they accounted for only 11 percent of debtors transferred to TAMC.

transferred to TAMC. For many cases that were restructured, the debtors and original FIs had also reached preliminary restructuring agreements before the debtors were transferred to TAMC. To this end, TAMC has not disclosed in detail its real performance and effectiveness in NPL resolution.

TAMC has also been opaque with regard to its recoveries. For NPLs that had been restructured or rehabilitated during the first half of 2002, TAMC indicated that it expected to recover around 47.3 percent of the total legal claims on the debtors.[150] Although this recovery rate is higher than TAMC's average purchase price of 33.2 percent, the two numbers are not comparable as the average purchase price was computed on the basis of all TAMC's NPLs, including those that would need to be liquidated.

The second concern is caused by the fact that the government wants TAMC to restructure as many debtors as possible rather than liquidate them and foreclose their assets. By restructuring debtors, it is hoped that TAMC will fuel economic recovery. Furthermore, TAMC does not have to prepare itself for large asset liquidation in the future. This policy has created a public concern that unviable debtors would be bailed out at public expense. Given that TAMC was set up in the fourth year of the crisis, most viable debtors would have been restructured before TAMC's establishment and many remaining NPL debtors would have limited business potential. Bailing them out not only requires a large "hair cut," but could also unfairly affect their competitors. To this end, the problems of excess capacity and inefficiency in certain sectors will remain.

Lastly, the authorities want to transfer small NPLs from state-owned banks and AMCs to TAMC during the second half of 2002. The NPLs concerned will cover around 60,000 debtors and amount to around 100,000 million baht in value.[151] The authorities believe that such a transfer will complement its efforts to promote SMEs, especially in revitalizing non-performing SME debtors. Moreover, it could help to further lower NPLs in state-owned banks, thereby facilitating the authorities' privatization efforts. As TAMC has not been equipped with the capability of dealing with small debtors, such transfer will increase TAMC's workload substantially and raise doubts about TAMC's overall effectiveness in NPL restructuring. In addition, it would disrupt ongoing NPL restructuring in state-owned banks and AMCs.

END REMARKS

State-led efforts in NPL resolution did not occur in Thailand until the later stage of the crisis, when it became evident that NPLs outstanding remained high and the pace of restructuring had slowed. However, state-led efforts, both through individual AMCs for state-owned banks and TAMC, have not shown clear signs of effectiveness and efficiency, partly because they were set up too late and were disrupted by policy uncertainties. Furthermore, their operations have been constrained by the lack of capable staff and proper incentive structure. Their implementation was also complicated by their initial designs that were intended to meet objectives other than effective NPL resolution. The lengthy period used in establishing these institutions and appointing professional asset managers also led to further asset deterioration, which would eventually contribute to higher public costs. Lastly, the operations of state-owned AMCs and TAMC could have a lasting impact on the long-term credit culture and the country's competitiveness if they give too much preferential treatment to debtors or bail out inefficient debtors who should otherwise be liquidated.

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[150] TAMC press release No. 8/2002.

[151] TAMC press release No. 8/2002.

Chapter 10
Main Lessons Learned and Remaining Challenges for the Thai Financial System

It has been more than five years since the Thai financial crisis erupted in 1997. Throughout this period, the authorities have implemented drastic financial restructuring measures to restore financial stability and address a number of the financial system's weaknesses. During the early stage of the crisis (1997-1998), the restructuring measures were intended to contain the crisis' contagious effects, bring FIDF's liquidity support under control, and eliminate distortions in the financial system. Key measures were, therefore, focused on separating solvent from insolvent FIs and ensuring that the remaining FIs have adequate capital. During the second stage of the crisis (1999-2002), the authorities had concentrated their efforts on addressing the remaining legacies, especially NPL resolution, restructuring and privatization of state-owned banks, tightening the relevant legal framework, and consolidating small FIs.

The authorities have implemented a wide range of restructuring measures based on both market-driven and state-led mandatory approaches. On capital adequacy, key measures ranged from suspension and closure of insolvent FIs, intervention in FIs, liberalization of foreign ownership, and providing a public capital support scheme, to allowing FIs to recapitalize by hybrid capital instruments. To address the problems of NPLs and distressed assets, key measures included forced liquidation of closed finance companies' assets by FRA, establishing CDRAC's advisory and coordination framework to support decentralized market-driven NPL restructuring, encouraging FIs to set up their own asset management companies, and establishing TAMC as a central NPL resolution agency with special legal power and mandatory elements. Furthermore, the authorities have implemented a number of supportive measures including, among others, a blanket guarantee scheme for depositors and creditors, comprehensive legal reform, and keeping interest rates low to reduce NPL carrying costs and enhance FIs' profitability.

MAIN LESSONS LEARNED

The authorities managed to restore financial stability and deal with a number of structural weaknesses early in the crisis. However, Thailand's financial sector restructuring is estimated to have incurred public costs of around 30-40 percent of GDP, raising concerns over the country's long-term public debt sustainability. Apart from the severe magnitude of the crisis, the high public costs could be attributed to problems associated with the design and implementation effectiveness of certain financial-sector restructuring measures. To this end, Thailand's experience can provide valuable lessons for other crisis-affected countries. While issue-specific lessons are provided in each chapter, the general lessons learned can be summarized as follows.

First, it is crucial that a comprehensive financial-sector restructuring framework, covering measures to deal with both capital adequacy and resolution of distressed assets, be established at the outset of the crisis. During the early stage of the Thai financial crisis, the authorities spent most of their efforts on separating solvent from insolvent FIs and ensuring that the remaining FIs had adequate capital. Relatively limited attention was paid to preventing further asset deterioration and NPL restructuring. This unbalanced focus was largely dictated by the unfolding events of the crisis and the authorities' limited resources and capabilities in handling multiple tasks at the same time. In addition, it could be attributed to the lack of a crisis management plan prior to the crisis and the authorities' limited political strength to support simultaneously various drastic measures when the crisis emerged.

In addressing FIs' capital adequacy problems, the authorities had also emphasized dealing with the FIs' liabilities more than their assets. As one would expect from any democratic government, during the early stage of the crisis the Thai authorities concentrated on protecting FIs' depositors and creditors while little effort was spent on preventing further deterioration of FIs' assets. It became evident afterward that the ability to recover public investments in FIs in which the authorities intervened and to minimize public costs depends largely on the quality of FIs' assets. Therefore, it is crucial that the authorities implement the necessary measures to prevent asset deterioration from the outset in order to contain public costs. These measures may include (1) establishing a bridge bank to look after performing debtors of insolvent FIs, (2) separating the FIs in which the authorities intervened into a good bank and a bad bank before merging only the former with other FIs and engaging professional asset managers to manage the latter, and (3) ensuring continuity of policy and strategy on the resolution of distressed assets in FIs in which the authorities intervened and state-owned banks.

Second, denial and underestimation of FIs' solvency problems could lead to further deterioration of the financial systems' soundness and declining policy credibility. This lesson was evident during the initial stage of the Thai financial crisis when the authorities repeatedly assured the public of FIs' soundness before they subsequently suspended and intervened in many of them. These practices contributed to a sharp decline in the authorities' credibility and magnified public reactions to rumors, resulting in prolonged financial distortions and many illiquid FIs becoming insolvent. Denial and underestimation of FIs' problems also contributed to the delay in taking necessary preventive and remedy measures. At times, the authorities' low credibility also required that they implement stronger-than-necessary measures to restore policy credibility and public confidence at the expense of economic recovery and public costs. These measures included, for instance, the suspension of 42 finance companies in August 1998 and the early introduction of the blanket guarantee scheme for depositors and creditors.

Third, financial sector restructuring is a lengthy process that requires continued efforts from many government agencies within a well-defined framework. During the past five years, Thailand has had three governments, each of which had implemented its preferred financial-sector restructuring approach, resulting in disruptions and discontinuities in the work of the various agencies involved. The most evident of all was the policy shift from the decentralized and market-driven NPL resolution to establishing TAMC in 2002. Given uncertainties related to the timing and procedures of TAMC's establishment and operations, NPL resolution, particularly in state-owned AMCs, was severely disrupted, resulting in further asset deterioration. Other notable examples of policy shift included altering state-owned FIs' focus from gearing toward privatization to supporting government economic policies, and changing the emphasis of the NPL restructuring framework to help as many debtors as possible to resume their businesses rather than relying on strict market evaluation of their true business viability.

Given that certain restructuring measures were designed with a view to lowering up front public costs and deferring realization of losses into the future, policy shifts and changes in restructuring approaches could lead to failure in effective implementation of the steps necessary to safeguard and control the authorities' contingent liabilities. Consequently, policy shifts may result in higher overall public costs than originally planned.

Fourth, transparency is necessary for all financial-sector restructuring measures, especially those affecting depositors and private investors. Transparency not only ensures fairness and enhances policy credibility, but also minimizes public reactions to rumors that often occur during a financial crisis. In this context, the authorities need to publish all relevant conditions and criteria for identifying FIs in which intervention is necessary or FIs qualified for public assistance. As screening for long-term viable FIs during a financial crisis is indeed a difficult task, the authorities may wish to rely on transparent market mechanisms similar to those incorporated in the Thai public capital support scheme.

Fifth, financial-sector restructuring, especially NPL resolution, requires extensive coordination among related parties. The authorities need to put in place appropriate reward and penalty mechanisms to ensure effective cooperation while minimizing moral hazards. For certain measures, its incentive structure may require appropriate balancing between market forces and mandatory elements. Furthermore, they must not create economic distortions by yielding excessive benefits to certain parties, especially strategic non-performing debtors. To this end, the authorities should encourage NPL restructuring based on an arm's length commercial basis; debtors should not be allowed to bid for their own NPLs at discount; and the legal framework needs to be comprehensively effective with minimal loopholes.

Designing "carrots and sticks" also needs to take into account appropriate time horizons. During the early stage of the Thai financial crisis, FIs had a limited capital cushion and tried to obtain benefits associated with NPL restructuring while preserving their capital. For instance, they restructured NPLs of unviable debtors by rescheduling their payment obligations to minimize up front loan loss provisions and defer realization of actual losses to some time in the future. Such a practice has resulted in a high relapse rate of restructured loans and discouraged FIs and debtors from true restructuring.

Sixth, to minimize public costs from financial-sector restructuring, the authorities may need to make the depositors and creditors of insolvent FIs assume a fair share of the restructuring costs. However, there may be only one opportunity early on in the crisis to implement a measure that adversely affects depositors and creditors. Such a measure has to be implemented in a comprehensive manner before introducing a blanket guarantee for depositors and creditors. In the case of Thailand, only depositors and creditors of the suspended finance companies had shared the restructuring burden through the forced conversion of finance companies' liabilities into long-term promissory notes. Because the authorities failed to take necessary action against insolvent banks before the blanket guarantee was introduced, depositors and creditors of the banks in which the authorities intervened were bailed out at taxpayers' expense. Public costs could have been lower if the authorities had undertaken the necessary action against insolvent banks before introducing the blanket guarantee scheme.

Seventh, when taking over troubled FIs, the authorities need to design appropriate exit strategies from the outset and strictly restructure the FIs, together with their distressed assets, according to the exit plans. The government's ownership and involvement in these FIs should be temporary in order to minimize potential political interference in their operations. Furthermore, government officials have limited experience in guiding FI restructuring, and the FIs in which the authorities intervened may incur persistent losses and require continuing capital support from the authorities. To this end, one may argue that selling the FIs in which the authorities intervened early on at a low price may be preferable to keeping them in the hands of the authorities for a long period. If such FIs are not restructured effectively by capable staff, they will end up lagging behind private competitors and their chances of recovering public investments will be sharply reduced.

Lastly, it may be beneficial to import banking expertise and management during a financial crisis, especially to manage state-owned FIs and distressed assets. The Thai authorities had a limited number of capable staff as compared to the enormity of their tasks during the crisis. Most government officials also had limited commercial banking expertise, and were often reluctant to make commercial decisions, especially on NPL restructuring, and this resulted in the slow pace of NPL resolution in state-owned banks. It was also difficult to find local banking experts from the private sector to replace the managers of the FIs in which the authorities intervened during the crisis. Given that it is crucial to restructure NPLs and such FIs effectively to minimize public costs, it may be worth bringing in foreign professionals for the task.

It should be pointed out that financial-sector restructuring in Thailand is still going on, and additional important lessons have to be drawn over a longer period of time. Among others, one will have to evaluate whether or not (1) state-led NPL resolution through TAMC is more effective than decentralized market-driven NPL resolution; (2) actual realization of various contingent liabilities turn out within the authorities' original plan; and (3) the authorities' exit strategies from state-owned FIs can be materialized.

Obviously, the outcomes of the financial-sector restructuring measures will depend on each country's operating constraints, the severity of each crisis, and a number of uncontrollable factors, notably global macroeconomic conditions. Therefore, some lessons learned from the Thai financial crisis may be country-specific and need to be carefully evaluated within the context of each country before being applied.

REMAINING CHALLENGES FOR THE THAI FINANCIAL SYSTEM

Six years have passed since the financial crisis emerged. The Thai financial system has returned to stability and consolidated on a large scale. Most FIs are adequately capitalized, and almost all of them have returned to profitability. Nevertheless, there are still legacies from the crisis and certain financial restructuring measures that need to be effectively addressed over time.

For private FIs, they will have to continue their efforts in selling foreclosed properties and restructuring their distressed assets and relapsed NPLs, which may imply realization of additional losses and perhaps another round of recapitalization for certain FIs. Furthermore, they have to be prepared for intensified competition, particularly from foreign entries, as well as for new prudential regulatory frameworks, all of which will result in high investment costs. To this end, small private FIs, especially the remaining finance companies, would be handicapped from their limited scale of operations. Unless they can clearly establish their own niche markets, their long-term viability will be in doubt, possibly leading to another round of consolidation.

For state-owned banks, although most of their NPLs were carved out and transferred to other state-owned agencies, they need to be restructured and strengthened substantially for effective privatization to maximize recoveries of public investments. Among others, the authorities need to: (1) limit reliance on state-owned banks as their policy arms; (2) aggressively rationalize their workforce and excessive networks; (3) put in place an appropriate corporate governance framework and effective professional management; (4) clearly define business strategies with a view to facilitating the authorities' realistic exit plans; and (5) facilitate restructuring of state-owned banks' balance sheets in preparation for the retirement of a large amount of captive bonds issued in exchange for NPLs. Without these efforts, there will be limited opportunities to recover public investments in these state-owned banks. On the contrary, they will likely incur additional losses and the authorities may be required to recapitalize them further.

The authorities also need to ensure effective functioning of various specialized agencies that were established during the crisis. Top on the list are various NPL resolution agencies, including TAMC, SAM, PAM, and AMCorp. These agencies need to be supervised closely in order to maximize asset recoveries, minimize moral hazards, and minimize potential economic distortions between performing and non-performing debtors. Political interference in these agencies should also be strictly prohibited.

Furthermore, the authorities need to continue their efforts in strengthening the legal framework to reduce court backlogs and enhance the incentive systems that have been put in place. They also need to phase out the blanket guarantee for depositors and creditors in an orderly manner. Last but not least, the authorities need to develop a detailed plan to deal with the realization and fiscalization of the financial-sector restructuring costs, with a view to minimizing potential disruptions to the bond market and the interest rate structure. In the next few years, the government will have to settle on loss-sharing agreements with privatized banks and refinance a massive amount of captive bonds issued in exchange for NPLs, especially those transferred from state-owned banks. These refinancing plans need to be designed well in advance, taking into account the government's budget deficit financing requirements.

TOPICS FOR FURTHER RESEARCH

Finally, it should be emphasized that this study has focused on the micro aspects of each financial-sector restructuring measure and that it has not addressed a number of other relevant and crucial issues. In particular, the study has not evaluated the impact of each financial-sector restructuring measure on the economic recovery and macroeconomic conditions. It also leaves out issues related to the fiscalization of financial-sector restructuring costs and the reform of prudential regulations and supervisory framework that the Thai authorities have implemented over the past five years. These issues are definitely useful topics for further research and analysis.

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Veerathai Santiprabhob holds Ph.D. and A.M. degrees in Economics from Harvard University and a B.A. (first class honors) in Economics from Thammasat University.

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During the period 1998-2000, Veerathai took leave from the IMF to serve as a Co-director of the Policy Research Institute, Fiscal Policy Office, Thai Ministry of Finance. The Research Institute was created after the 1997 financial crisis to provide top executives of the Ministry with policy analyses and recommendations on issues relating to macroeconomic framework, financial-sector restructuring, and public finance.

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Lessons Learned from Thailand's Experience with Financial-Sector Restructuring

Veerathai Santiprabhob

Since the financial crisis erupted in Thailand in 1997, the Thai authorities have implemented a number of drastic financial-sector restructuring measures to restore financial stability and address prevailing structural weaknesses. The restructuring measures have been based on both market-driven and state-led mandatory approaches and could be categorized into two main groups: (1) those intended to address financial institutions' insolvency and capital adequacy, and (2) those intended to address non-performing loans and distressed assets. Owing mainly to the severe magnitude of the crisis, total public costs of Thailand's financial-sector restructuring are estimated to be in the range of 30-40 percent of GDP, raising serious concerns over the country's long-term public debt sustainability.

While the Thai financial-sector restructuring process is not yet complete, this study highlights relevant policy issues and tradeoffs as well as documents the rationale and the main features of key restructuring measures that have been implemented by three governments during the past five to six years. It also reviews their effectiveness, incentive structure, operating constraints, associated public costs, and subsequent impact on the Thai financial system going forward. It is hoped that the menu of policy and operational issues discussed in this study will assist the authorities of other crisis-affected countries in designing their financial-sector restructuring measures in the most cost-effective manner.

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